Expansionary gap

- when faced with a demand for their products that significantly exceeds their sustainable capacity, firms tend to raise prices = inflation

1) $\pi \uparrow$ because of expansionary gap
2) Fed $\uparrow r$ to $\downarrow C + I$
3) $C + I \downarrow \therefore$ PAE $\downarrow$ ~~via multiplier~~
4) $Y_{eq} \downarrow$ via multiplier
5) output gap starts to close

$\uparrow \pi \Rightarrow \uparrow r \Rightarrow \downarrow$ planned C & planned I $\Rightarrow \downarrow$ PAE $\Rightarrow$

$\downarrow Y$ (via multiplier)

Consequently: $\downarrow \pi \Rightarrow \downarrow r \Rightarrow \uparrow$ planned C & planned I $\Rightarrow \uparrow$ PAE $\Rightarrow$
(Recessionary gap)

$\uparrow Y$ (via multiplier)

* Remember that $\uparrow r$ reduces C because consumers would rather save and that $\uparrow r$ reduces planned I because a higher interest rate raises the cost of borrowing