

Potential and Natural Output with Alejandro Justiniano

Abstract

We estimate a DSGE model with imperfectly competitive products and labor markets, and sticky prices and wages. We use the model to back out two counterfactual objects: potential output, i.e. the level of output that would prevail under perfect competition, and natural output, i.e. the level of output that would prevail with flexible prices and wages. We find that potential output is smooth, resulting in an output gap that closely resembles traditional measures of detrended output. Meanwhile natural output is extremely volatile, due to the very high variability of markup shocks. These disturbances, however, are very similar to measurement errors because they only explain price and wage inflation at very high frequencies. Under this alternative interpretation, potential and natural output move one-to-one.