EXCESS DEMAND AND DEFICIT DEMAND

Q1. What is excess demand. Give its reasons and its impact.

Ans. Excess demand refers to a situation when aggregate demand is more than the aggregate supply corresponding to full employment level of output.

Diagram:

- Excess demand give rise to an inflationary gap.
- Inflationary gap refers to the gap by which actual AD exceed the AD required to establish full employment equilibrium.

❖ **<u>EXPLANATION</u>;-**

- In the above diagram AD & AS intersect at point E. Which indicates full employment equilibrium.
- Due to increase in investment expenditure AD ruses from AD to AD1.
- It denote the situation of excess demand & the gap between then i.e. EF is termed inflationary gap.

❖ **<u>REASONS</u>:-**

- **<u>RISE IN PROPENSITY TO CONSUME</u>;-** Excess may a rise because of increase in consumption expenditure due to rise in propensity to consume or fall in propensity to save.
- **<u>REDUCTION IN TAXES</u>;-** It may also occur due to increase in disposable income and consumption demand because of decrease in taxes.
- **<u>INCREASE IN GOVERNMENT EXPENDITURE</u>:-** Rise in government demand for goods and service due to increase in public expenditure result in excess demand.
- **<u>FALL IN IMPORTS</u>;-** Decrease in imports due to higher international prices in comparison to domestic prices may also lead to excess demand.
- **<u>RISE IN EXPORTS</u>:-** Excess demand lay also a rise when demand for exports increases due to comparatively low prices of domestic goods due to decrease in exchange rate.
- **<u>DEFICIENT FINANICING</u>:-** Excess demand may also cause due to increase in money supply caused by deficit financing.

❖ **<u>IMPACT OF EXCESS DEMAND</u>;-**

- **<u>EFFECT ON OUTPUT</u>;-** Excess demand doesnot effect the level of output because economy is already at full employment level and there is no idle capacity in the economy.
- **<u>EFFECT ON EMPLOYMENT</u>;-** There will be no change in the level of employment as the economy is already operating at full employment equilibrium and there is no involuntary unemployment
- **<u>EFFECT ON GENERAL PRICE LEVEL</u>:-** Excess demand leads to rise in general price level as aggregate demand is more than aggregate supply.

Q2. Explain deficit demand, reason & its impact.
Ans. Deficit demand refers to the situation when AD is less than AS corresponding to full employment level of output in the economy.

- Deficit demand give rise to deflationary gap.
- Deflationary gap is the gap by which actual AD falls short to AD requires to establish full employment equilibrium.

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Diagram:

- In the above diagram AD & AS intersect at point E. Which indicates full employment equilibrium.
- Due to decrease in investment expenditure AD fall from AD to AD1. It denotes the situation of deficit demand.
- The gap between then i.e. EG is termed as deflationary gap.
- Point F indicates the under employment equilibrium.

❖ **<u>REASONS</u>;-**

- **<u>DECREASE IN PROPENSITY TO CONSUME</u>;-** A decrease in consumption expenditure due to fall in the propensity to consume leads to deficit demand in the economy.
- **<u>INCREASE IN TAXES</u>;-** AD may fall due to imposition of higher tax. It leads to decrease in disposable income and as a result the economy suffer from deficit demand.
- **<u>DECREASE IN GOVERNMENT EXPENDITURE</u>;-** When government reduces its demand for goods and services due to fall in public expenditure it leads to deficit demand.
- **<u>FALL IN INVESTMENT EXPENDITURE</u>:-** Increase in the rate of interest or fall in the expected return leads to decrease in the investment expenditure and give rise to deficit demand.
- **<u>RISE IN IMPORTS</u>;-** When international prices are comparatively less than domestic prices then it may leads to rise in imports.
- **<u>FALL IN EXPORTS</u>;-** Export may fall due to comp rives of higher prices of domestic goods or due to increase in the exchange rate for domestic currency.

❖ **<u>IMPACTS</u>;-**

- **<u>EFEECT ON OUTPUT</u>;-** Due to lack of sufficient AD there will be an increase in the inventory stock. It will force the firm to produce less production for subsequent periods. As a result, planned output fall.
- **<u>EFFECT ON EMPLOYMENT</u>;-** Deficit demand cause involuntary unemployment in the economy due to fall in the planned output.
- **<u>EFFECT ON GENERAL PRICE LEVEL</u>:-** Deficit demand causes the general price to fall due to lack of demand for goods and services in the economy.

Q3. What are the measures to correct the excess demand?

Ans. <u>QUANTITATIVE INTRUMENT</u>;-   {MONETARY POLICY)

1. **<u>INCREASE IN BANK RATE</u>;-** Bank rate is the rate in which the central bank leads money to commercial bank to meet their long term needs. During excess demand central bank increases the bank rate which raises the cost of borrowing from the central bank. It forces the commercial bank to increase their lending rates, which discourages borrowers from taking loan. It reduces the availability of credit in the economy. And helps to correct the excess demand.
2. **<u>OPEN MARKET OPERATION</u>:-** It refers to the sale and purchase of securities in the open market by the central bank. It directly influences the level of money supply in the economy during the excess demand. Central bank offer securities for sale. Sale of securities reduces the reserves of commercial bank and decreases the level of aggregate demand.

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3. **INCREASE IN LEGAL RESERVE REQUIREMENT;-** Commercial banks are obligated to maintain legal reserves an increase in such reserve is a direct method to reduce the availability of credit. There are two component of a legal reserve ratio.

a. **CASH RESERVE RATIO;-** It is the minimum percentage of the net demand and time liabilities to be kept by commercial banks with the central bank.

b. **STATUTORY LIQUIDITY RATIO:-** It refers to the minimum percentage of net demand and time liabilities which commercial banks are require to maintain with themselves.
To correct the excess demand central bank increase CRR and SLR. It reduces the amount of effective cash resources of commercial banks and limits their credit crediting power.

❖ **QUALITATIVE INSTRUMENT:-**

1. **INCREASE IN MARGIN REQUIREMENT:-** Margin requirement refers to difference between the market value of security offer and the value of amount lend. When the economy suffering from excess demand. Central bank increases the margin requirement which restrict the credit dealing power of bank and reduces the excess demand.
2. **MORAL SAUSION;-** This is the combination of persuasion & pressure that central bank applies on other banks in the order to get them at in a manner in line with its policy it exercise through discussion, letter, speeches etc. During excess demand central bank advises or request to the commercial bank not to advance credit for speculative or non essential activities. It helps to reduce availability of credit and aggregate demand.
3. **SELECTIVE CREDIT CONTROL:-** It refers to the method in which the central bank gives direction bank to give a not to give credit for certain purpose to particular sectors. During excess demand central bank introducing the rationing of credit in order to prevent excess flow of credit particularly for speculative activities. It will reduce the excess demand.

❖ **FISCAL POLICY;-**

1. **DECREASE IN GOVERNMENT EXPENDITURE;-** Government should reduce its expenditure to the maximum possible extend expenditure on unproductive works should be reduced. So the excess aggregate demand come down and helps to correct inflationary pressure.
2. **INCREASE IN TAXES:-** During excess demand the government increases the rate of taxes and even imposed some new tax. It leads to decrease in the level of aggregate expenditure and reduces the excess demand.

❖ **DEFICIT DEMAND;-**

1. **DECREASE IN BANK RATE;-** Bank rate is the rate in which central bank lends money to commercial bank to meet their long term needs. During deficit demand central bank decreases the bank rate which lower the cost of borrowing from the central bank. It forces the commercial bank to decrease their lending rates, which encourages borrowers from taking loan. It increases the availability of credit in the economy. And helps to correct the deficit demand.
2. **OPEN MARKET OPERATION:-** It refers to the sale and purchase of securities in the open market by the central bank. It directly influences the level of money supply in the economy during the deficit demand. Central bank purchase securities. The purchase of securities increases the reserves of commercial bank and this also raise the level of aggregate demand.

3. **DECREASE IN LEGAL RESERVE REQUIREMENT;-** Commercial banks are obligated to maintain legal reserves. Decrease in such reserve is a direct method to raise the availability of credit. There are two component of a legal reserve ratio.

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3. **SELECTIVE CREDIT CONTROL:-** It refers to the method in which the central bank gives direction bank to give or not to give credit for certain purpose to particular sectors. During deficit demand central bank removing the selective credit control and give credit for productive and non productive activities. It will reduce deficit demand.

❖ **FISCAL POLICY;-**

1. **INCREASE IN GOVERNMENT EXPENDITURE;-** Government should increase its expenditure to the maximum possible. Expenditure on unproductive works should be increase. So the deficit demand come down and helps to correct deflationary pressure.
2. **DECREASE IN TAXES:-** During deficit demand the government reduce the rate of taxes. It leads to increase in the level of aggregate expenditure and reduces the deficit demand.

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