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(Paper-2)

Inflationary and Deflationary Gap (With Diagram)

Deflationary Gap:

If the equilibrium level of income is estimated to be below the full employment level of income then emerges deflationary gap. If in the economy there arises insufficient aggregate demand, equilibrium in the economy will occur to the left of the full employment income (Y_f).

In other words, a deflationary gap shows the amount by which aggregate demand must be increased so that equilibrium level of income is increased to the full employment level. Fig 11.7 shows that equilibrium level of income is OY* while full employment output is Y_f.

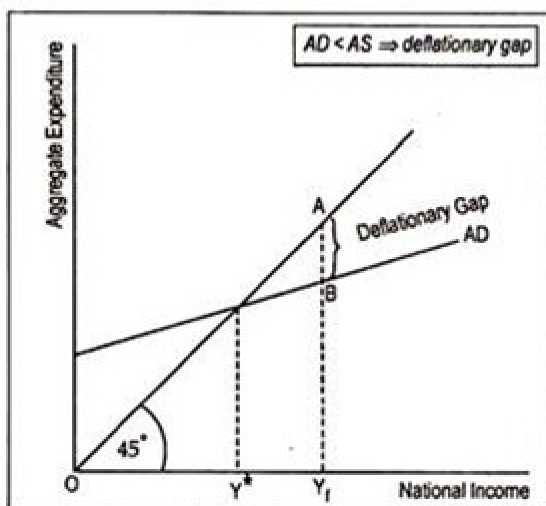

Fig. 11.7: Deflationary Gap

Thus, the economy faces unemployment situation. The distance between the 45° line and the AD line at the full employment output situation is referred as the deflationary gap. It is AB in Fig. 11.7. Since aggregate demand is less than the country's potential output, the economy suffers from unemployment of labour and other resources.

The deficiency in aggregate demand thus causes price level to fall. This is what happened in the USA, UK, etc., in the 1930s. Keynes was arguing at that time that unemployment was the result of deficiency of aggregate demand. He suggested demand management policy (such as, increase in government spending, reduction in taxes, etc.,) to come out from the Great Depression of the 1930s.