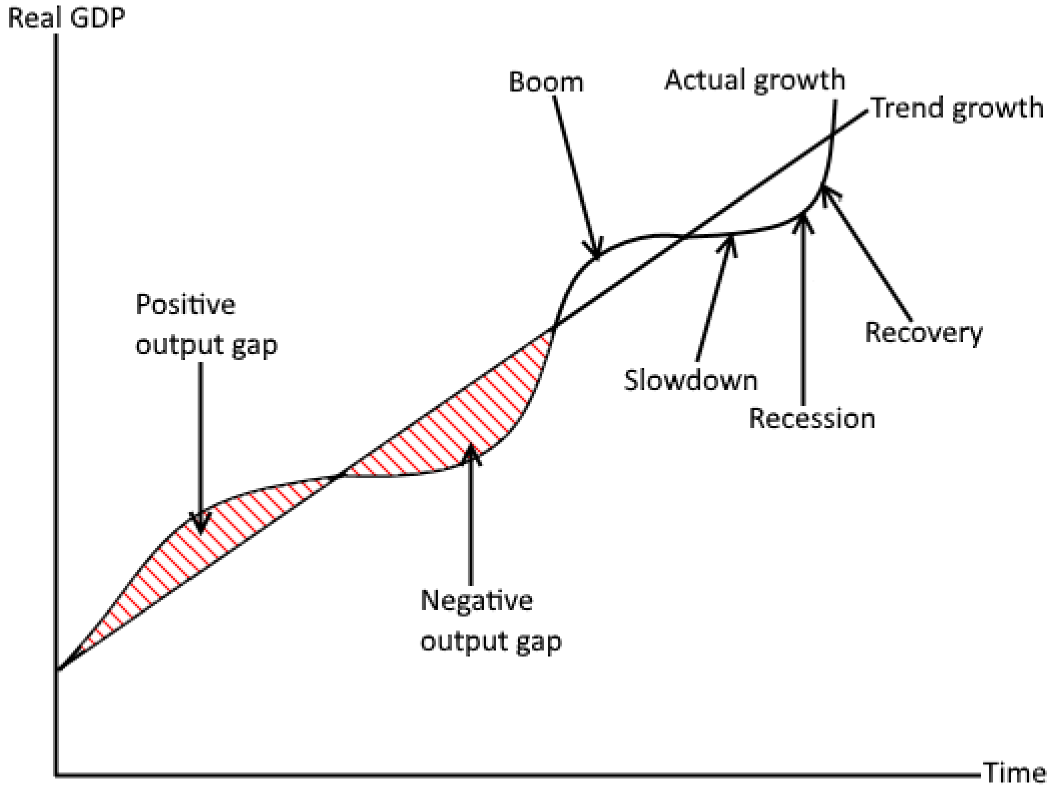
2.5.2 Output Gaps

Actual Growth Rates and Long-Term Trend Growth Rates

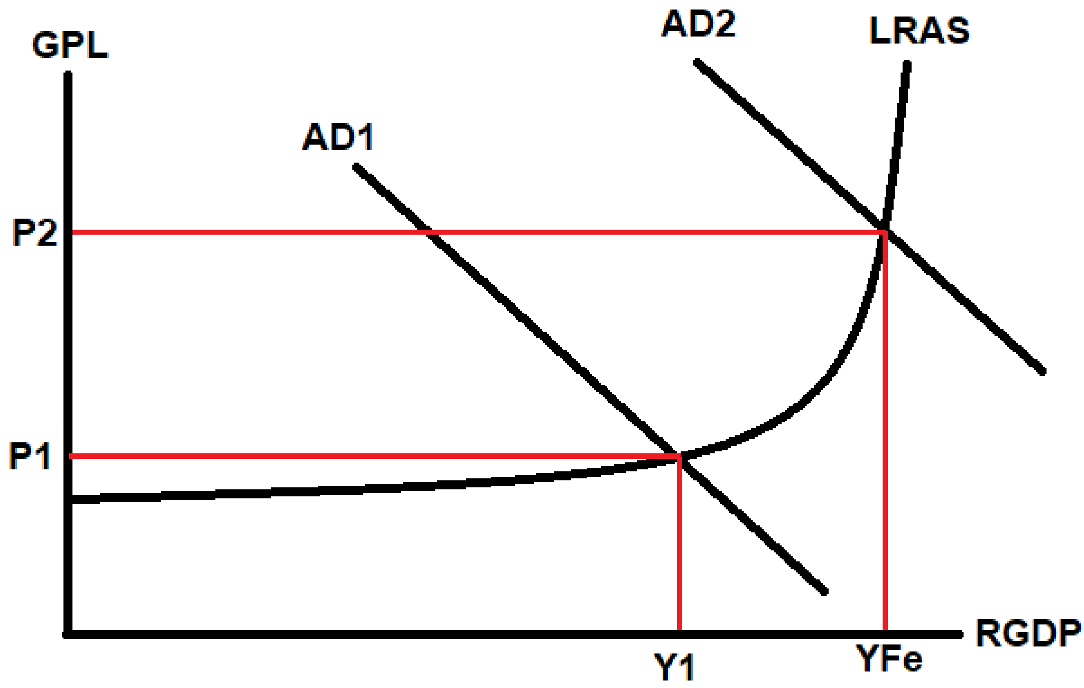
- Actual growth rate is the rate at which RGDP changes year by year
- Trend growth is calculated as the average rate of economic growth over multiple years. It is determined by increases in productive capacity and is

consistent with a stable rate of inflation



Negative Output Gaps (Deflationary, Recessionary)

- A negative output gap occurs when actual growth is smaller than potential growth

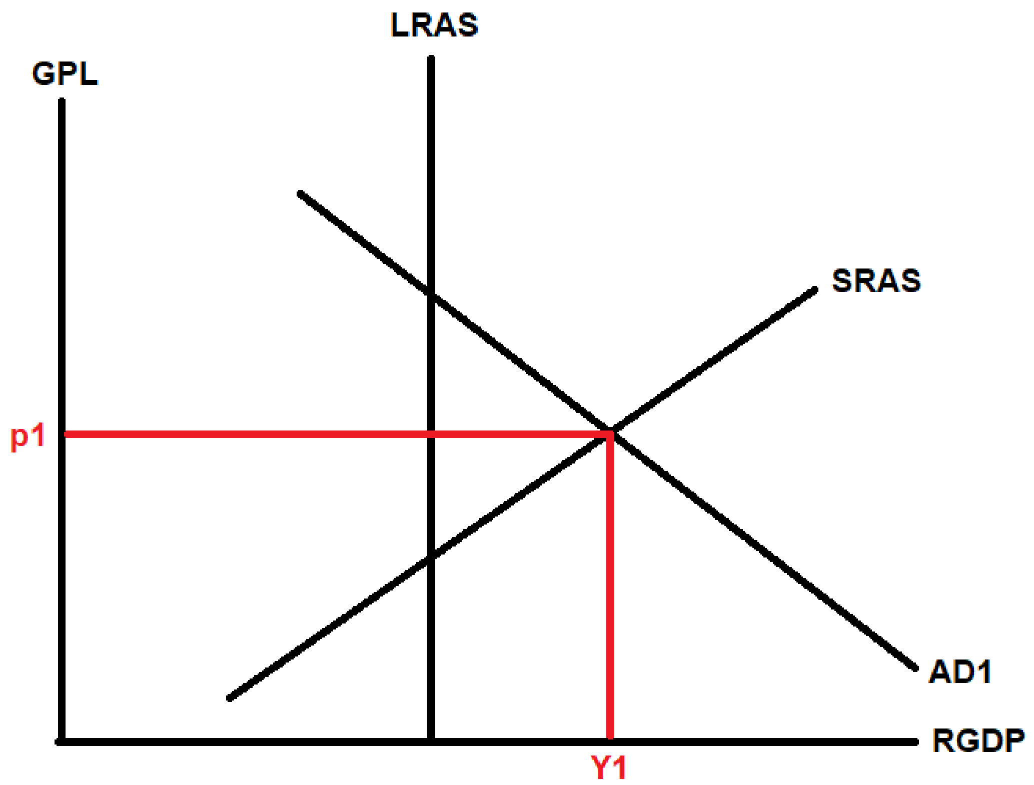


- On the graph above, at AD1 there is a negative output gap between Y1 and YFe. Keyensian theory states that this is possible to persist in the long run and hence government intervention is required to stimulate AD1 in order to close the output gap by shifting AD1 to AD2

Positive Output Gaps (Inflationary)

- A positive output gap occurs when actual growth is larger than potential growth, when growth rates are higher than the economy can sustain
- It occurs when actual growth is greater than long-term trend growth
- When a positive output gap is occurring, there is high demand and firms operate far beyond their most efficient capacity
- In the short run, output can exceed Yfe since Yfe is a long run concept of full employment at a SUSTAINABLE level
- There is usually upwards pressure on inflation due to large demand and the government may monetary and fiscal

policy to reduce demand



Problems Associated with Measuring Output Gaps

- The problems with measuring output gaps arise due to the difficulties of measuring potential output. Only actual output can be known at a given point in time
- Potential output depends on spare capacity which is hard to estimate due to the following reasons:

- Available resources may not be suited to the economy
- Production may be relocated
- Structural changes/shocks can result in permaent losses to productive capacity