Big Question:
Why does a macroeconomy not usually operate at equilibrium?

Webnote 222
Syllabus: item 90
grade weight 5
Note: see also syllabus item 121

SYLLABUS REFERENCE 2.2: Aggregate Demand + Aggregate Supply

Inflationary and Recessionary Gaps

See also syllabus 2.4 item 119 for "crowding out" as government tries to solve a recession.

Inflationary gap (Y1) occurs where the level of AD is above the level of output at the full employment level. This can be indicated on diagram 1 where ad1 cuts the Lras 1

see Macromanagement solution to the inflationary gap: government could reduce G or increase T by the amount of the inflationary gap

Macroeconomic equilibrium and full employment

- **Equilibrium occurs where sras = ad see X in diagram 1**
- **Key issue is that this may occur without unemployment equilibrium which can be shown with the lras 1 and 2 curves on diagram 1**

Note that inflationary gap is said to exist if full employment income is below actual income. In fact this situation 'cannot exist in reality'(see Anderton p. 104) since full employment income represents the maximum output of the country.

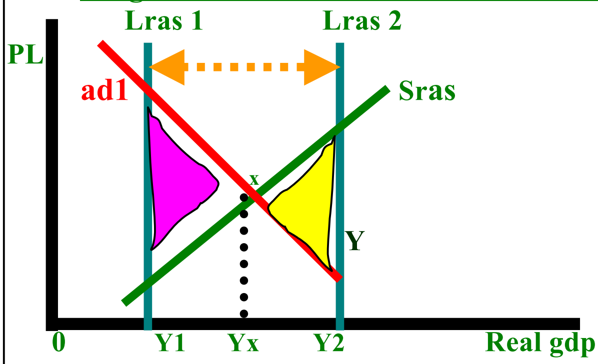
Recessionary gap (Y2) occurs when the level of AD is below the level of output at the full employment level

See Diag. 1

Macromanagement solution to the recessionary gap: government could increase G or reduct T

Ib question:
May 2007 HP2
"Macroeconomic equilibrium does not necessarily occur at full employment".
Explain this statement using the concepts of inflationary and deflationary gaps.

Diagram 1: Macroeconomic Inflationary + Recessionary Gaps

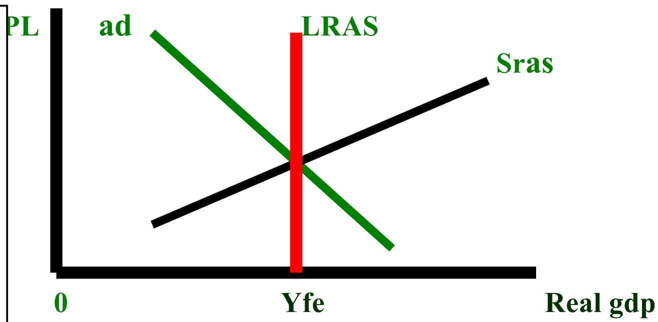


= recessionary gap
(deflationary output at

= inflationary gap
(inflationary output at Y1)

Diagram 2: Macroeconomic Full Employment Equilibrium

Yfe = full employment income (with natural unemployment) = max output of the economy.
Macroeconomic 'utopia' as SR and LR equilibrium occur at yfe



Exam box:

M07 HP 2- q4

"Macroeconomic equilibrium does not necessarily occur at full employment".
Explain this statement using the concepts of inflationary **and** deflationary gaps.