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Problem of Deficient and Excess Demand

CONCEPT OF FULL EMPLOYMENT

Full employment refer to the situation when all workers who are able and prepared to work at current wage rate get employment.

In the situation of full employment, the equality between aggregate demand and aggregate supply is established at the level where all the resources of the Country get employment. Full employment is an ideal situation and it is hardly found in an economy.

CONCEPT OF INVOLUNTARY UNEMPLOYMENT

Involuntary unemployment refers to the situation when workers are prepared to work at current or slightly low wage rate, but jobs are not available to them due to deficiency of aggregate demand.

FULL EMPLOYMENT EQUILIBRIUM

When aggregate demand equals to the aggregate supply at a point where all the resources of country get employment, this is called full employment equilibrium.

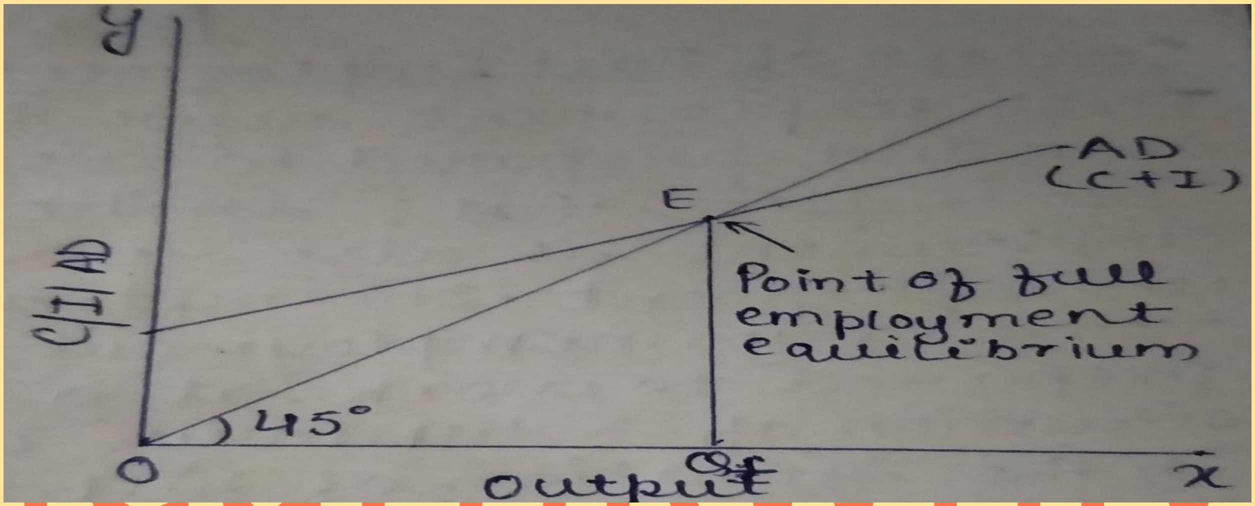
If aggregate demand is equal to the aggregate demand required for the level of full employment, it is termed as a full employment equilibrium.

$AD = AD_F$

Where, AD= Aggregate demand AD_F = Aggregate demand required for full employment

According to this diagram with the intersection of the given aggregate demand (C + I) curve and 45° line, equilibrium is established at Q_f level

of output and it can be said that this is the equilibrium at the level of full employment. In the diagram OQ_f represents the full employment level of output. Diagram indicates that EQ_F aggregate demand is essential to produce the OQ_f level of output. However, in the diagram, aggregate demand is just EQ_f. Thereby meaning that we had the requirement of EQ_f level of aggregate demand to produce full employment level of output and our actual aggregate demand was just equal to it.



PROBLEM OF DEFICIENT AND EXCESS DEMAND

It is not always essential that existing volume of aggregate demand would require always be equal to the aggregate demand required to reach the level of full employment and income. It is this disequilibrium which creates the problem of excess demand or deficient demand in the economy.

DEFICIENT DEMAND

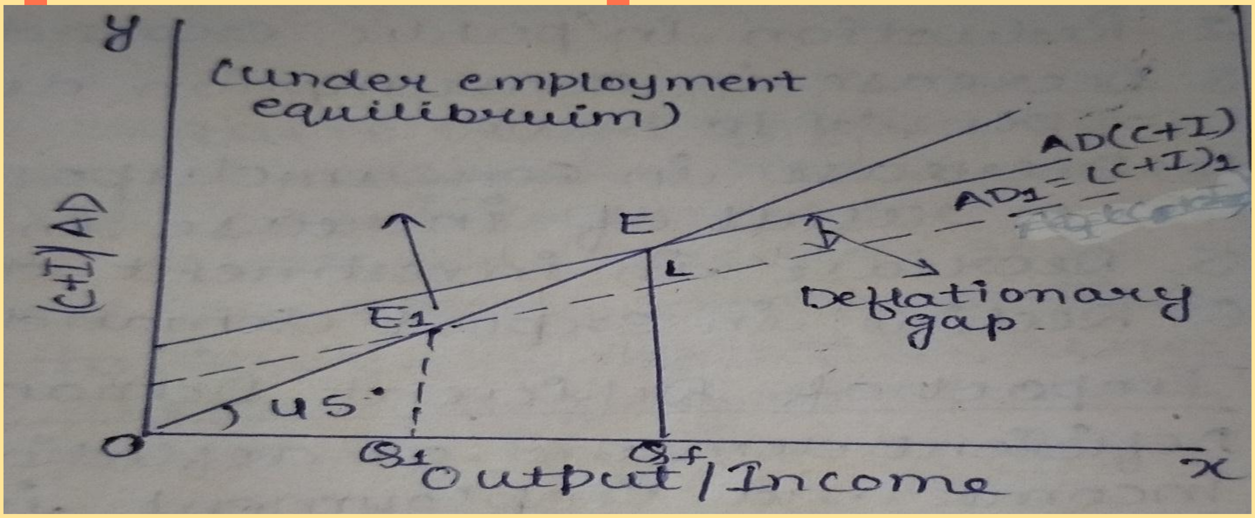
Deficient demand refer to the situation when actual aggregate demand fall short of the aggregate demand required for full employment level of output. The problem of deficient demand depend primarily on deflationary gap. The extent to which actual aggregate demand falls shorts of aggregate demand required for full employment is termed as deflationary gap.

(i) $AD < AD_f \rightarrow$ Deficient demand

(ii) $AD_f - AD \rightarrow$ Deflationary Gap

AD = Actual Aggregate demand

AD_f = Aggregate demand required for full employment



In diagram, x - axis measures the level of output and income, and Y-axis measures the consumption demand, Investment demand and aggregate demand. OQ_f is the full employment Level of output and income. When the aggregate demand curve is AD or (C + I) Curve, it intersect at 45° line at the point E. Hence point E is the equilibrium point. It indicates that aggregate demand is EQ_f which is just equal to the aggregate demand required for full employment equilibrium.

Suppose aggregate demand curve become AD_1 or $(C + I)_1$ curve. We require EQ_f aggregate demand to reach the level of full employment income but our actual aggregate demand is only equivalent to LQ_f. Thus actual aggregate demand fall short to the tune of EL (EQ_f – LQ_f) to the aggregate demand required for full employment. As a result of deficiency in demand the new AD_1 meet the 45 ° line at point E_1. This gives OQ_1, as the equilibrium level of output. Hence, point E_1, and OQ, level of output represent the case of under -employment equilibrium.

REASON OF THE PROBLEM OF UNDER- EMPLOYMENT EQUILIBRIUM

Deficiency in aggregate demand is the main reason for under employment equilibrium. Due to lack of aggregate Country's resources are not fully utilised and this gives birth to the situation of under-employment equilibrium.

SOLUTION TO THE PROBLEM OF UNDER- EMPLOYMENT EQUILIBRIUM

According to Keynes, full employment equilibrium can be achieved by raising the level of aggregate by demand through the increase in public investments. When we increase the level of aggregate demand, it increases the level of output and employment in the economy.

REASON FOR DEFICIENT DEMAND

1. Decrease in total supply of money in the country.

2. Reduction in public expenditure or government purchases.

3. Decrease in consumption demand as a consequence of increase in propensity to save.

4. Decrease in disposable income and consumption demand as a result of increase in taxes.

5. Decrease in investment demand due to increase in bank rate and

6. Decline in export demand.

IMPACT OF DEFICIENT DEMAND

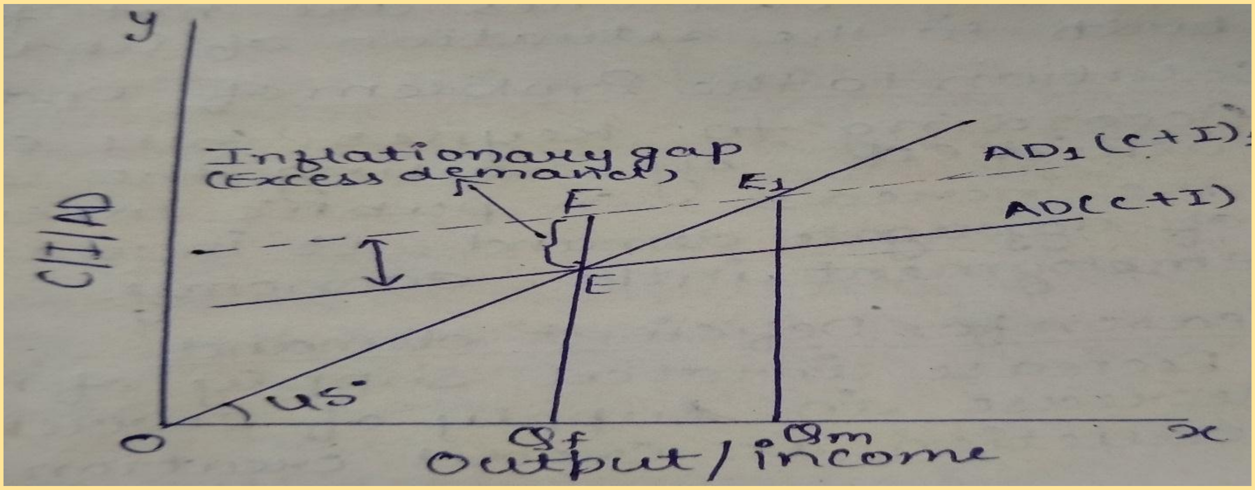
Deficient demand or deflationary gap reduces the level of output, income and employment in the economy. In this situation aggregate demand is less than the full employment, level of output. Consequently it increases the unplanned stock of inventory. Hence, firms tend to reduce their production by reducing employment. Thus, there is overall reduction in the output, income and employment in the economy.

EXCESS DEMAND

When actual aggregate demand becomes higher than the amount of aggregate demand required for full employment it is called excess demand. The extent to which actual aggregate demand becomes higher than the aggregate demand required for full employment is referred as inflationary gap.

AD > AD_F Excess demand

AD = AD_f Inflationary gap



In order to achieve full employment we require only EQ_f level of aggregate demand but our current aggregate demand has reached the level of FQ_f. Thus, aggregate demand has increased to FE which is over and above the level what was needed. It is this surplus demand which is termed as excess demand. This excess or surplus demand gives rise to the price inflation, hence is called inflationary gap. From figure, the new aggregate curve AD_1 $(C+I)_1$ meets the 45 ° line at point E_1. This bring Q_m level of output and employment.

Reason for Excess demand (or inflationary gap)

1. Increase in money supply.

2. Increase in the government demand for goods and services as a result of rise in public expenditure

3. Increase in consumption demand as a result of rise in propensity to consume.

4. Increase in disposable income and consumption demand as a consequence of reduction in taxes.

5. Increase in demand due to increase in credit facilities.

6. Increase in investment demand.

7. Increase in export demand

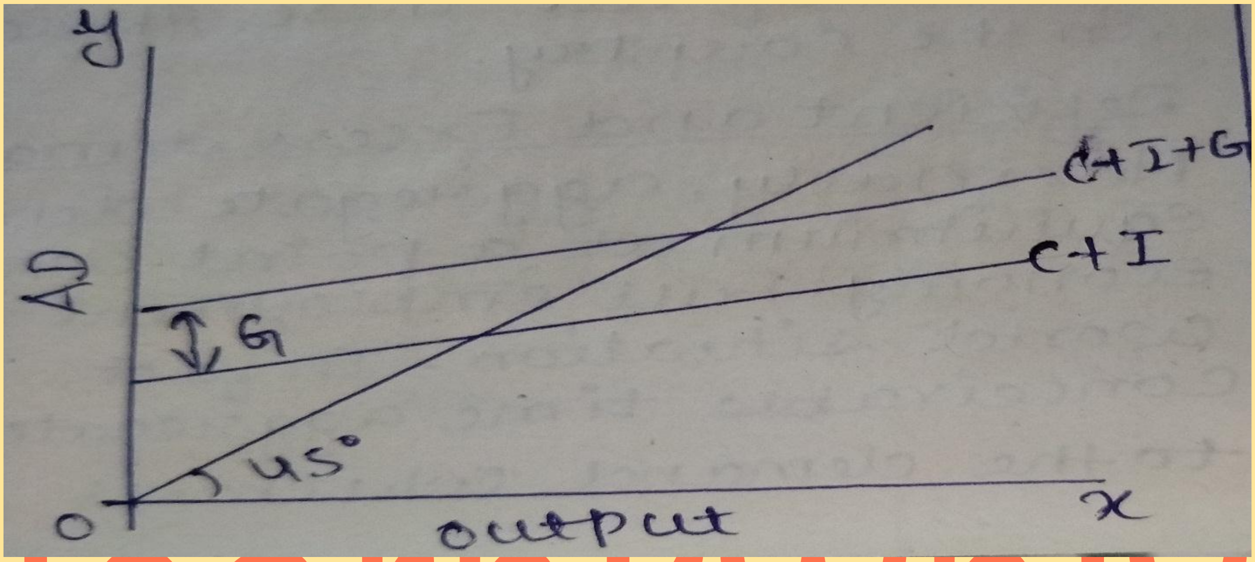
The Impact of Excess Demand or Inflationary gap

Excess demand leads to price- inflation in the economy. In the situation of inflation, inequalities in distribution widens; the burden on the poor man's increases; budget the activities of hoardings, black marketing and profiteering increased and which distort the distribution pattern and as a result of all these, there is social and economic instability in the country.

AGGREGATE DEMAND IN THREE SECTOR ECONOMY

The three sectors in the economy are: Household sector, firms sector and Government sectors. Therefore aggregate demand will be equal to the sum of consumption, Investment and government expenditure. Our old aggregate Curve (in two sector economy) is equal to C + I and the new aggregate demand curve (in a 3 sector economy is C + I + G. It is clear from diagram that new C + I + G lies parallel to old aggregate demand curve C + I. It indicates that at every level of output the

vertical distance between the C + I curve and C + I + G curve is the constant amount of government expenditure.



MEASURES TO CORRECT DEFICIENT DEMAND

The problem of deficient demand arises when aggregate demand is less than the aggregate demand required for full employment. In order to overcome the problem of deficient demand, we have to increase the level of aggregate demand in the economy. For the increase in aggregate demand two important policy measures are adopted (1) Fiscal policy measures and (2) monetary policy measures.

I Fiscal Policy Measures

Measures related to taxation and public expenditure are normally called fiscal measures and the policy concerning them as fiscal policy.

1. Increase in public expenditure (or Government Spending's)

Government should increase its public expenditure in the days of deficient demand. Government increases its expenditure equal to the deflationary gap so that the economy reaches to its full employment equilibrium.

2. Reduction in taxes

Aggregate demand can also be increase through reduction in taxes. Reduction in taxes raises the disposable income of the people. As a result of it, the consumption demand increases. And increase in consumption demand increases the level of aggregate demand.

II MONETARY POLICY MEASURES

Monetary policy is operated by the central bank of the country. Measure to increase the availability of credit & investment demand should be adopted in times of deficient demand.

1. Reduction in Cash Reserve Ratio: - **Central bank reduces the reserve ratio in the times of deficient demand or deflation. This raise loanable amount of funds available with the banks because commercial bank are able to create more reduction CRR increases the availability of credit in the economy. It helps to increase the level of aggregate demand, output and employment.**

<u>2. Reduction in interest rate: -</u> **In the situation of deficient demand government reduces the interest rate either by reducing bank rate or by increasing the money supply. Reduction in interest rate increases the investment demand. Increase in investment demand further increases the aggregate demand.**

MEASURES TO CORRECT EXCESS DEMAND

In order to overcome the problem of excess demand, we reduces the level of aggregate demand in the economy. In this regards following measures are adopted.

I Fiscal Policy Measures

Fiscal measure which are to be adopted in the situation of excess demand or inflation should aim at curtailing the purchasing power of the people and the level of aggregate demand in the economy. Following measures are adopted.

1. Reduction in government expenditure: In the situation of excess demand government should curtail the public expenditure. This reduces the government purchases aggregate which, in turn, reduces the aggregate demand.

2. Increase in taxes: Government increases the level of taxation in the economy in the days of excess demand. Increase in taxes reduces the disposable income of the people. As a result of it, the consumption demand will falls. And decrease in consumption demand decreases the level of aggregate demand.

II Monetary Measures

In the situation of excess demand, availability of credit is Restricted and the investment demand is curtailed. For this following monetary measures can be adopted.

1. Increase in CRR: In the situation of excess demand, Central bank can raise the CRR. This will reduces credit creation capacity of the bank and which, in turn, reduces credit creation capacity of the bank. Thus, increase in CRR would decrease the availability of credit in the economy.

2. Increase in interest rate: The increase in interest rate adversely affect the availability of credit and makes the borrowing costlier which, in turn, discourage investment. Thus investment demand can be reduces by increasing interest rate. The decrease in investment demand further reduces the level of aggregate demand resulting into controlling of inflation.