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(Paper-2)

Inflationary and Deflationary Gap (With Diagram)

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.

To describe inflationary gap in a simple way, we use Fig. 11.6. In this figure, we weigh aggregate demand (i.e., C + I + G + X-M) and aggregate supply. Since the former exceeds the latter, an inflationary gap emerges.

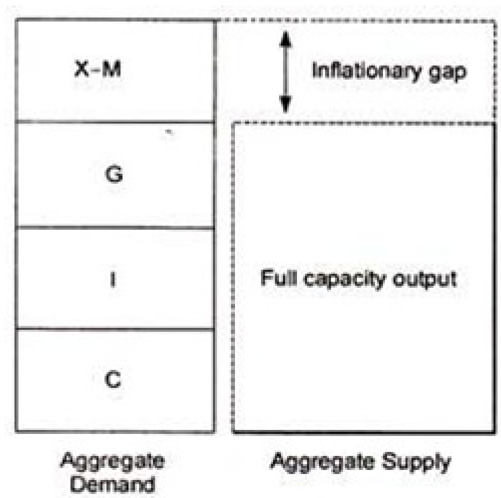

Fig. 11.6: Inflationary Gap

Inflationary gap can be eliminated/ minimized by using monetary policy and or fiscal policy instruments. Under the monetary policy, money supply is reduced and/or interest rates are increased. This gap, however, can be reduced either by reducing money income through reduction in government expenditure, or by increasing output of goods and services, or by increasing taxes.