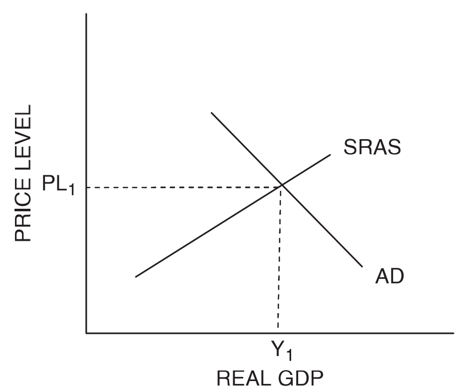
Actual versus Full-Employment Output

The model of aggregate demand (AD) and aggregate supply (AS) predicts that the macroeconomy will come to equilibrium at the intersection of a downward-sloping AD curve and an upward-sloping short-run aggregate supply (SRAS) curve. The short-run equilibrium is described as the only price level where the goods and services purchased by domestic and foreign buyers are equal to the quantity supplied within the economy. It's important to realize that, while the economy might be in equilibrium, this equilibrium level of output can be less than, equal to, or greater than full-employment output.

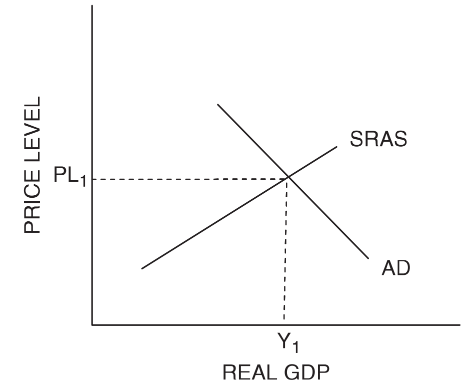
Full-employment output is the level of real gross domestic product (GDP) that exists when the economy's unemployment rate is at its natural rate. This natural rate of unemployment doesn't correspond to an unemployment rate of zero; rather, it is the unemployment rate that exists when there is no cyclical unemployment. When the economy is recessionary, the unemployment rate will exceed this natural rate. When the economy is experiencing an inflationary gap, the unemployment rate will fall below the natural rate.

The distinction between the actual unemployment rate and the natural rate allows us to reconsider the short-run equilibrium in the macroeconomy. If AD and SRAS intersect at a level of output that falls below full-employment output (at the vertical long-run aggregate supply [LRAS] curve), the economy has a recessionary gap. If the AD and SRAS curves intersect at a real output that exceeds full employment, the economy has an inflationary gap.

1. Draw an LRAS curve that illustrates a recessionary gap. Label the full-employment level of output on the graph.

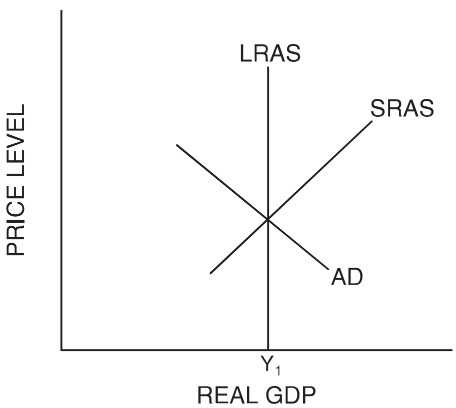


2. Draw an LRAS curve that illustrates an inflationary gap. Label the full-employment level of output on the graph.



3. Suppose households in the United States experience a decrease in wealth. Assume the economy starts at long-run equilibrium as shown in Figure 3-9.1. Use the AS/AD model to show the short-run effect on output, unemployment, and the price level.

Figure 3-9.1
Price Level



(A) Will the unemployment rate increase or decrease? Explain.

(B) What type of gap results from the decrease in wealth?