Mona
Assistant Professor (Guest Faculty)
Department of Economics
Maharaja College
Veer Kunwar Singh University, Ara
B.A. Economics
B.A. Part -1
Paper -2
Topic - Inflationary gap
Email address : monapryal2223@gmail.com

Inflationary gap :

The inflationary gap refers to the difference (that is, the gap) between the actual gross domestic product (GDP) and the GDP that would exist if the economy were at full employment (this is also known as the “potential GDP”).

In the case of an inflationary gap, the real GDP is higher than the potential GDP. (This is in contrast to a deflationary gap, when the real GDP is lower than the potential GDP.) The real GDP is greater than the potential GDP due to the fact that, when the real GDP increases, the general price level also increases in the long run.

First established by influential economist **John Maynard Keynes,** the macroeconomic concept of the inflationary gap is applied in order to assess and quantify the pressure of inflation. During the course of the business cycle, it arises when the economy is in the process of expanding. Specifically, they appear when the output of an economy that could potentially be created at full employment (that is, the full-employment real GDP) is less than the equilibrium level of that economy.

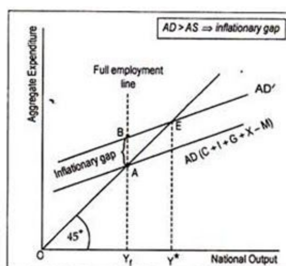

Fig. 11.5: Inflationary Gap

The above given graph is a visual representation of an inflationary gap. In this image, the vertical axis shows aggregate expenditure, while the horizontal axis shows national income or aggregate output.
Furthermore, in the above graph, Yf is the national income level at full employment. C + I + G + X – M is equal to the aggregate demand curve marked AD. This crosses the 45 degree line at point A, which means that an equilibrium income is at Y1.

The price will not rise, because aggregate demand and supply are equal. And then if the AD1 curve moves up to AD2, the equilibrium output does not increase–output can't increase past the full employment level.

To put it another way, full employment means output is unable to go up to Y2. So when we're at the level of Yf full employment output, the inflationary gap is AB (as marked in the diagram). The distance, vertically, from the aggregate demand and the 45 degree line–at the full employment level of national income–is the **inflationary gap.**

A more straightforward diagram of inflationary gap
Here's another, more straightforward way to visualize the inflationary gap. When aggregate demand (C + I + G + X – M) is greater than aggregate supply, this means there is an inflationary gap.

Methods to reduce Inflationary Output Gap

Inflationary gap can be reduced by adopting fiscal and monetary policies.

Governments have an array of contractionary fiscal policies at their disposal that they can put into practice to help minimize inflationary gaps. The most significant of such policies include the following:

- Increasing taxes
- Reducing overall government spending
- Reducing transfer payments
- Increasing interest rates
- Issuing bonds and securities

These and other such fiscal policies work to bring the economy back to a state of equilibrium. They do so by influencing demand for goods and reducing the amount of money at consumers' disposal.