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(Paper-2)

Inflationary and Deflationary Gap (With Diagram)

Keynes' demand inflation is often couched in terms of the concept of inflationary gap. We now graphically explain this gap with the help of the Keynesian cross that we use in connection with the determination of equilibrium national income. In Fig. aggregate expenditure is measured on the vertical axis and national income or aggregate output is measured on the horizontal axis.

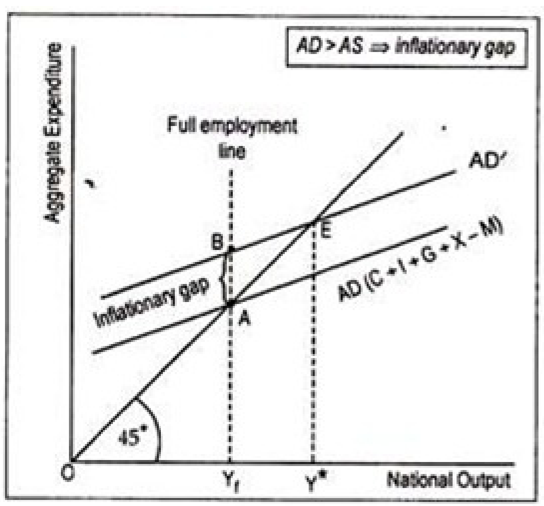

Fig. 11.5: Inflationary Gap

Let us assume that Y_f is the full employment level of national income. If C + I + G + (X – M) is the aggregate demand (AD) curve that cuts the 45° line at point A then an equilibrium income is determinded at Y_f. There will not be any price rise since aggregate demand equals aggregate supply. Now if the AD curve shifts up to AD', equilibrium output will not increase since output cannot be increased beyond the full employment level. In other words, because of full employment, output cannot increase to Y*. Thus at Y_f level of full employment output, there occurs an inflationary gap to the extent of AB. The vertical distance between the aggregate demand and the 45° line at the full employment level of national income is termed the inflationary gap. Or at full employment, there is an excess demand of AB that pulls up prices.

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