BANK OF CANADA

The Output Gap

BACKGROUNDER

The output gap is the difference between the economy’s actual output and the level of production it can achieve with existing labour, capital, and technology without putting sustained upward pressure on *inflation*.

The output gap is also referred to as spare capacity or excess capacity. The gap is positive when actual output exceeds the economy's potential and negative when actual output is below potential output. A positive output gap is also referred to as excess demand and a negative output gap is referred to as excess supply.

Pressure on output must be sustainable

When spending in the economy is high in relation to capacity, this tends to put upward pressure on prices. Conversely, a low rate of spending tends to put downward pressure on prices.

This relationship can also be expressed in the reverse manner—if the rate of inflation begins to increase, it is typically a sign that spending levels are approaching the economy’s level of potential output and that output growth is not sustainable. Conversely, if the rate of inflation is consistently below expectations, this is a sign of continuing slack in the economy.

The Bank is concerned about both too much and too little demand in the economy when either puts sustained upward or downward pressure on prices.

Thus, when the output gap is thought to be small and demand is seen to be increasing faster than potential output, the Bank of Canada will typically act to tighten *monetary conditions* to curb demand and the inflationary pressures. If the economy can be kept from overheating, then it will be less likely that even tighter monetary conditions will be required later to control inflation.

Tracking the output gap

It is obviously an important challenge for the Bank to determine (as closely as possible) the level of potential output, the level of actual output at any given time, and the direction in which they are heading in order to judge whether the output gap is closing or growing.

Both the level of potential output and the output gap, are estimated numbers, and therefore, there is a major uncertainy in their calculation.

This uncertainty may be larger now because the estimated output gap is relatively small, and the economy seems to have undergone some significant changes during the 1990s. As a result, the Bank now places increased weight on a range of indicators to assess the degree of pressure on the economy's production capacity. These include movements in inflation relative to expectations, the growth of money and credit, wage pressures, and evidence of supply bottlenecks.

The increased confidence of Canadians in ongoing low inflation allows the Bank to gather this additional information before taking action and gives *monetary policy* somewhat more flexibility to accommodate demand pressures that test the limits of the economy’s capacity to produce.