JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

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NAAC Accredited University

Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA (Hons) Economics 2nd Semester

Course – Macroeconomics II

Digital session name – Inflationary Gap

Inflationary Gap

Keynes in his pamphlet How to pay for the War published in 1940, Keynes explained the concept of the inflationary gap. It differs from his views on inflation given in his General Theory. In the General Theory, he started with underemployment equilibrium. But in How to Pay for the War, he began with a situation of full employment in the economy.

He defined an inflationary gap as an excess of planned expenditure over the available output at pre-inflation or base prices. According to Lipsey, "The inflationary gap is the amount by which aggregate expenditure would exceed aggregate output at the full employment level of income." The classical economists explained inflation as mainly due to increase in the quantity of money, given the level of full employment.

Keynes, on the other hand, ascribed it to the excess of expenditure over income at the full employment level. The larger the aggregate expenditure, the larger the gap and the more rapid the inflation. Given a constant average propensity to save, rising money incomes at full employment level would lead to an excess of demand over supply and to a consequent inflationary gap. Thus Keynes used the concept of the inflationary gap to show the main determinants that cause an inflationary rise of prices.

The inflationary gap is shown diagrammatically in Figure 5 where OY_F is the full employment level of income, 45° line represents aggregate supply AS and C + 1 + G line the desired level of consumption, investment and government expenditure (or aggregate demand curve).

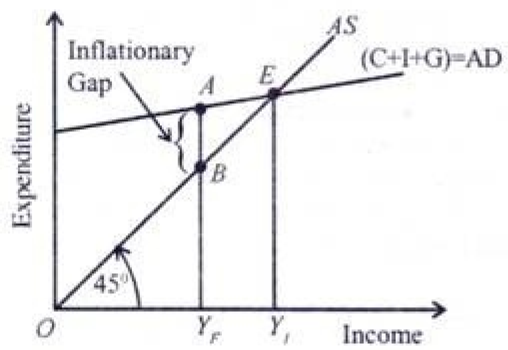

Fig. 5

Source: Internet

The economy's aggregate demand curve (C + l +G) = AD intersects the 45° line (AS) at point E at the income level OY_1which is greater than the full employment income level OY_F The amount by which aggregate demand (Y_FA) exceeds the aggregate supply (Y_FB) at the full employment income level is the inflationary gap.

This is AB in the figure. The excess volume of total spending when resources are fully employed creates inflationary pressures. Thus the inflationary gap leads to inflationary pressures in the economy which are the result of excess aggregate demand.

How can the inflationary gap be wiped out?

The inflationary gap can be wiped out by increase in savings so that the aggregate demand is reduced. But this may lead to deflationary tendencies.

Another solution is to raise the value of available output to match the disposable income. As aggregate demand increases, businessmen hire more labour to expand output. But there being full employment at the current money age, they offer higher money wages to induce more workers to work for them.

As there is already full employment, the increase in money wages leads to proportionate rise in prices. Moreover, output cannot be increased during the short run because factors are already fully employed. So the inflationary gap can be closed by increasing taxes and reducing expenditure. Monetary policy can also be used to decrease the money stock. But Keynes was not in favour of monetary measures to control inflationary pressures within the economy.

It's Importance:

Despite these criticisms the concept of inflationary gap has proved to be of much importance in explaining rising prices at full employment level and policy measures in controlling inflation. It tells that the rise in prices, once the level of full employment is attained, is due to excess demand generated by increased expenditures. But the output cannot be increased because all resources are fully employed in the economy. This leads to inflation. The larger the expenditure, the larger the gap and more rapid the inflation.

As a policy measure, it suggests reduction in aggregate demand to control inflation. For this, the best course is to have a surplus budget by raising taxes. It also favours saving incentives to reduce consumption expenditure.

"The analysis of the inflationary gap in terms of such aggregates as national income, investment outlays and consumption expenditures clearly reveals what determines public policy with respect to taxes, public expenditures, savings campaigns, credit control, wage adjustment—in short, all the conceivable anti-inflationary measures affecting the propensities to consume, to save' and to invest which together determine the general price level."

Course Outcome: The goal of this paper will be to expose the students to the basic principles of macroeconomics. The emphasis will be on thinking like an economist and course will illustrate how economic concepts can be applied to analyse real-life situations. In this course, the students are introduced to money and interest, theories of inflation, rate of interest, trade cycle and growth models.