2.5.2 Output gaps

a) Distinction between actual growth rates and long-term trends in growth rates
b) Understanding of positive and negative output gaps and the difficulties of measurement
c) Use of an AD/AS diagram to illustrate an output gap (level of spare capacity) in an economy

- Output gap: the different between actual output (Y) and potential output (Yfe)
- Positive output gap: growth above the trend rate which is inflationary
- Negative output gap: economic downturn with unemployment of resources
- Output gaps are a sign that the country is not using it resources efficiently, or at their maximum potential.
- Actual growth: the percentage increase in a country's GDP measured annually; it is caused by increases in AD
- The long-term trend in growth rates: the long run expansion of the productive potential of an economy; it is caused by increases in AS
- Reasons output gaps are formed:
  - Resources available are not suited to the needs of the economy
  - The welfare system pays generously for some people not to work
  - The effects of relocation of production to other countries
  - Increased competitiveness of other countries
  - Structural changes, meaning the economy no longer produces output that is tailored to the needs of the market
- A negative output gap exists when actual growth rates are below potential growth rates and means there is a downward pressure on inflation.
- A positive output gap is when growth rates are higher than an economy can sustain i.e. resources are being overused and usually means an upward pressure on inflation. This can be shown on a classical AS curve, as a temporary situation where the economy can produce more, but this cannot be sustained in the long run. In the long-run, the AS is vertical and the positive output gap disappears
- It is difficult to measure output gaps as we cannot tell what the level of potential output is. All we know is actual output (GDP). The potential levels depend on spare capacity, and without actually trying to use the spare capacity, we do not know how much the economy can produce. Data is not always reliable, especially from emerging markets
- A output graph can be shown on a PPF:
  - A negative output gap is a point inside the PPF where some resources are not being used fully
  - A positive output gap is a point outside the PPF as the economy is producing at a level beyond its potential e.g. workers may be working excessively long hours