Edexcel (A) Economics A-level

Theme 2: The UK Economy, Performance and Policies

2.5 Economic Growth

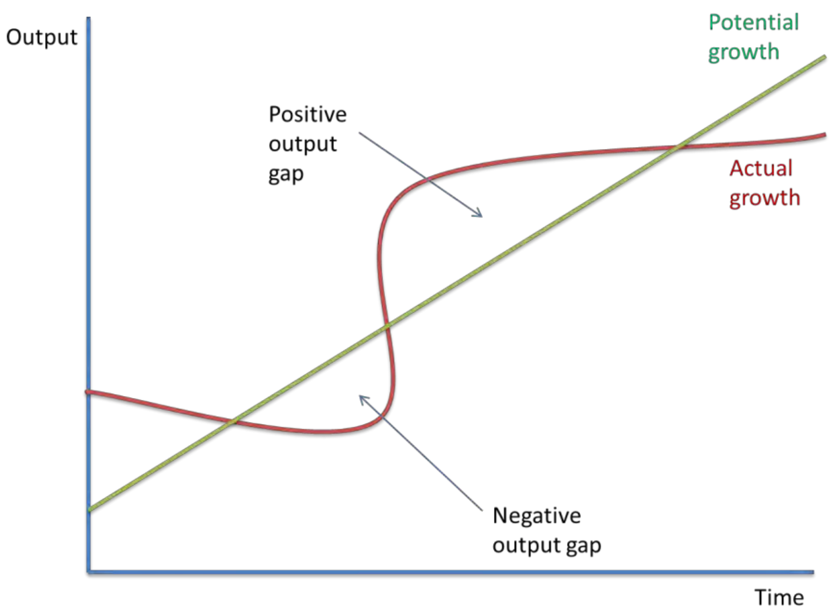
2.5.2 Output gaps

Notes

The difference between actual growth rates and long-term trends in growth rates:

- **Actual growth** is the percentage increase in a country's real GDP and it is usually measured annually. It is caused by increases in AD.
- **The long-term trend in growth rates** is the long run expansion of the productive potential of an economy. It is caused by increases in AS.
- The potential output of an economy is what the economy could produce if resources were fully employed.

Positive and negative output gaps and the difficulty of measurement:



- An output gap occurs when there is a difference between the actual level of output and the potential level of output. It is measured as a percentage of national output.

- A **negative output gap** occurs when the actual level of output is less than the potential level of output.
  This puts downward pressure on inflation. It usually means there is the unemployment of resources in an economy, so labour and capital are not used to their full productive potential. This means there is a lot of spare capacity in the economy.

- A **positive output gap** occurs when the actual level of output is greater than the potential level of output.

It could be due to resources being used beyond the normal capacity, such as if labour works overtime. If productivity is growing, the output gap becomes positive. It puts upwards pressure on inflation.
Countries, such as China and India, which have high rates of inflation due to fast and increasing demand, are associated with positive output gaps.

- **Difficulties with measuring the output gap**

- It is difficult to estimate the trend in a series of data.

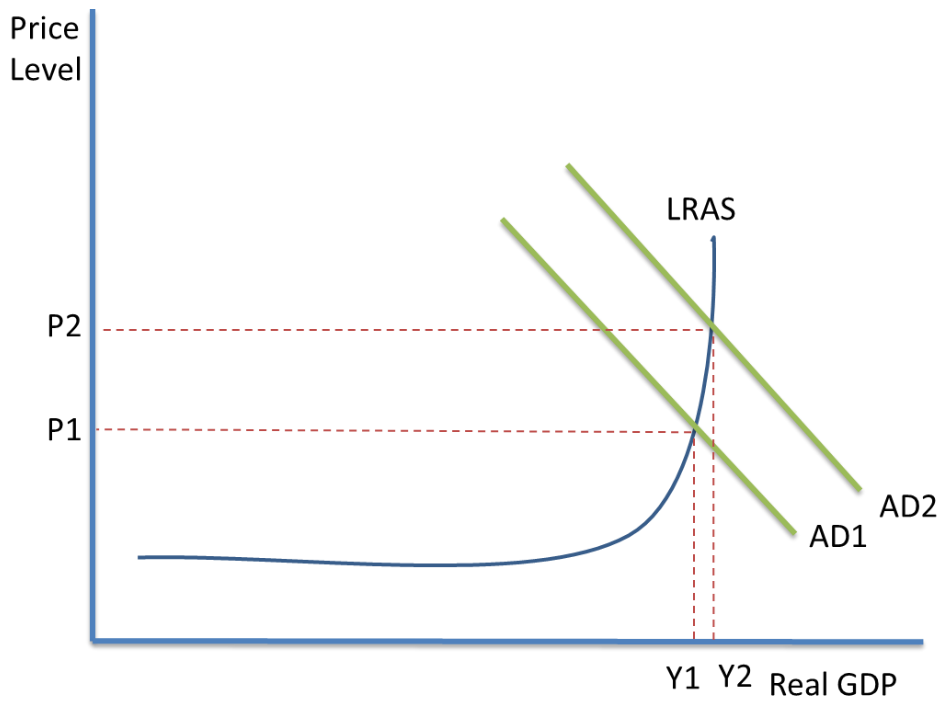
- The structure of the economy often changes, which means estimates may not always be accurate. For example, immediately after a recession, the level of spare capacity might fall below the level anticipated, since some workers might become economically inactive, firms might close and some banks might be unwilling to lend.

- Changes in the exchange rate might offset some inflationary effects of a positive output gap.

- Data is not always reliable, especially from emerging markets, and extrapolating data from past trends might lead to uncertainties.

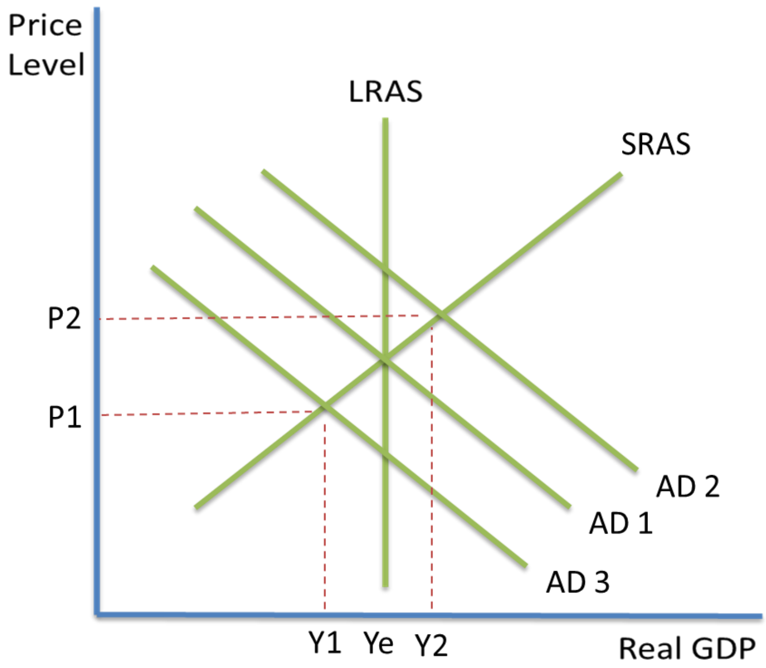
Illustrating an output gap:

Keynesian economists



There is a negative output gap between Y1 and Y2. Keynesians believe that output gaps exist in both the short and long run.

Classical economists



Classical economists believe markets clear in the long run, so there is full employment. They believe there are output gaps in the short run. A negative output gap is between Ye and Y1, and a positive output gap is between Ye and Y2.