

Multivariate Filter Estimation of Potential Output for the United States: An Extension with Labor Market Hysteresis

2019-08-26

Central Bank of Armenia
Working Paper 19/1/12

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August 2019

Abstract

This paper extends the multivariate filter approach of estimating potential output developed by Alich and others (2018) to incorporate labor market hysteresis. This extension captures the idea that long and deep recessions (expansions) cause persistent damage (improvement) to the labor market, thereby reducing (increasing) potential output. Applying the model to U.S. data results in significantly smaller estimates of output gaps, and higher estimates of the NAIRU, after the global financial crisis, compared to estimates without hysteresis. The smaller output gaps partly explain the absence of persistent deflation despite the slow recovery during 2010-2017.

Going forward, if strong growth performance continues well beyond 2018, hysteresis is expected to result in a structural improvement in growth and employment.

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