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Paper - 1 (Macroeconomics)
Topic : Inflationary Gap

Inflationary Gap

The Inflationary Gap

In the pamphlet How to Pay for the War published in 1940, Keynes explained the concept of the inflationary gap. It differs from his view of inflation given in the 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 ($AD = C + I + G$) 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 side, 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."

• When a constant increase propensity to consume (S_y), rising money income at full employment level would lead to an excess of demand over supply and to a consequent inflationary gap.

The inflationary gap is explained with the help of the following example:-

Suppose the GNP at pre-inflation prices is Rs 200 crores. Of this Rs 80 crores is spent by the Government. Thus Rs (200-80) = 120 crores worth of output (AS) is available to the public consumption at pre-inflation prices.

But the Gross National Income (GNI) at current prices at full employment level is Rs 250 crores. Suppose the govt. takes away Rs 60 crores, leaving Rs 190 crores as disposable income. Thus Rs 190 crores is the amount to be spent on the available output worth Rs 120 crores, thereby creating an inflationary gap of Rs 70 crores.

This inflationary gap is explained with the help of following chart:

1. Gross National Income at current prices = Rs 250 Cr
2. Taxes = Rs 60 Cr
3. Disposable Income (DI) = Rs 190 Cr
4. GNP at pre-inflation prices = Rs 200 Cr
5. Government Expenditure = Rs 80 Cr
6. Output available for consumption at pre-inflation prices = Rs 120 Cr

$$\text{Inflationary gap} = \text{Disposable Income (DI)} - \text{Output available for consumption (AS)}$$

$$= \text{Rs } 190 \text{ Cr} - \text{Rs } 120 \text{ Cr}$$

$$\text{Inflationary gap} = \text{Rs } 70 \text{ Cr} \rightarrow \text{Before saving}$$

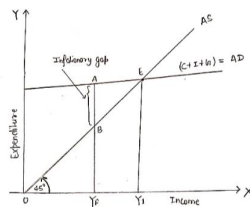
In reality, the entire disposable income of Rs 190 crores is not spent and a part of it is saved. If say, 20% (Rs 38 crores) of it is saved, then Rs 52 crores (Rs 190 - Rs 38 crores) would be left to create demand for the goods worth Rs 120 cr.

Thus, the inflationary gap would be Rs 32 (Rs 52 - 120 cr) instead of Rs 70 crores.

$$\text{Inflationary gap} = \text{Rs } 52 - \text{Rs } 120 = \text{Rs } 32 \text{ cr}$$

↓
After saving

Graph : Inflationary Gap



In the above given graph;

OX represents the level of income
OY axis represents level of expenditure.

Y_f is the full employment of income, 45° line represents aggregate supply (AS) and $(C+I+G)$ line = AD; it is the summation of desired level of consumption, investment and government expenditure. The economy's aggregate demand $(C+I+G) = AD$ intersects the 45° line (AS) at point E at the income level Y_1 which is greater than full employment income level Y_f . The amount by which AD (Y_1) exceeds the aggregate supply (Y_f) at the full employment level of Y_f is the inflationary gap.

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