Inflationary Gap and Deflationary Gap

HS202

Inflationary Gap

- Inflationary gap occurs when aggregate demand (AD) exceeds aggregate supply (AS) at full employment level of output.

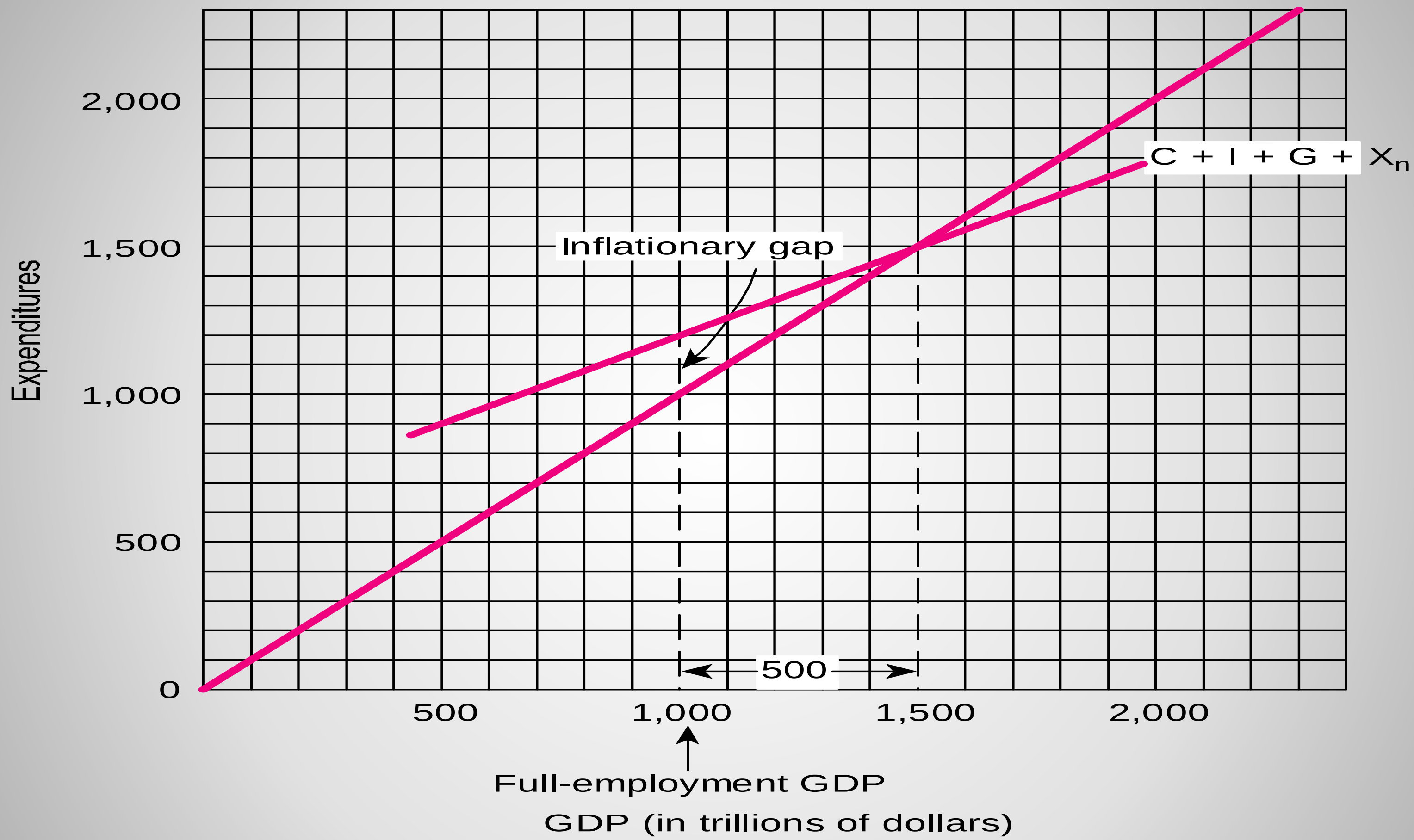
  In this case, money income rises to a higher equilibrium, but real income (being at full employment output level) remains unchanged.

  As a result, there is an upward rise in prices because the consumers compete for limited supply of output and bid prices up.

  Inflationary gap reflects that at full employment level of output, real income cannot rise, but the prices rise to the extent that AD > AS at full employment.

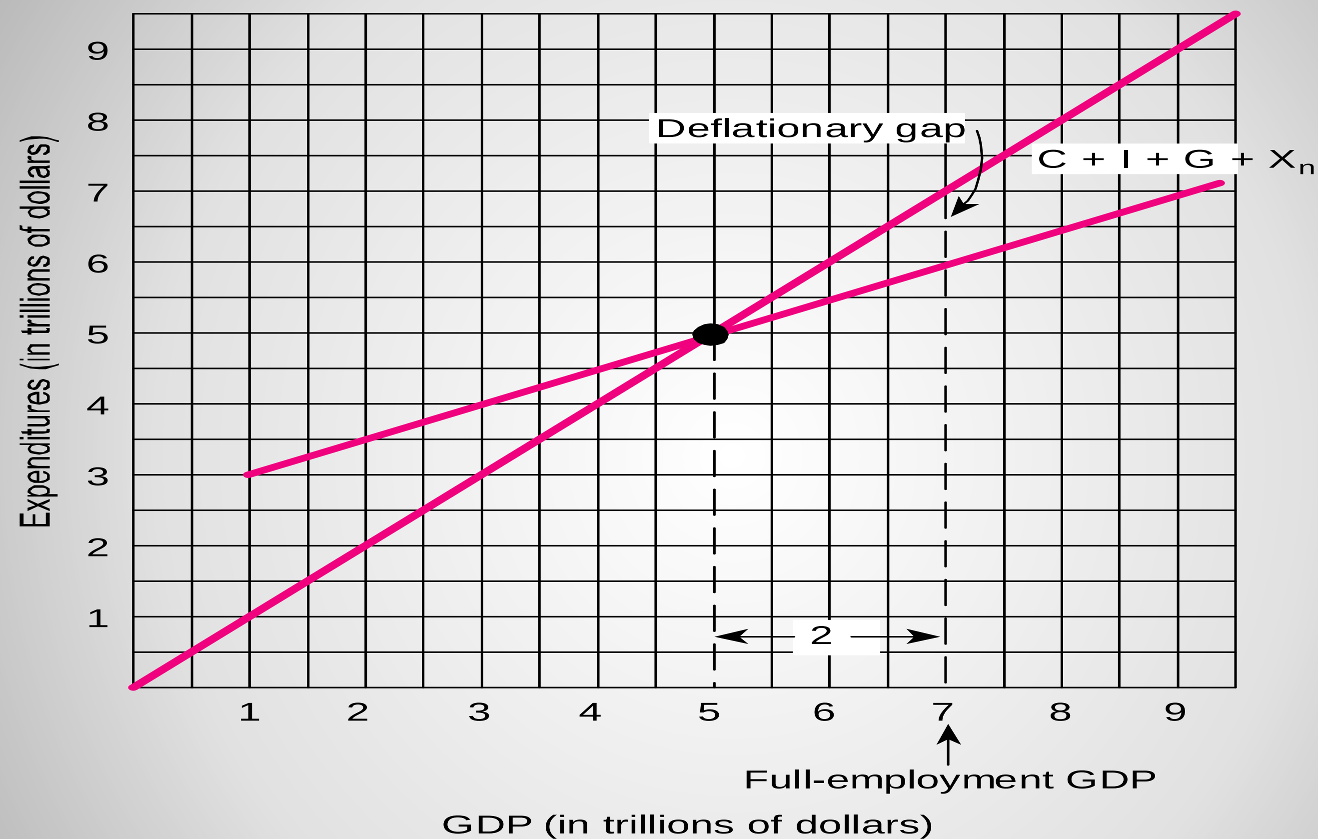
Deflationary gap

- Deflationary gap prevails when aggregate demand (AD) is less than aggregate supply (AS) at full employment level of output.
- In this case, income equilibrium occurs while some resources are unemployed.
- In other, words, deflationary gap depicts unemployment situation attributable to the fact that at full employment level of output, AD <AS.



Expenditures
2,000
1,500
1,000
500
0
C + I + G + X_n
Inflationary gap
500
500
1,000
1,500
2,000
Full-employment GDP
GDP (in trillions of dollars)

I G


Expenditures (in trillions of dollars)
9
8
7
6
5
4
3
2
1
Deflationary gap
C + I + G + X_n
2
1
2
3
4
5
6
7
8
9
Full-employment GDP
GDP (in trillions of dollars)

DG