

Potential Growth and Its Role in Policymaking

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**BIDS CRITICAL
CONVERSATIONS**

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Roadmap

- Potential output or potential growth for a developing economy
- Motivation and background
- Its role in fiscal and monetary policy
- Estimation Issues

Speed Limit and Potential Growth (PG)



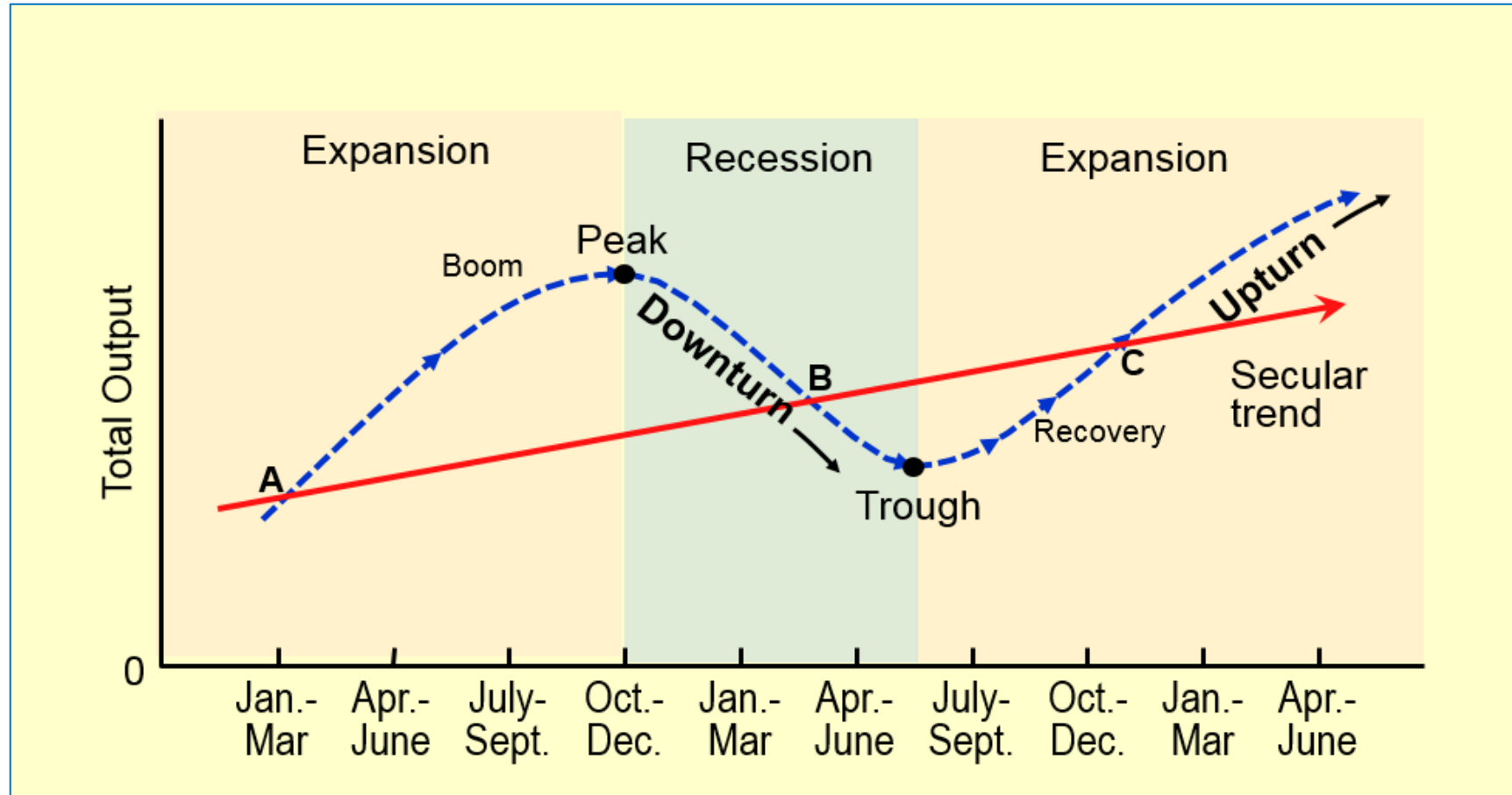
What is Potential Growth (PG)

- Potential growth provides us with that very rate which is achievable by using the factors of production and that rate must be sustainable for the economy in the long run.
- That PG will ensure natural level of unemployment (such as 5-6%).
- That PG will not create any inflationary or deflationary pressures on the economy.

Methods

- There are principally two major categories related to the calculation.
 1. Statistical methods are mostly univariate and they calculate PG mechanically based on given data. Examples include HP filter, Kalman filter, Baxter-King filter, Beveridge-Nelson decomposition
 2. In contrast, theory-based methods have economic theory in the background. This is a supply side calculation of PG based on a country's capital stock, labor supply, and technology. The Cobb-Douglas Production Function (CDPF) is engaged to calculate PG.

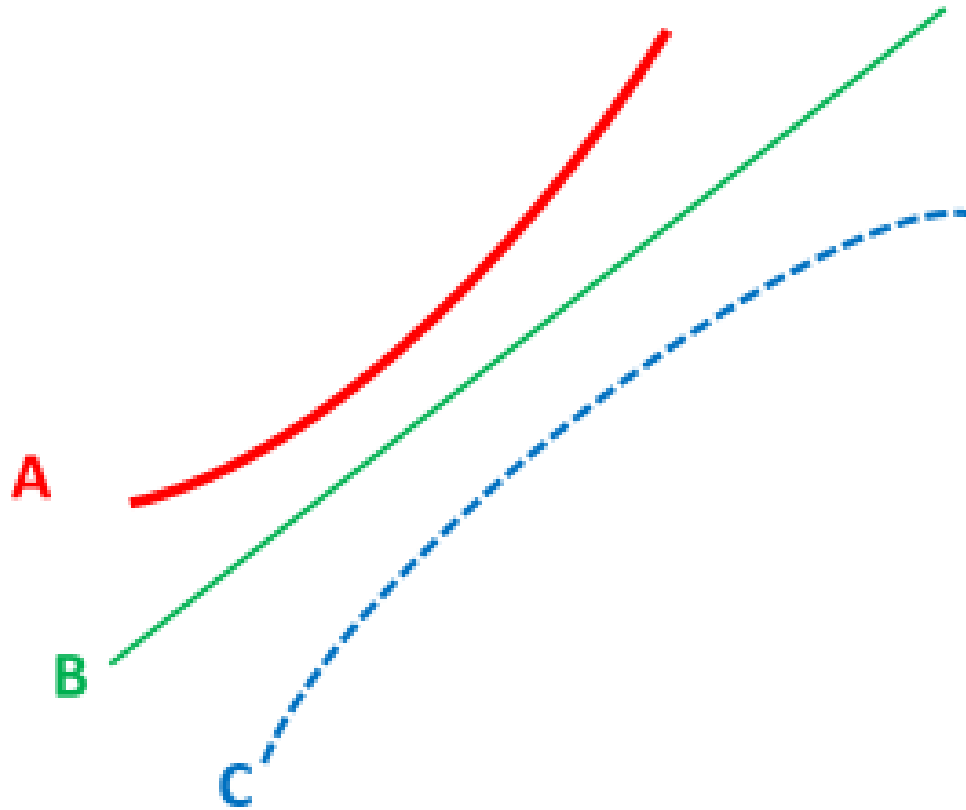
Why is Potential Growth Needed?



Potential Growth: Why Needed?

- The same reason the driver needs to know the speed limit decided by the engineers.
- There are mainly three areas where it is needed: 1) Long-term Planning 2) Fiscal Budgeting 3) Monetary Policy Formulation
- Five-year planning needs to know potential growth before designing strategies.
- The growth target in the budget should be grounded on potential output.
- The Central Bank needs to know whether the economy is overheated or below its potential growth before tightening and loosening.

3 Situations of Potential Output and Policy



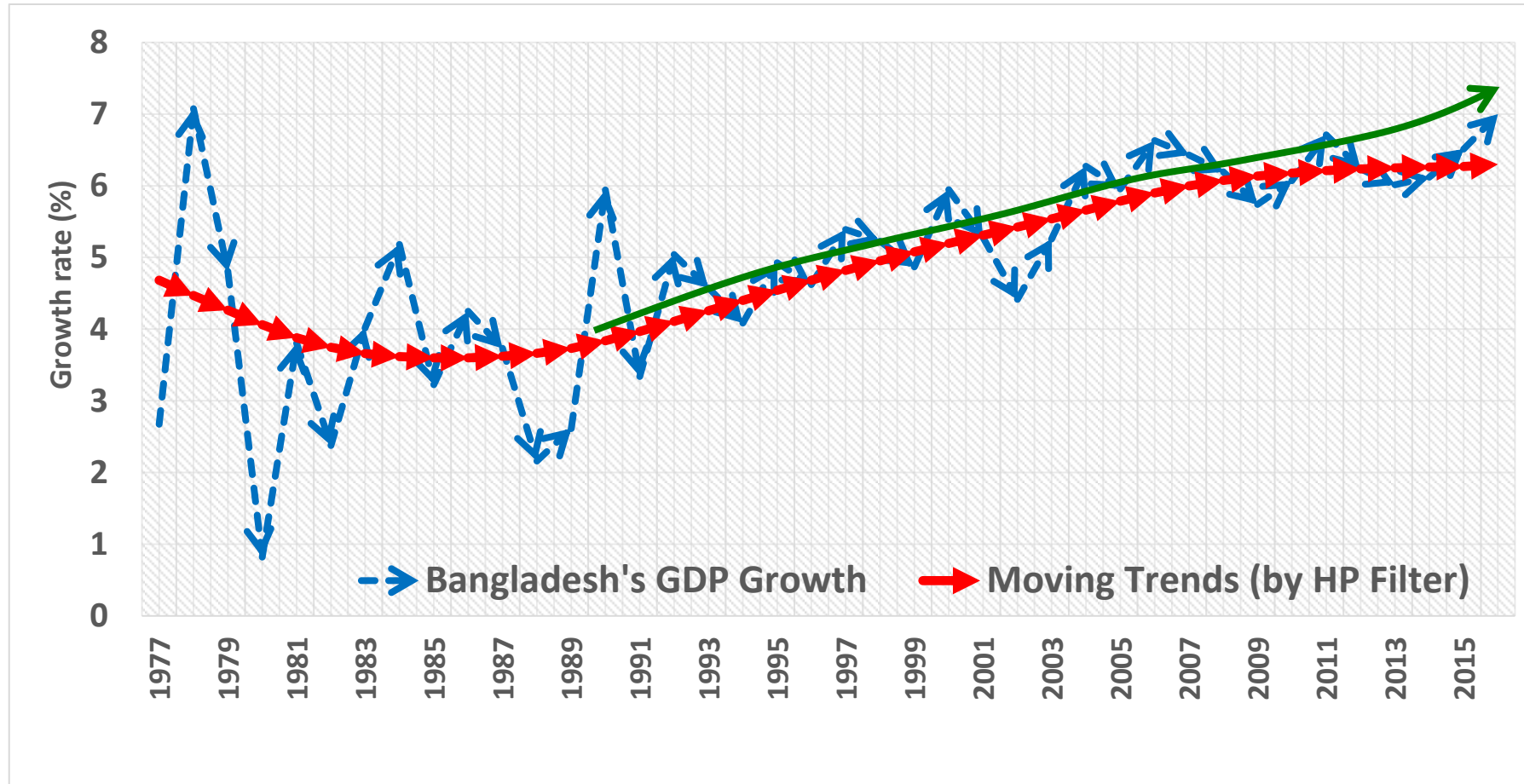
Global Practices

- All developed countries have different agencies to calculate potential growth.
- The Fed Reserve, Congressional Budget Office, and NBER calculate potential growth in the US.
- The European Commission conducts regular studies on potential growth and output gaps in particular.
- The practice is not that prevalent in developing economies, but their central banks usually try to estimate the figure.

Regional Practices and Our Stance

- Countries like China and India calculate potential growth (PG) before policymaking.
- Research is on the rise to calculate PG for the other South Asian countries including Bangladesh.
- One ADB study (2013) on Bangladesh's potential output depicts the necessity for this variable. As a pioneering attempt, the work is appreciable. However, the paper has a number of shortcomings.
- PG rates are almost similar to the actual figures. It does not have any prediction or future horizon in the exercise.

Actual and Potential Growth for Bangladesh



Issues and Challenges

- Data paucity is a compelling reason.
- Data on labor supply in an economy with a high informal sector are difficult to derive.
- Unemployment rates in developing nations are not comparable to their developed counterparts. As a result, the NAIRU becomes unreliable.
- Making TFP an exogenous variable is a challenge.
- Determining capital stock and depreciation is an issue.

Your Suggestions for this Trigger Discussion

- Direction
- Data
- Usefulness