Questions for Review

1. Explain the concept of multiplier with the help of a suitable example.
2. What are the important leakages in the multiplier?
3. What is the importance of multiplier in economic theory?
4. Write five assumptions of multiplier.
5. What is hoarding?

22 EXCESS AND DEFICIENT DEMAND

MEANING OF EXCESS DEMAND

Excess demand is a situation when aggregate demand exceeds aggregate supply at the full employment level of income. The difference between aggregate demand and supply at the level of full employment is called the 'inflationary gap'. Inflationary gap in the economy exists when planned expenditure is greater than the value of available output produced by making full use of resources. It is to note that an increase in demand beyond the equilibrium level of full employment does not increase the output and employment but only prices. Fig. 22.1 illustrates excess demand in the economy. It is seen that aggregate demand exceeds aggregate supply at full employment level OY by AB length. This gap is called inflationary gap, where aggregate demand is AY and aggregate supply is BY. Aggregate demand AY > aggregate supply BY. Therefore, AY – BY = AB (inflationary gap).

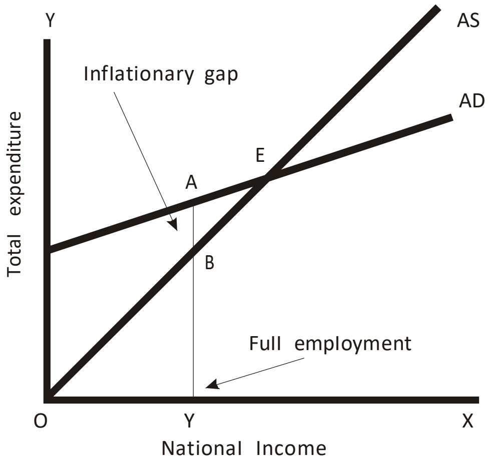

Fig. 22.1

Impact of Excess Demand in the Economy

If the economy has involuntary unemployment, an increase in demand will increase employment and output. Once the economy reaches full employment level and demand is further increased, it will lead to rise in prices, i.e., an inflationary situation in the economy. Output and employment cannot be increased. An increase in productivity of labour could to some extent increase output but this is not generally considered in short period analysis of business cycle.

MEANING OF DEFICIENT DEMAND

Deficient demand is a situation when aggregate demand is less than aggregate supply of goods and services at the full employment level of income. It is also termed as the 'deflationary gap'. Deflationary gap in the economy causes large scale unemployment. It comes to exist in the economy when demand for goods and services do not match the level of good and services available. It falls short rather.

The adjacent Fig. 22.2 explains deficient demand in the economy. It is seen that aggregate demand falls short of aggregate supply at full employment level OY by CD length. This gap CD is called deflationary gap, where aggregate demand is DY and aggregate supply is CY. Aggregate demand DY < aggregate supply CY. Therefore, CY – DY = CD (deflationary gap).

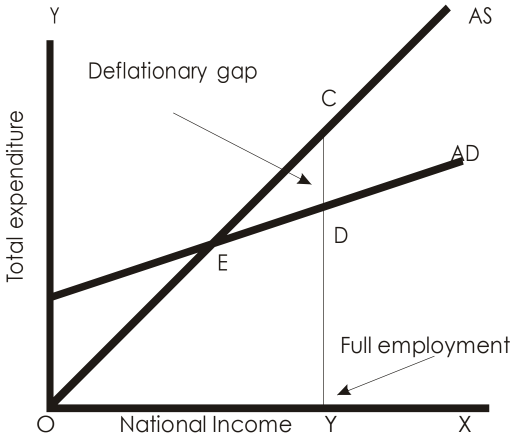

Fig. 22.2

Impact of Deficient Demand in the Economy

The impact of deficient demand may be analyzed in three respects—impact on output, employment and prices. However, one should note that its impact depends upon various factors, important among these are:

1. The structure of the economy—competitive or oligopolistic;
2. Elasticity of supply of factors of production;
3. Influence of trade unions.

In case the economy is competitive (large number of produces); a fall in the aggregate demand will result in a quick fall in prices of goods and services. But if the economy is oligopolistic (a few sellers dominating the market) in nature, then prices will not be much affected as employment and output are. Employment and output may get reduced in such an economic structure.

UNIT-8

Elasticity of supply of the factors of production also affects output, employment and prices in the economy. If the economy is competitive, and supply of factors is perfectly elastic (slight changes in price leads to infinite change in factors supply), prices will not be affected. This is because a change in demand will be matched by a change in output and employment. But if the supply of factors is inelastic, prices generally fall depending upon the extent of inelasticity of factors.

Trade unions' influence is also noteworthy. Trade unions may not accept lower wages. In other words, if wages are prevented to fall with the fall in aggregate demand, the producers will be compelled to reduce the level of output and employment.

CAUSES OF EXCESS AND DEFICIENT DEMAND

The following are the important factors that cause excess or deficient demand in the economy:

(i) An increase in government expenditure (spending), which is not matched by a corresponding increase in taxation. Deficient demand may be caused if the government expenditure falls short of the revenue.

(ii) Increase in autonomous investment (due to past savings) without any increase in current savings. And no corresponding increase in taxation. Reduction in autonomous investment may lead to deficient demand.

(iii) Increasing surplus on the balance of payments. Increasing deficits on the balance of payments may result in deficient demand.

(iv) If available resources are used for the production of goods other than consumer goods, it will result in the fall in the supply of consumer goods and services. The available output will not be sufficient to match the aggregate demand, i.e., there will be excess demand. Conversely, deficient demand will occur due to cut in capital formation.

MEASURES TO CORRECT EXCESS AND DEFICIENT DEMAND

There are generally the following ways to come out of excess or deficient demand:

1. Fiscal Policy
2. Monetary Policy
3. Foreign Trade Policy

Let us explain these in brief.

Fiscal Policy

This is referred to as government expenditure and taxation policy. Fiscal policy influences aggregate demand significantly. In a situation of excess demand, it may help if there is cut in the government expenditure — to reduce budgetary deficit — and rise in incomes/revenues through ways that are not inflationary such as progressive taxation and borrowing.

Government may reduce expenditure on public works programmes such as road building, rural electrification etc; investment in public health and education, defence, internal administration and maintenance of state.

Borrowing will reduce purchasing power of people and as a result reduce effective demand. Similarly taxation withdraws purchasing power from circulation and reduces the effective demand.

Deficient demand can be corrected by increasing government expenditure and increased budgetary deficit met through the creation of more money and other inflationary ways. Taxes, particularly the corporate and income taxes may be cut down to increase effective demand by encouraging private investment. In times of depression, government expenditure on transfer payments such as unemployment subsidies, tax receipts etc go down automatically. Vigorous public works programmes may be undertaken to generate more demand.

Monetary Policy

Monetary policy refers to the policy through which the monetary authority expands or contracts the money supply in the economy. In other words, it relates to changes in the rate of interest and the availability of credit in the economy.

Higher rate of interest means costlier credit, which discourage effective demand. Investors get discouraged as borrowing becomes costlier. As a result excess demand gets reduced.

A lowering rate of interest, on the other hand, makes borrowing cheaper. Investors are encouraged to borrow more. If marginal efficiency of capital remains constant, the low rate of interest will increase the level of investment. Thus, deficient demand in the economy tends to be corrected.

Availability of Credit

Commercial banks create credit in the economy. To influence availability of credit, bank credit needs to be influenced. Important monetary tools that are available with the central bank of a country to control credit are explained as under:

1. **Cash reserve ratio:** Every commercial bank in a country is required to maintain a minimum percentage of its total deposits in the form of cash with the central bank. If the central bank increases this ratio, the cash reserves with the commercial banks get reduced. As a result they are forced to contract credit. Thus excess demand in the economy is also reduced.

   In case of deficient demand, where the objective is to expand credit, the cash reserve ratio is lowered by the central bank. This will increase cash availability with the commercial banks and they can lend more and create more credit.

2. **Bank rate:** Bank rate is the rate at which central bank lends money to commercial banks. If this rate is raised, cost of borrowing increases as interest rate rises. This results in credit contraction.

   In the situation of deficient demand, bank rate is lowered. When the bank rate is lowered, costs of borrowing get reduced as interest rate decreases. This results in credit expansion in the economy. This is because businessmen will now borrow more than before.

3. **Open market operations:** Open market operations refer to sale and purchase of government securities in the open market by the central bank. These operations have

an effect on the volume of cash reserves and hence the overall cost and availability of credit. At the times of excess demand, central bank sells these securities which are generally purchased by commercial banks or by their customers. Sale of government securities reduces the cash reserves with the banks, which reduces lending power of the banks and thereby forces to decline deposits.

Purchase of securities by the central bank increases the cash reserves with the commercial banks. In this case, money flows from governments' hands to commercial banks and their customers. This expands deposits and hence credit. Thus deficient demand gets corrected.

4. **Changing margin requirements:** Margin requirement is the percentage down payment on borrowing to finance purchase of stock by firms. For example, if central bank fixes a 30 percentage margin on the value of a security worth Rs. 20000, then commercial banks can lend Rs. 6000 only to the holder of the security. To correct excess demand, central bank raises the margin requirement. When margin requirements are raised, credit borrowed for speculative purposes is discouraged. This results in downswings of economic activity and thus, has a disinflationary impact. To correct deficient demand central bank lowers the margin requirement.
5. **Moral suasion:** Moral suasion is the method of persuasion, request, advice and suggestion to the commercial banks by the central bank of a country. Central bank arranges the meeting of the heads of the commercial banks and clarify them the need for implementation of a particular monetary policy and requests them to follow this policy. This is effective in both cases — excess demand and deficient demand.

Foreign Trade Policy

Foreign trade generally relates to exports and imports of a country. Excess and deficient demand can be influenced substantially by adopting a favourable foreign trade policy.

Additional exports increase incomes directly and enlarge spending. But additional incomes also create demand for imports. Thus, income generated in the economy is partly spent on goods produced by other economies and imported into the country. To this extent the excess demand will be reduced.

To correct excess demand i.e., to reduce inflationary gap, an economy can create and increase the size of its imports surplus (excess of imports over exports).

Import surplus can be created or increased by selling a country's holdings of foreign assets; raising loans from foreign governments or other international institutions such as IMF, World Bank etc., and through receipt aid from other countries in the form of grants.

An inflationary situation can be brought under control by preventing wage to increase and increasing output by fuller use of existing idle (inactive) capacities. Wage increase matched by an increase in productivity of labour is desirable as it also improves supply position. But when wage increase is without corresponding increase in productivity, then it leads to increase in costs and prices.

In an inflationary situation, an increase in production through increased investment is not advisable as it will only increase prices further. If large under-utilized capacity in the industrial