

PROBLEM OF DEFICIENT DEMAND AND EXCESS DEMAND

➤ Full employment equilibrium and Underemployment equilibrium.

• Full employment equilibrium: It refers to that situation in the economy when $AS = AD$ or $S = I$ with fuller utilization of resources. There is no ~~need~~ excess capacity or unemployment in the economy.

• Underemployment equilibrium: It refers to that level of economy when $AS = AD$ or $S = I$ but without fuller utilization of resources. There is excess capacity or unemployment in the economy even in the state of equilibrium.

➤ Voluntary and Involuntary Unemployment

• Voluntary Unemployment: It refers to that situation when some people are not willing to work at all, or are not willing to work at the ~~ex~~ existing wage rate.

• Involuntary Unemployment: It refers to that situation when some people are not getting work, even when they are willing to work at the existing wage rate.

→ In this situation economy fails to create enough jobs because planned output is lower than the potential output (full employment output), due to lack of AD.

→ Problem of unemployment refers to the the problem of involuntary unemployment, not the problem of voluntary unemployment.

➤ Full employment and Natural Unemployment

- **Full Employment:** It refers to a situation when all those who are able to work and willing to work at the existing wage rate are getting work.

- **Natural Unemployment:** Situation of full employment does not mean 'zero unemployment'.

→ There always exist some degree of unemployment, called 'natural unemployment'.

→ It is a minimum rate of unemployment that always exist in the economy.

→ It is a situation of 'frictional and structural unemployment'

► **Frictional Unemployment:** It is the unemployment related to shifting from one job to another.

→ It occurs due to shortage of raw materials and power, lack of information about opportunities of employment, shifting of workers from one job to another, etc.

► **Structural unemployment**: It is the unemployment that results from long-term decline of certain industries due to change in production technology.

It occurs due to these situation:

- ① When labour lack expertise (not experience) for new emerging industries.
- ② When there is change in production technique.

* PROBLEM OF DEFICIENT DEMAND

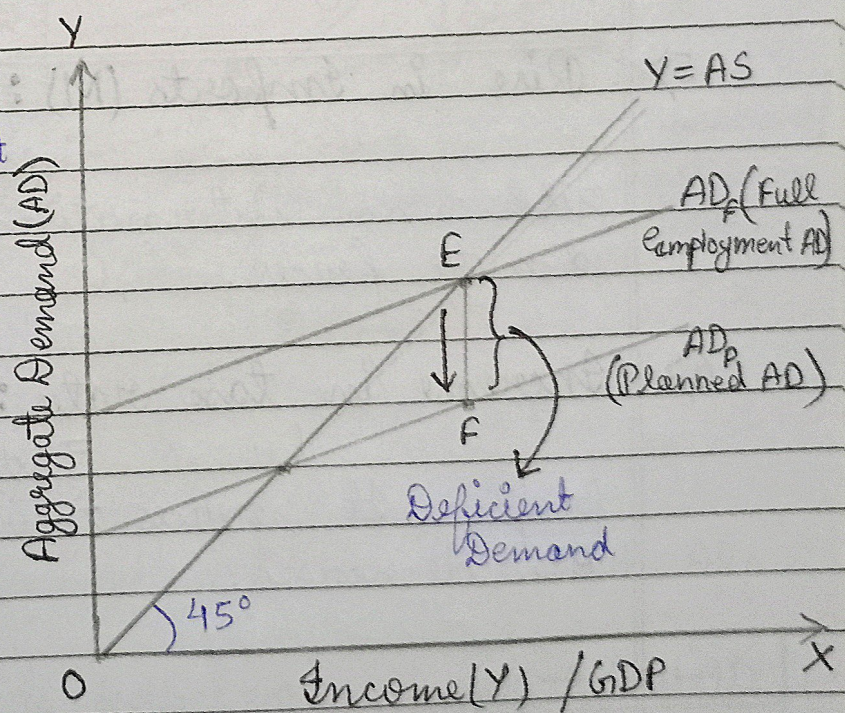
► **Deficient Demand**: It refers to a situation when aggregate demand (AD) is less than aggregate supply (AS) corresponding to full employment in the economy. $AD < AS$

- AD is deficient when it is lower than what is required for the fuller utilization of resources.
- AD is deficient when there is excess capacity in the economy.

→ AD_F = Required level of AD for full employment in the economy.

→ AD_P = Planned AD which is lower than full employment AD.

→ Difference between AD_F and AD_P = Deficient Demand (EF)



→ Causes of Deficient Demand

- 1) Reduction in Private Consumption Expenditure (C): The most common cause of decrease in private consumption expenditure is reduction in propensity to consume or increase in propensity to save.
- 2) Reduction in Private Investment Expenditure (I): Investment expenditure decreases situation of poor business expectations.
- 3) Reduction in Government Expenditure (G): The government may cut its consumption or investment expenditure due to budgetary constraints (limited).
- 4) Decline in exports (X): Fall in exports implies fall in expenditure on the domestically produced goods and services.
- 5) Rise in Imports (M): Imports are negative component of AD. Imports may rise when international prices are lower than domestic prices.
- 6) Increase in tax rates: Increase in tax means lesser (remaining) disposable income with the people. It reduces their capacity to spend. As, AD decreases.

Consequences of Deficient AD

Four situation in the economy

Underemployment
equilibrium

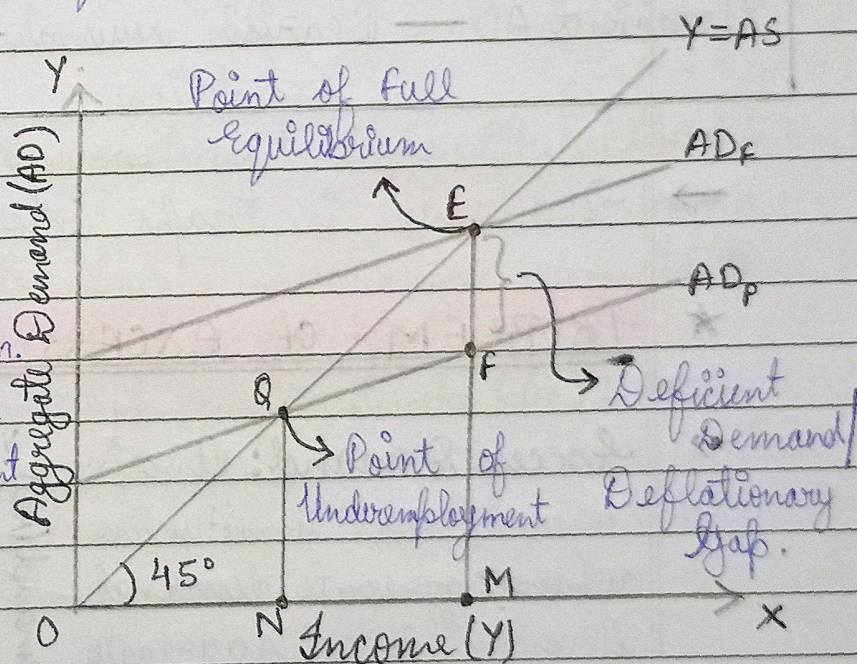
Deflationary
Gap

Undesired
Stocks

Loss of
Profits

1) Underemployment equilibrium:

- Due to deficient AD, producers are not able to fully utilize their capacity.
- Planned output is less than potential output.
- So, underemployment equilibrium is struck in the economy.
- Deficient Demand = EF
- Due to deficient demand, equilibrium struck at point Q . This is underemployment equilibrium.
- Underemployment equilibrium GDP is $<$ full employment equilibrium GDP.



2) Deflationary Gap

- Deficient demand causes 'deflationary gap' in the economy.
- Deflationary gap = deficient demand.
- It is measured as difference between AD_f and AD_p .

Low AD $\rightarrow$ Low Investment $\rightarrow$ Low Output $\rightarrow$ Low Income $\rightarrow$ Low AD

3) Undesired stock

- In case of deficient AD, producers are not able to sell all that they plan to sell.
- It leads to undesired stock.
- Clearance of undesired stock leads to
 - (i) Fall in prices.
 - (ii) Fall in planned output for the year ahead.
- It causes 'deflationary spiral' in the economy.

4) Loss of Profits

- Deficient demand causes loss of profits.
- Reason:
 - ① Producers are not able to clear their stocks.
 - ② To clear undesired stocks, producers decrease prices.

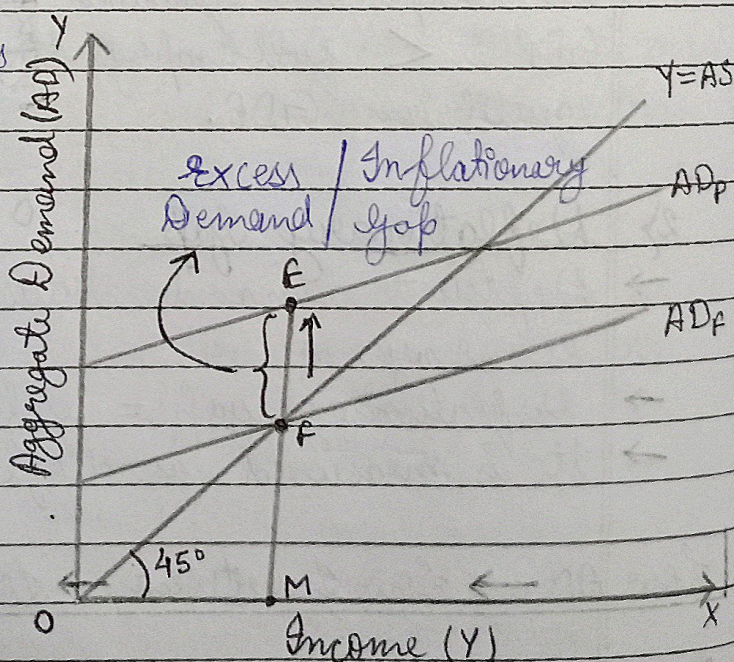
Deficient AD ———> Bearish business expectations ———> Low Investments ———> Low Output ———> Low Income & employment

- economy is traps into 'low level equilibrium trap'

★ PROBLEM OF EXCESS DEMAND

- > Excess Demand: It refers to situation when aggregate demand is more than aggregate supply corresponding to full employment in the economy.

$$AD > AS$$



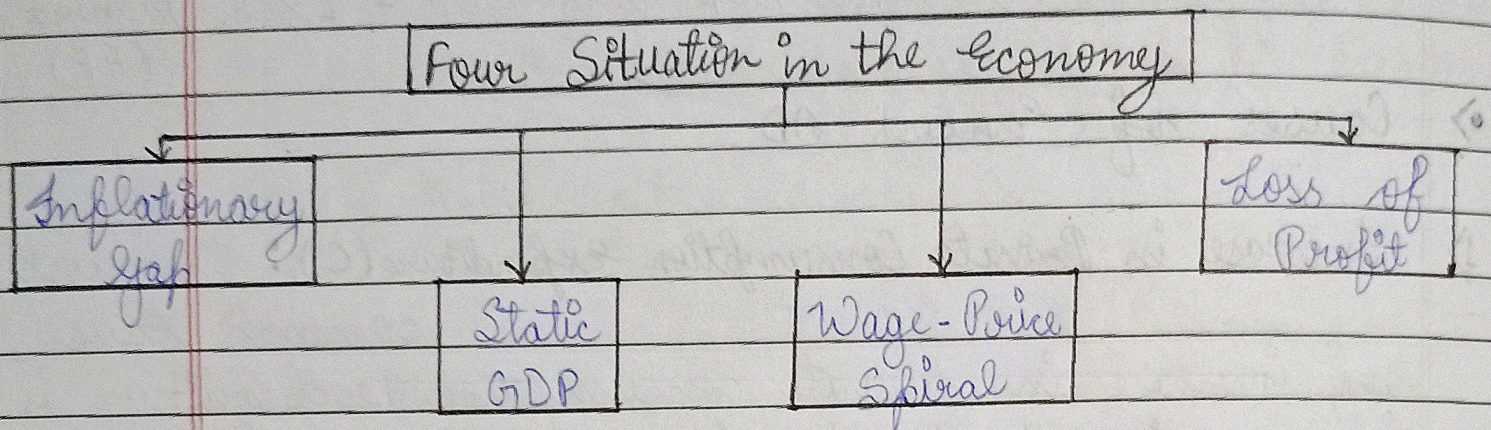
- AD is excess when it is more than what is required for the fuller utilization of resources.
- AD_F = Required level of AD for full employment in the economy.
- AD_P = Planned AD which is higher than full employment AD.
- Difference between AD_F and AD_P = Excess Demand (EF)

→ Causes of Excess AD

- 1) Increase in Private Consumption expenditure (C): The most common cause of increase in private consumption expenditure is increase in propensity to consume or decrease in propensity to save. MPC increases due to demonstration effect.
- 2) Increase in Private Investment expenditure (I): Investment expenditure increases due to 'bullish' business expectations.
- 3) Increase in Government expenditure (G): It increases when government spends more on development as well as welfare projects.
- 4) Increase in Exports (X): It is due to ^{lower} domestic prices in relation to international prices.
- 5) Decrease in Imports (M): It is due to higher international prices compared with domestic prices.

6) Decrease in Tax Rates: Decrease in tax rates means higher ~~dispos~~ disposable income with the people.

→ Consequences of Excess Demand



1) Inflationary gap

- Excess demand causes 'inflationary gap' in the economy.
- Inflationary gap = Excess Demand
- It is measured as the difference between 'planned AD which is beyond full employment' and 'AD corresponding to full employment'.
- In a situation of excess demand, the level of output cannot rise because factors of production are already fully employed and technology is assumed to be constant.

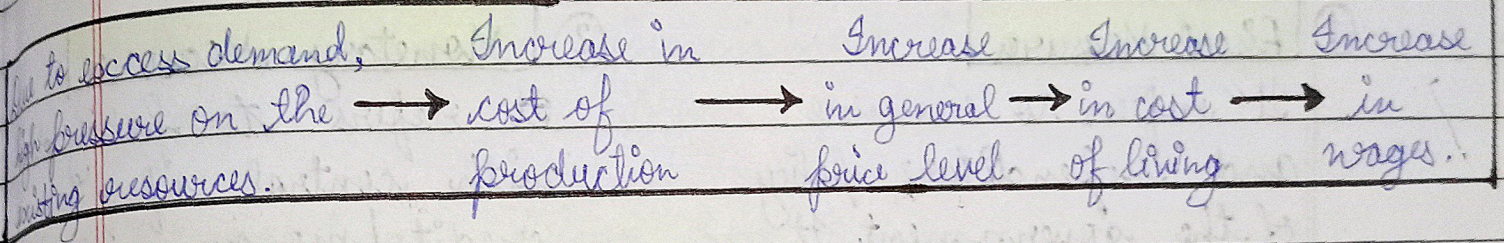
2) Static GDP

- Even when the level of AD is higher than its full employment level, the level of GDP does not rise. It remains constant.
- Because resources are already fully employed. There is no excess capacity in the economy.

- We are referring to real GDP, not nominal GDP.
- excess demand leads to rise in general price level implies rise in nominal GDP.
- In a situation of excess demand, quantum of goods and services produced remains constant, market value of goods and services rise.

3) Wage-Price Spiral

- excess demand causes wage-price spiral.
- The economy is driven into a situation of hyper inflation.



4) Loss of Profits

- Due to lack of excess capacity, producers are not able to rise their supplies.
- There is loss of profit due to unfulfilled demand in the economy.
- It generates inflationary spiral in the economy.

→ Difference between Inflationary and Deflationary gap.

Basis	Inflationary gap	Deflationary gap.
Meaning	Excess of AD over and above its level required for full employment equilibrium in the economy.	Deficiency of AD from the level of required to maintain full employment equilibrium in the economy.

Causes	$AD > AS$	$AD < AS$
Impact on Output	Level of output does not rise (OM)	Level of output is less than that at full employment.
Impact of Employment	There is no unemployment.	There is unemployment.
Overall Impact	It leads to wage-price spiral, but GDP remains constant.	It leads to low level of equilibrium trap.

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MEASURES TO CORRECT DEFICIENT / EXCESS DEMAND

① Fiscal Measures

It refers to revenue and expenditure policy of the government. It is called budgetary policy of the government.

② Monetary Measures

It refers to policy deal with control of flow credit / money supply in the market by RBI.

1) Fiscal Measures

(i) Government Expenditure

- Deficient Demand → Government ~~increases~~ ^{decrease} its expenditure
- Excess Demand → Government increases its expenditure

→ Types of government expenditure

- Expenditure on education and public welfare programs.
- On defence and maintenance of law and order.
- On public works programmes.
- On subsidy to the producers.

Taxes

→ Tax is a compulsory payment made to the government by the households and producers.

- Deficient Demand → Government decreases tax rates
- Excess Demand → Government increases tax rates.

Public Borrowings / Debts

→ By borrowing from public, the government creates public debt.

- Deficient Demand → Government reduces its borrowing from public.
- Excess Demand → Government increases its borrowing from public.

Borrowings from RBI

→ Government increases its borrowings from RBI to fight deflationary gap, and reduces to fight inflationary gap.

- Deficient Demand → Government ↑ borrowings from RBI
- Excess Demand → Government ↓ borrowings from RBI.

Monetary Measures

(i) **Bank Rate** : It is the rate of interest at which RBI lends money to the commercial banks.

- Deficient Demand → Bank rate ↓
- Excess Demand → Bank rate ↑

- (ii) **Repo Rate**: The rate at which the RBI offers short period loans to the commercial banks by buying the government securities in the open market.
- Deficient Demand $\rightarrow$ Repo rate decreased.
 - Excess Demand $\rightarrow$ Repo rate increased.
- (iii) **Reverse Repo rate**: The rate at which RBI accepts deposits from the commercial banks (through government securities).
- Deficient Demand $\rightarrow$ Reverse Repo rate is $\downarrow$
 - Excess Demand $\rightarrow$ Reverse Repo rate is $\uparrow$
- (iv) **Cash Reserve Ratio (CRR)**: It refers to bank's total deposits required to be kept with RBI.
- Deficient Demand $\rightarrow$ CRR is decreased
 - Excess Demand $\rightarrow$ CRR is increased
- (v) **Statutory Liquidity Ratio (SLR)**: Every bank is required to maintain a fixed percentage of its assets in the form of liquid assets.
- Deficient Demand $\rightarrow$ SLR is decreased
 - Excess Demand $\rightarrow$ SLR is increased
- (vi) **Open Market Operations**: It refers to sale and purchase of securities in the open market by RBI on behalf of the government.
- Deficient Demand $\rightarrow$ Securities are purchased by RBI to inject liquidity into the economy.
 - Excess Demand $\rightarrow$ Securities are sold by RBI to soak liquidity.

(vii) **Margin Requirement**: It refers to difference between current value of securities offered for loan and the value of loan granted.

- Deficient Demand $\rightarrow$ Margin requirement $\downarrow$
- Excess Demand $\rightarrow$ Margin requirement $\uparrow$

(viii) **Moral Pressure**: It means rendering an advice to commercial banks by RBI to follow its directives.

- Deficient Demand $\rightarrow$ It is built on commercial banks ~~try~~ to be liberal in lending.
- Excess Demand $\rightarrow$ It is built on commercial banks to be strict in lending.

(ix) **Credit Rationing**: It refers to fixation of credit quotas for different business activities.

- Deficient Demand $\rightarrow$ Credit rationing is withdrawn.
- Excess Demand $\rightarrow$ Credit rationing is introduced.

	Monetary Policy	Fiscal Policy
Meaning	Policy of correcting excess or deficient demand by controlling the supply of credit (money).	Policy of correcting excess or deficient demand by managing revenue and expenditure of government.
Implementation	Central bank (RBI in India)	Government
Tools	Bank rate, Repo rate, CRR, SLR, etc.	Government expenditure, taxes, etc.