Abstract of "Capacity Utilization, Inflation, and Aggregate Demand Policy"
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It is commonly asserted that with excess plant capacity, expansive policy stimulates output and lowers unemployment without substantially boosting inflation, while at full capacity most of the impact is on inflation. This assertion is critically examined. First, two common definitions of capacity--engineering and economic--are examined and found to be nebulous. The concepts of supply and demand are older, but better. Full capacity is reinterpreted as points where the supply curve is steep and excess capacity as points where it is fairly flat. Then the "Keynesian" model in which stimulative policy shifts only the demand curve is compared to the "classical" model where stimulative policy shifts both demand and supply curves. For the former model the assertion on capacity utilization is correct, while in the latter it is not. Empirical tests are performed to determine whether measured capacity utilization is useful for predicting inflation. The tests are ambiguous, but certainly do not strongly favor capacity utilization.