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(Paper-2)

Inflationary and Deflationary Gap (With Diagram)

Inflationary Gap:

We have so far used the theory of aggregate demand to explain the emergence of DPI in an economy. This theory can now be used to analyse the concept of **'inflationary gap'**—a concept introduced first by Keynes. This concept may be used to measure the pressure of inflation.

If aggregate demand exceeds the aggregate value of output at the full employment level, there will exist an inflationary gap in the economy. Aggregate demand or aggregate expenditure is composed of consumption expenditure (C), investment expenditure (I), government expenditure (G) and the trade balance or the value of exports minus the value of imports (X – M).

Let us denote aggregate value of output at the full employment by Y_f. This inflationary gap is given by $C + I + G + (X – M) > Y_f$. The consequence of such gap is price rise. Prices continue to rise so long as this gap persists. Inflationary gap thus describes disequilibrium situation.

Inflationary gap is thus the result of excess demand. It may be defined as the excess of planned levels of expenditure over the available output at base prices. An example will help us to clear the meaning of the concept of inflationary gap.

Suppose, the aggregate value of output at current price is Rs. 600 crore. The government now takes away output worth Rs. 100 crore for its own requirements, leaving thus Rs. 500 crore for civilian consumption. National income analysis says that the value of aggregate money income equals the net value of aggregate output.

Here also the total money income of the people (Rs. 500 crore) is equal to the net value of aggregate output (i.e., Rs. 600 crore – Rs. 100 crore = Rs. 500 crore). Thus, prices will remain stable since aggregate expenditure is equal to aggregate output. Let us further assume that the money income of the community is increased to Rs. 800 crore by creating additional purchasing power.

Let the government takes away Rs. 50 crore as taxes. A part of the increased income, say Rs. 100 crore, may now be saved. So the net disposal income available for spending becomes Rs. (800 – 50 – 100 =) 650 crore. Since the aggregate demand at old prices is Rs. 500 crore, an excess of Rs. 150 crore appears.

This excess represents inflationary gap that pulls up prices. If there is no corresponding increase in aggregate output, prices will continue to rise until aggregate output becomes equal to aggregate expenditure.