ASK AN ECONOMIST

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Q: What is potential output, and how is it measured?

A. When discussing the performance of the U.S. economy, people sometimes cite the output gap, which is the difference between actual and potential output. But what is potential output? A common misperception is that it is the maximum output the economy could produce if everyone were employed and all capital were used. Economists define potential output as what can be produced if the economy were operating at maximum sustainable employment, where unemployment is at its natural rate.[1] Therefore, actual output can be either above or below potential output.

Unlike actual GDP, we cannot observe potential GDP and must estimate it. As a result, different economists can have different views of potential output. One way to construct potential GDP is by fitting a trend line through actual GDP. Looking at a short sample period, however, may lead to an inaccurate estimate of potential. For instance, starting in 2000 would lead to a trend line that is defined by the expansion period and is relatively steep. If, on the other hand, output rose above potential during the expansion period, then the trend line would be slightly flatter. The latter case implies that output would have been above potential during the boom period and perhaps not quite so far below potential during the recession.

Many people believe that the previous decade had a housing bubble, with construction much higher than in normal times. If that is correct, the notion that the economy was producing output above potential prior to the recession does not seem that far-fetched. In that case, actual output today may not be as far below potential as a lot of people think.

ENDNOTE

[1] See Okun, Arthur M. "Potential GNP: Its Measurement and Significance," Cowles Foundation Paper 190, reprinted from the 1962 Proceedings of the Business and Economic Statistics Section of the American Statistical Association. See http://cowles.econ.yale.edu/P/cp/p01b/p0190.pdf.

LETTER TO THE EDITOR

We received comments from several readers regarding a statement appearing in "Banks and Credit Unions: Competition Not Going Away" (April 2013 issue of The Regional Economist*). The article states that credit unions and Subchapter S corporations are "similarly exempt" from federal income taxes. We asked Julie L. Stackhouse, senior vice president of the St. Louis Fed's Banking Supervision and Regulation division, to clarify the tax treatment of Subchapter S corporations. Her comments are below:*

A Subchapter S corporation is a corporation that has between one and 100 shareholders and that passes through net income or losses to shareholders in accordance with Internal Revenue Code, Chapter 1, Subchapter S. Subchapter S election is subject to criteria beyond restrictions on number of shareholders, including limitations on the class of permissible stock (only one class is allowed) and on who may be an eligible shareholder. There is no guarantee of dividends from the Subchapter S corporation to its shareholders for purposes of paying tax liability.

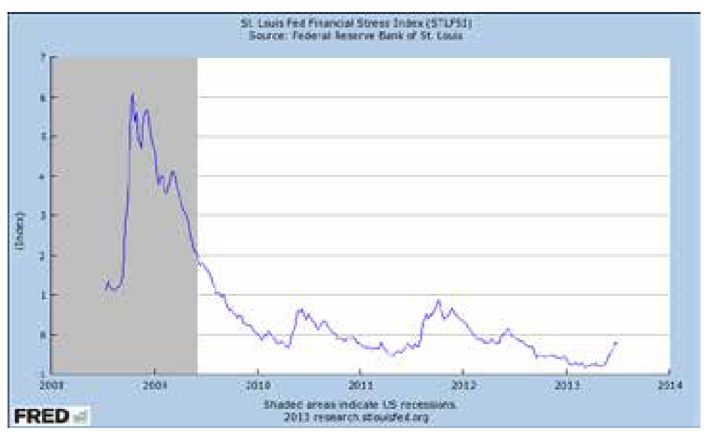
Because of these limitations, most commercial banks are organized as typical C corporations. Earnings of a C corporation are first taxed at the corporate level and then again at the shareholder level when dividends are paid on those earnings.

Credit unions, in contrast, do not pay taxes at the corporate level, nor do they have an outstanding tax liability that is passed through to their members.

In summary, Subchapter S corporations avoid the double taxation experienced by C corporations and their shareholders. However, these advantages do not amount to an exemption from federal taxation.

THE ST. LOUIS FED FINANCIAL STRESS INDEX

The St. Louis Fed Financial Stress Index (STLFSI) measures the degree of financial stress in U.S. markets; values below zero suggest below-average financial market stress, and values above indicate the opposite. To see the latest weekly reading, as well as to find out how the index is constructed, see www.stlouisfed.org/newsroom/financial-stress-index/.



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