O. P. JINDAL SCHOOL, RAIGARH (CG) 496 001, INDIA

Phone: 07762-227042, 227293, (Extn. 227001 - 49801, 02, 04, 06, 09); Fax: 07762-262613; website: www.opjsrgh.in; e-mail: opjsraigarh@jspl.com

CLASS: XII ECONOMICS

Excess demand and deficient demand

The problems of excess demand and deficient demand occur when the current aggregate demand is more or less than the aggregate demand required for full employment equilibrium.

These problems can be solved by bringing a change in the level of aggregate demand in the economy. There are number of measures to control excess and deficient demand.

Some of the measures to rectify the situation of excess demand and deficient demand are:

1. Fiscal policy 2. Monetary Policy 3. Export Promotion

Deficient demand, i.e., aggregate demand falling short of 'output at full employment level' causes great impact.

It leads to depression marked by overproduction, rise in unemployment, and fall in prices and income, and idleness of resources. It indicates deflationary gap which hurts employers and adversely affects productive activity.

With fall in price, employers reduce wages leading to conflicts and lockouts. Such a situation must be avoided. Hence, there is great need to close the deflationary gap. Aggregate demand has to be increased by an amount equal to deflationary gap.

To rectify excess demand should be attempted in the reverse direction to remedy the situation of deficient demand. Some of the important measures to remedy deficient demand are discussed below:

1. Increase investment and reduce taxes:

Fiscal policy comprises of expenditure policy and taxation policy of the government.

Government has legal powers to impose taxes and to spend. The object of fiscal policy is to increase aggregate demand.

Main tools of fiscal policy are:

(i) Expenditure policy (ii) Revenue policy

(iii) Deficit financing (iv) Public borrowing.

(i) Expenditure Policy (Increase expenditure):

The objective of expenditure policy should be to pump more money in the system that gives a fillip to the demand. During period of deficiency in demand, the government should make large investments in public works like construction of roads, bridges, buildings, railway lines, canals and provide free education and health facilities, although it may enlarge budget deficit. The aim is to give more money in the hands of people so that they should also spend more. Keynes in fact advocated deficit budget to step up aggregate demand.

(ii) Revenue Policy (Reduce tax rate):

Taxes on personal incomes and corporate incomes should be reduced to encourage private consumption and investment. If possible, tax on lower income groups is abolished. This will increase their disposable income for spending. In addition, subsidies, old-age pension, unemployment allowance and grants should be given. Incentives like interest free loans, instalment schemes, etc. should be given to consumers to boost aggregate demand.

(iii) Deficit financing (Printing of currency/notes) should be encouraged.

(iv) Government borrowing from public should be discouraged so as to increase aggregate demand.

Practice questions

Q1Whether the following changes by the Reserve Bank will increase the money supply or decrease the money supply ?

(i) Rise in Bank rate.
(ii) Purchase of Securities in the open market.
(iii) RBI increases the margin from 20% to 30%.
(iv) RBI reduces the Cash reserve ratio

Q 2 Name the monetary measure indicated in the following statements. Also indicate, whether the following measures will be adopted during excess demand or deficient demand.
(i) RBI starts selling Government securities to the public.
(ii) Instead of 80%, now 90% of the security amount will be given as loan.
(iii) It resulted in increase in interest rate charged by commercial bank from the borrowers.
(iv) RBI advised SBI to stop advertising for home loans in order to discourage lending.
(v) Central bank reduces the amount of time and demand deposits required to be kept as reserves.
(vi) RBI instructed not to advance loans to people with income above 5 lakhs per annum.

Q 3 What is inflationary gap ?

Or

When does inflationary gap arise ?

Q 4 Name two policies to combat the problems of deficient and excess demand.

Q 5 What is fiscal policy ?

Q 6 What does deflationary gap measure ?

Q 7 How does excess demand affect output and price ?

Or

What happens to the price level when there is excess demand ?

Q 8 What happens to economy's output, income and employment when there is a deficient demand ?

Q 9 What is the relation between MPC and MPS?

Q 10 If APC is 0.7 then how much will be APS?

Q 11 When can the APC be equal to one? Give reason for your answer.

Q 12 Can the average propensity to consume be greater than one? Give the reason for your answer.