Answer on Question#37796 – Economics - Macroeconomics

In economics, potential output (also referred to as "natural gross domestic product") refers to the highest level of real Gross Domestic Product output that can be sustained over the long term. The existence of a limit is due to natural and institutional constraints. If actual GDP rises and stays above potential output, then (in the absence of wage and price controls) inflation tends to increase as demand for factors of production exceeds supply. This is because of the limited supply of workers and their time, capital equipment, and natural resources, along with the limits of our technology and our management skills. Graphically, the expansion of output beyond the natural limit can be seen as a shift of production volume above the optimum quantity on the average cost curve. Likewise, if GDP is below natural GDP, inflation will decelerate as suppliers lower prices to fill their excess production capacity.