

The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps

Cross-country evidence from industry-level data

Karel Havik, Kieran Mc Morrow, Fabrice Orlandi, Christophe Planas,
Rafal Raciborski, Werner Röger, Alessandro Rossi, Anna Thum-Thysen,
Valerie Vandermeulen

This paper provides a detailed description of the current version of the Ecofin Council approved production function (PF) methodology which is used for assessing both the productive capacity (i.e. potential output) and cyclical position (i.e. output gaps) of EU economies. Compared with the previous 2010 paper on the same topic, there have been two significant changes to the PF methodology, namely an overhaul of the NAWRU methodology and the introduction of a new T+10 methodology. The new NAWRU approach extends the existing static / adaptive expectations framework to also cover rational expectations. In interpreting changes in the NAWRU, it is important to bear in mind that both structural and non-structural factors are driving developments. Analysis shows that, in the presence of rigidities, crisis-related events can have temporary, but nevertheless long-lasting, effects on labour market performance. The second important change since the 2010 paper has been the work to date on the T+10 methodology. Whilst further work will be carried out to fine tune the methodology over the coming months / years, nevertheless sufficient progress has been made for the new T+10 methodology to be endorsed by the Economic Policy Committee, in May 2014, for use in the 2015 Ageing Report.