Equilibrium and Disequilibrium in the Economy

PART 1

Objective Questions

• Multiple Choice Questions

1. In the AD-AS model, the level of aggregate demand can influence the level of output.

(a) If and only if aggregate supply has a positive relationship with the price level
(b) If and only if the price level is constant
(c) If and only if aggregate supply is not invariant with changes in the price level
(d) If and only if aggregate supply is invariant with changes in the price level

Ans. (a) In the model, aggregate demand = aggregate supply. The level of aggregate demand can influence the level of output only if aggregate supply has a positive relationship with the price level

2. When does a situatioin of deficient demand arise in an economy?

(a) AD > AS (b) $S > I$
(c) AD < AS (d) $S < I$

Ans. (c) Deficient demand arises when AD is short of AS corresponding to full employment in the economy.

3. If an individual deposits a sum of money in a bank, then the amount of traditional credit that the banking system can create is

(a) fraction of that sum defined by the cash reserve ratio
(b) a fraction of that sum defined by the statutory liquidity ratio
(c) a multiple of the sum defined by the cash reserve ratio
(d) None of the above

Ans. (d) The process of credit creation is a multiple of that sum defined by the sum of cash reserve ratio and statutory liquidity ratio.

4. The main cause(s) of deficit demand is/are

(a) decrease in money supply
(b) increase in public expenditure
(c) decrease in investment demand
(d) Both (a) and (c)

Ans. (d) Deficit demand occurs due to fall in government expenditure, fall in level of autonomous investment, fall in supply of money and credit and decrease in marginal propensity to consume.

5. …… refers to selling of government approved securities by RBI to general public and commercial banks in case of excess demand.

(a) Bank rate
(b) CRR
(c) SLR
(d) Open market operation

Ans. (d) Open market operation

6. In order to correct the situation of excess demand

(i) cost of credit is raised
(ii) availability of credit is raised
(iii) availability of credit is reduced

Alternatives

(a) Only (iii)
(b) Only (i)
(c) Both (i) and (iii)
(d) (i), (ii) and (iii)

Ans. (c) Both (i) and (iii)

7. By increasing the tax burden on the producers, the government intends to

(i) correct the situation of inflationary gap
(ii) correct the situation of excess demand

Which statement is true?

(a) Both (i) and (ii)
(b) Only (i)
(c) Only (ii)
(d) None of the above

Ans. (a) Both (i) and (ii)

8. In case of an underemployment equilibrium, which of the following alternative is not true? **(CBSE 2020)**

(a) Aggregate demand is equal to aggregate supply.
(b) There exist excess production capacity in the economy.
(c) Resources are not fully and efficiently utilised.
(d) Resources are fully and efficiently utilised.

Ans. (d) Resources are fully and efficiently utilised.

9. Match the following.

Column I	Column II
A. Inflationary gap	(i) Boom, recession, depression, recovery
B. Deflationary gap	(ii) Excess demand
C. Taxation	(iii) Deficit demand
D. Business cycle	(iv) Revenue policy

Codes

	A	B	C	D		A	B	C	D
(a)	(i)	(ii)	(iii)	(iv)	(b)	(ii)	(iii)	(iv)	(i)
(c)	(iii)	(ii)	(iv)	(i)	(d)	(ii)	(iii)	(i)	(iv)

Ans. (b) (ii) (iii) (iv) (i)

10. To reduce credit availability in the economy, the central bank may .... **(CBSE 2020)**

(a) buy securities in the open market
(b) sell securities in the open market
(c) reduce reserve ratio
(d) reduce repo rate

Ans. (b) sell securities in the open market

11. The Cash Reserve Ratio (CRR) refers to

(a) the liquid cash that banks have to maintain with the Reserve Bank of India as a certain percentage of their demand and time deposits.
(b) the cash that banks have to keep in their vaults in order to meet sudden demand from depositors in times of crisis.
(c) the cash that households have to keep in reserve to meet sudden increases in the price of essential goods and services.
(d) the cash that the government keeps in reserve so as to be ready to meet unexpected contingencies.

Ans. (a) Cash Reserve Ratio (CRR) refers to the liquid cash that banks have to maintain with Reserve Bank of India as a percentage of their demand and time deposits.

12. The money multiplier in an economy increases with

(a) increase in cash reserve ratio
(b) increase in statutory liquidity ratio
(c) increase in banking habits of the population
(d) increase in the population of the country

Ans. (c) Money multiplier in an economy increases with the increase in the banking habits of the population. It measures the amount of money that commercial banks would create out of their deposits after keeping certain fractions as reserve. So, as the banking habits of the people increase, the deposits will also increase leading to an increase in the value of money multiplier.

13. Which of the following is not a tool of monetary policy?

(a) Tax rate
(b) Interest rate
(c) Cash reserve ratio
(d) Open market operations

Ans. (a) It is not a tool of monetary policy as it does not affect the demand and supply of money.

14. The central bank can increase availability of credit by **(CBSE 2018)**

(a) raising repo rate
(b) raising reverse repo rate
(c) buying government securities
(d) selling government securities

Ans. (c) buying government securities

15. Which fiscal measure should be adopted for correcting deficient demand?

(a) Government should spend more on public works.
(b) Taxation should be reduced.
(c) Public debt should be reduced.
(d) All of the above

Ans. (d) All of the above

16. Match the following.

Column I	Column II
A. Corrective measure for deficient demand	(i) Deficit demand
B. Qualitative method of controlling credit	(ii) Credit rationing
C. Inflationary gap shows the measurement of	(iii) Monetary measures

Codes

	A	B	C		A	B	C
(a)	(i)	(ii)	(iii)	(b)	(iii)	(ii)	(i)
(c)	(iii)	(i)	(ii)	(d)	(ii)	(iii)	(i)

Ans. (b) (iii) (ii) (i)

17. With which component of monetary policy, central bank tries to attain economic stability in the country?

(a) Supply of money
(b) Interest rate
(c) Availability of money
(d) All of these

Ans. (d) Supply of money, interest rate and availability of money.

18. Inflationary gap shows the measurement of

(a) deficit demand
(b) surplus demand
(c) full employment
(d) None of the above

Ans. (a) deficit demand

• Assertion-Reasoning MCQs

Directions (Q.Nos. 1 to 7) *There are two statements marked as Assertion (A) and Reason (R). Read the statements and choose the appropriate option from the options given below*

(a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
(b) Both Assertion (A) and Reason (R) are true, but Reason (R) is the not the correct explanation of Assertion (A).
(c) Assertion (A) is true, but Reason (R) is false.
(d) Both the statement are false.

1. **Assertion** (A) AS increases proportionate to the increase in AD as long as there is excess capacity in the economy.

Reason (R) Excess capacity arises because of the deficiency of demand, so that as demand increases, supply increases proportionately.

Ans. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

2. **Assertion** (A) In a situation of deficient demand, there is underemployment equilibrium in an economy.

Reason (R) Owing to deficient AD, equilibrium between desired AD and desired AS is struck at a lower level of GDP, lower than the full employment in an economy.

Ans. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

3. **Assertion** (A) During periods of economic downturn, Central Bank raises cash reserve ratio as a monetary policy tool to stabilise the economy.

Reason (R) This in turn will increase the credit creation power of the commercial banks and thus reduces the level of AD in an economy.

Ans. (d) Central Bank decreases CRR during periods of recession which in turn will increase the credit creation power of commercial banks and thus expand the level of AD in the economy.

4. **Assertion** (A) Fiscal policy focuses on both the principles of economic growth and stability.

Reason (R) Stability is achieved by correcting the situation of inflationary and deflationary gap, while growth is achieved by way of lower taxation and higher subsidies to the producers.

Ans. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

5. **Assertion** (A) During the pandemic, income of the people have fallen and as a result there has been a reduction in aggregate demand.

Reason (R) According the Keynesian economics, government should follow expansionary fiscal policy implying a higher level of government expenditure and lower level of taxes.

Ans. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

6. **Assertion** (A) SLR is increased to correct the situation of deflationary gap.

Reason (R) Higher SLR increases credit creation capacity of commercial banks which in turn increases liquidity in the capital market.

Ans. (d) SLR is decreased to correct the situation of deflationary gap. Lower SLR increases credit creation capacity of commercial banks which in turn would increase AD and correct the deflationary gap.

7. **Assertion** (A) During periods of economic depression, economy is caught in a low level equilibrium trap as investment in the private sector tends to slide to its bottom.

Reason (R) The government can break the deadlock of low demand side factors by pumping investment into an economy and there by raising AD till such time the private investment is revived to achieve higher level of output and employment.

Ans. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

• Case Based MCQs

1. **Direction** *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

When an economy undergoes a deflationary shock, the implications can be both positive and negative for consumers and businesses.

There is a big difference between the terms disinflation and deflation, which we will first go over before getting into the causes and effects of deflationary shocks, and how these shocks can affect the economy, consumers and businesses. Disinflation usually occurs during a period of recession and manifests itself by slowing down the rate at which prices increase; this occurs as a result of a decrease in consumer sales.

If the inflation rate drops to a lower level than before, technically that difference is disinflation. Deflation, on the other hand, can be thought as the opposite of inflation or as negative inflation and it occurs when the supply of goods or services rises faster than the supply of money.

(i) ……… helps to correct the situation of deflationary shock in a country through its credit control policy.

(a) Central bank
(b) Commercial bank
(c) Either (a) or (b)
(d) None of the above

Ans. (a) Central bank

(ii) Which of the following statements stands true during deflationary gap?

(a) Actual output falls short of potential output
(b) Potential output falls short of actual output
(c) Actual demand is less than expected demand
(d) Expected demand is less than actual demand

Ans. (c) Actual demand is less than expected demand

(iii) Which of the following steps should be taken by central bank to boost demand in the economy during deflationary gap?

(a) Decrease tax rate
(b) Deficit financing
(c) Decrease legal reserve requirements
(d) Increase foreign exchange reserve

Ans. (c) Decrease legal reserve requirements

(iv) What will be the impact on money supply during deflationary gap?

(a) Increase (b) Decrease
(c) Remain constant (d) Can't be predicted

Ans. (b) Decrease

(v) All types of physical goods imported and exported are known as .... items.

(a) visible (b) invisible
(c) Both (a) and (b) (d) None of these

Ans. (a) visible

(vi) **Assertion** (A) Excess demand raises the market value of the output.

Reason (R) In situation of excess demand, output level remaining constant, higher demand leads to a rise in the general price level, implying a situation where market value of the output increases in the economy.

Alternatives

(a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
(b) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(c) Assertion (A) is false, but Reason (R) is true
(d) Both the statements are false

Ans. (a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).

2. **Direction** *Read the following text and answer the question no. (i) to (vi) on the basis of the same.*

In the simple Keynesian model of income determination, we assume that there is no government activity in the economy. If we remove this assumption to see how the equilibrium level of income can be determined in the presence of economic activity of the government, it can be seen that, the government collects money from the economy and spends money into the economy. Government expenditures and receipts have an important effect on the economy.

Government budget has two sides viz. the expenditure side and the receipt side. Money inflows in the receipt side of the budget are of three types, i.e. taxation, public borrowing and sales of goods and services; money outflow in the expenditure side of the budget are also of three types i.e., purchase of goods and services, transfer payment and repayment of debts. Taxation is a compulsory contribution made by the people to the government against which no direct payments are made by the government.

A taxpayer becomes poorer by the amount of taxes. Hence, the income available in the hands of the people is reduced by the amount of taxes paid.

Public borrowing is made through the sale of new government bonds, which people voluntarily purchase. Neither their income nor their wealth is deduted thereby. They simply alter the form and composition of wealth in the private sector.

An increase in the net indebtedness of the government to the central bank takes place through the creation of new money by the central bank.

(i) If government increase its expenditure on infrastructural development project, how will this impact the aggregate demand?

(a) Increase
(b) Decrease
(c) Remains constant
(d) Increase in a three-sector closed economy

Ans. (d) Increase in a three-sector closed economy

(ii) What will be the impact on aggregate demand, if the government increase tax rates as it is a main source of government's revenue?

(a) Increase
(b) Decrease
(c) Remains constant
(d) Either increase or decrease

Ans. (b) Decrease

(iii) Public borrowings by the government will lead to .... money supply in the economy.

(a) increase
(b) decrease
(c) remains constant
(d) increase in a three-sector closed economy

Ans. (a) increase

(iv) Which of the following statements is/are correct?

(i) Government raises money through sale of treasury bills and other securities.
(ii) Treasury bills are considered as risk free and the return so achieved is referred as risk free rate of return.

Alternatives

(a) Both are true (b) Both are false
(c) (i) is true, but (ii) is false (d) (i) is false, but (ii) is true

Ans. (a) Both are true

(v) The Keynesian solution to deal with a problem of deficient demand or to correct recessionary gap is to
(a) enhance the level of government expenditure
(b) lower the level of taxes
(c) Both (a) and (b)
(d) None of the above

Ans. (c) Both (a) and (b)

(vi) **Assertion** (A) Central Bank buys government securities in the open market to correct the situation of inflationary gap.

Reason (R) By buying the securities, the banks soaks liquidity from the market which is required to correct inflationary gap.

Alternatives
(a) Both Assertion (A) and Reason (R) are true and Reason (R) is the correct explanation of Assertion (A).
(b) Both Assertion (A) and Reason (R) are true, but Reason (R) is not the correct explanation of Assertion (A).
(c) Assertion (A) is false, but Reason (R) is true
(d) Both the statements are false

Ans. (d) Central Bank sells government securities in the open market to correct the situation of inflationary gap. It is by selling the securities that the banks soaks liquidity from the market which is required to correct inflationary gap.

PART 2

Subjective Questions

• Short Answer (SA) Type Questions

1. Explain the concept of inflationary gap. Explain the role of repo rate in reducing this gap. **(CBSE 2015)**

Ans. **Inflationary gap** is the excess of aggregate demand over and above its level required to maintain full employment equilibrium in the economy. It causes excess demand in the economy. Owing to excess demand, price levels tend to rise without any rise in the level of income or employment in the economy.

Repo rate is the rate at which the central bank lends money to the commercial banks. To correct the situation of inflationary gap, repo rate is increased. As a follow-up action, the commercial banks raise the market rate of interest (the rate at which the commercial banks lend money to the consumers and the investors) which reduces demand for credit.

Consequently, consumption expenditure and investment expenditure are reduced implying a reduction in aggregate demand, as required to correct inflationary gap.

2. Keynesian theory tell us that inflationary gap emerges only when full employment is reached. But, in India we often find high rate of inflation along with high rate of unemployment. How can you explain this paradox?

Ans. Keynesian theory is related to the problem of developed economies. In these economies, unemployment occurs because of the lack of Aggregate Demand (AD). Lack of AD leads to a cut in planned output. Accordingly, lay-off occurs and excess capacity emerges. In such situations, increase in expenditure (implying increase in AD) would lead to increase in planned output,without any increase in the price level.

The inflationary gap would emerge only when AD continues to rise even when excess capacity is totally exhausted and full employment is reached.

In developing countries like India , unemployment occurs not because of the lack of AD, but because of the lack of production capacity or the lack of capital. Unlike developed countries, there is no excess capacity in less developed countries like India. Accordingly, price level starts rising following increase in AD, even when there is unemployment in the economy.

3. What is 'deficient demand'? Explain the role of 'bank rate' in removing it. **(CBSE 2015)**

Ans. **Deficient demand** refers to a situation when Aggregate Demand (AD) is short of Aggregate Supply (AS) corresponding to full employment in an economy.

Bank rate is the rate at which the central bank lends money to the commercial banks. To correct the situation of deficient demand, bank rate is decreased. As a follow-up action, the commercial banks lower the market rate of interest (the rate at which the commercial banks lend money to the consumers and the investors). This increases demand for credit.

Consequently, consumption expenditure and investment expenditure are increased, implying an expansion in aggregate demand, as required to correct deficient demand.

4. Explain the concept of deflationay gap and the role of 'open market operations' in reducing this gap. **(CBSE 2015)**

Ans. **Deflationay gap** is the shortfall in aggregate demand from the level required to maintain full employment equilibrium in the economy. It causes deficient demand in the economy . Owing to deficient demand, planned level of output is reduced. Along with reduction in the level of output, level of income and employment also tend to reduce. The economy is driven into a state of low level equilibrium trap.

Open market operations is the policy that focuses on increasing and decreasing the stock of liquidity (or cash balances) with the people as well as with the commercial banks, through sale and purchase of securities by the central bank. During the situation of deflationary gap, when cash balances need to be increased (to stimulate the level of aggregate demand), the central banks starts buying securities. Purchase of securities injects purchasing power into the money market.

Cash balances of the commercial banks start picking up. This enhances their capacity to create credit. Flow of credit increases, leading to increase in AD and deflationary gap is corrected.

5. What is 'excess demand'? Explain the role of 'reverse repo rate' in removing it.

Ans. **Excess demand** refers to the situation when aggregate demand is in excess of aggregate supply corresponding to full employment.

Reverse repo rate is the rate of interest at which commercial banks can park their surplus funds with the central bank, for short period of time. To correct the situation of excess demand, reverse repo rate is increased. As a follow-up action, the commercial banks will be encouraged to increase their deposits with the central bank. This, in return, will reduce their ability to lend money. Consequently, consumption expenditure and investment expenditure will be reduced, implying a reduction in aggregate demand, as required to correct excess demand.

6. What is 'deficient demand''? Explain the role of 'margin requirements' in removing this gap. **(CBSE 2015)**

Ans. **Deficient demand** refers to a situation when Aggregate Demand (AD) is short of Aggregate Supply (AS) corresponding to full employment in an economy.

Margin requirements refer to minimum down payment that the borrowers have to make as a percentage of their total borrowing from the commercial banks. To correct the situation of deficient demand, margin requirement is reduced. Lower margin requirement acts as an incentive to borrow. This induces borrowers to raise more credit implying a rise in aggregate demand, as desired to correct deficient demand.

7. Giving valid reasons, state whether the following statements are true or false.

(i) An excess of aggregate demand over full employment level of aggregate supply represents a situation of inflationary gap.

(ii) If the ratio of Marginal Propensity to Consume (MPC) and Marginal Propensity to Save (MPS) is 4 : 1, then the value of investment multiplier will be 4. **(CBSE 2019)**

Ans. (i) The given statement is true, an excess of aggregate demand over full employment level of aggregate supply represents the situation of inflationary gap because when economy is working at full employment level, there is no chance of increase in production and aggregate demand still increases then producers have to increase the general price level to control the situation.

(ii) The given statement is false.
Ratio of MPC and MPS is 4:1

$$\text{MPC}\ \frac{4}{5} = 0.8; \quad \text{MPS} = \frac{1}{5} = 0.2 \Rightarrow K = \frac{1}{\text{MPS}}$$

$$K = 1 / 0.2 = 5$$

Thus, the value of multiplier is 5 not 4.

8. If government spending leads to multiple times increase in GDP, why should fiscal deficit be curbed?

Ans. Government spending leads to multiple times increase in GDP only when there is excess capacity in the economy or when planned output is low owing to lack of Aggregate Demand (AD).

But, in situations when excess capacity does not exist (or when AD is not deficient), government spending would only contribute to inflationary spiral in the economy. In such situations (when inflation needs to be curbed), the government must curb fiscal deficit.

9. Explain all the changes that takes place in an economy when aggregate demand and aggregate supply are not equal.

Ans. (i) If aggregate demand is greater than aggregate supply i.e., AD > AS, flow of goods and services in the economy tends to be less than their demand. The existing stocks of the producers would be sold out and the producers would suffer the loss of unfulfilled demand.

To rebuild the desired stocks and avoid the loss of unfulfilled demand, the producers would plan greater production. AS would increase to become equal to AD. This is how AS converges with AD.

(ii) If aggregate demend is less than aggregate supply, i.e., AD < AS, flow of goods and services in the economy tends to exceed their demand. As a result, some of the goods would remain unsold.

To clear unwanted stocks, the procedures would plan a cut in production. Consequently, AS would reduce to become equal to AD. This is how AS adapts itself to AD.

10. Covid-19 has significantly impacted the income level of the households and thus have reduced the level of household and investment expenditure and thereby the level of AD.

Examine the economic implications of increase in government investment expenditure when the economy is in a state of depression.

Ans. During depression, the economy faces a deficient demand situation. To correct this situation,the government takes various fiscal measures. Increase in government investment expenditure is the principal instrument to correct the deficiency in demand. Increase in government investment expenditure acts as a pump priming when the inducement to invest is low, owing to deficiency of demand.

It breaks the vicious circle of 'low demand-low inducement to invest-low production-low income-low demand'. The economy is pulled out of the state of depression.

The GDP growth accelerates in response to increase in AD, trigged by increase in government investment expenditure.

11. How can the problems of excess and deficient demand be combated?

Ans. Monetary and fiscal instruments are the key to combat the problems of excess and deficient demand. Fiscal instruments revolve around revenue and expenditure policy of the government. Monetary instruments relate to the regulation of money supply in the economy.

To combat excess demand, the government needs to curb its expenditures and raise its revenue. On the monetary front, it needs to pursue a 'Dear Money Policy', making availability of credit tougher than before and shrinking the credit creation capacity of the commercial banks.

To combat deficient demands, on the other hand, expenditure needs to be stimulated while revenue needs to be curbed. On the monetary front, cheap money policy needs to be pursued, facilitating easy availability of credit and enhancing credit creation capacity of the commercial banks.

12. Explain three measures by which excess demand in an economy can be corrected.

Ans. The problem of excess demand can be corrected through the following measures

(i) Public expenditure on public works, public welfare and public investment should be reduced. Reduction in expenditure will lead to a fall in aggregate demand.

(ii) The direct and indirect taxes should be increased. It will lead to decrease in disposable income and thereby, decrease in demand.

(iii) The repo rate should be increased. It will induce an increase in the market rate of interest. Consequently, demand for the funds for the purpose of consumption expenditure and investment expenditure will reduce. Implying a fall in aggregate demand.

13. Read the following statements carefully. Write true or false with a reason.

(i) Excess demand raises the market value of output.

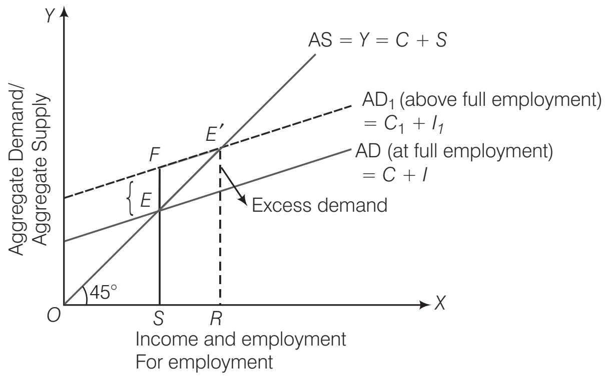
(ii) Prices and output increase in a situation of inflationary gap in an economy.

Ans. (i) True, excess demand raises the market value of the output. Because in a situation of excess demand, output level remaining constant, higher demand (higher than the supply) leads to a rise in general price level, implying a situation when market value of the output increases in the economy.

(ii) False, inflationary gap is the excess of AD over and above its level required to maintain full employment equilibrium in the economy. Inflationary gap generates extra pressure on the existing flow of goods and services at the level of full employment. Accordingly, prices tend to rise but output will not increase. Output remains constant corresponding to full employment level in the economy.

14. Explain the role of taxation in reducing excess demand. **(CBSE 2016)**

Ans. Excess demand refers to the situation when Aggregate Demand (AD) is in excess of Aggregate Supply (AS) corresponding to full employment in the economy.



In a situation of excess demand, government raises the rates of all taxes.

This reduces the purchasing power of the people and reduces both consumption and investment expenditures. A fall in consumption and investment expenditures reduces the level of aggregate demand and helps to check the problem of excess demand.

15. State which of the following statements are true or false? Give valid reasons. **(CBSE 2019)**

(i) According to Keynesian theory of employment, a state of under-employment can never exist in an economy.

(ii) In a two-sector economy, if income is zero, average propensity to consume will also zero.

Ans. (i) The given statement is false, according to Keynesian theory of employment, a state of under-employment can exist. This may occur at that level of income where equilibrium between AD and AS happens at less than full employment level.

(ii) The given statement is false, because when income is zero, autonomous consumption may exist in economy for survival, thus APC$\left(\frac{C}{Y}\right)$ will never be zero.

16. Read the following statements carefully. Write true or false with an appropriate reason.

(i) Central bank buys government securities in the open market to correct the situation of inflationary gap.

(ii) SLR is increased to correct the situation of deflationary gap.

Ans. (i) False, Central bank sells government securities in the open market to correct the situation of inflationary gap. It is by selling the securities that the banks soaks liquidity from the market which is expected to correct the inflationary gap.

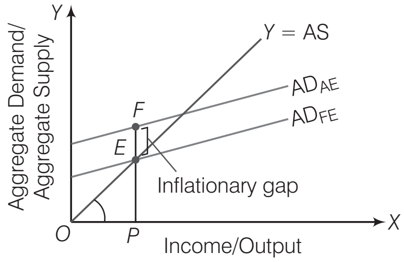
(ii) False, SLR is decreased to correct the situation of deflationary gap. Lower SLR increases credit creation capacity of the commercial banks because a cut in the SLR raises cash balances with the commercial banks. Accordingly, availabiltiy of credit increases in the capital market. This increases aggregate demand and deflationary gap is corrected.

• Long Answer (LA) Type Questions

1. Explain the concept of inflationary gap. Also explain the role of legal reserves in reducing it. **(All India, 2012, 2009)**

Or Define and represent inflationary gap on a diagram. Explain the role of the varying reserves requirement in removing the gap. **(Delhi 2010C)**

Ans. Inflationary gap occurs when AD>AS corresponding to full employment level. This inflationary gap, i.e, excess of Aggregate Demand causes inflation in the economy and price levels tend to rise.



In this figure,

AD_{FE} = AD at full employment level

AD_{AE} = AD above full employment level

The point E is the equilibrium point where AD = AS. But there is excess demand (current) at AD_{AE}, where Aggregate Demand FP is more than the Aggregate Supply in the economy. This difference of actual Aggregate Demand and Supply, i.e. EF is the inflationary gap.

Inflationary Gap = Excess Demand = $AD_{AE} - AD_{FE} = EF$

Role of Legal Reserves to Correct the Problem of Inflationary Gap

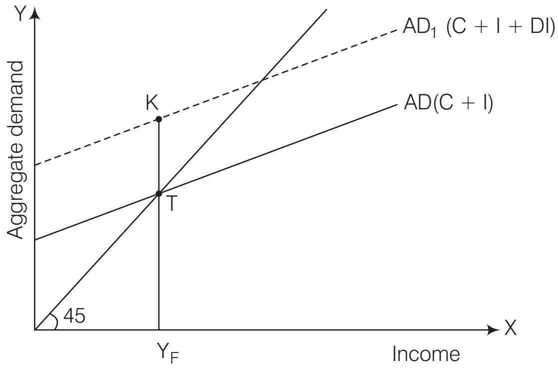
Legal reserves like Cash Reserve Ratio and Statutory Liquidity Ratio are the tools to correct the problem of inflationary gap

(i) **Cash Reserve Ratio** (CRR) Each and every commercial bank has to keep a certain proportion of its demand and time deposits in the form of cash and other liquid assets with the Central Bank. This ratio is termed as Cash Reserve Ratio. To correct the problem of inflationary gap, the Central Bank increases the CRR.

It reduces the supply of money and credit creation capabilities of commercial banks. Due to lesser supply of money, the Aggregate Demand comes down and the economy attains equilibrium situation.

(ii) **Statutory Liquidity Ratio** (SLR) It refers to a fixed percentage of the total assets of a bank in the form of cash or other liquid assets that is required to be maintained by the bank. During the situation of inflationary gap, SLR is increased. This reduces the credit creation capacity of commercial banks and reduces the flow of money in the economy. As a result of that, the Aggregate Demand comes down and ultimately, the economy attains equilibrium.

2. In the given figure, what does the gap '*KT*' represent? State and discuss any two fiscal measures to correct the situation. **(CBSE 2020)**



Ans. '*KT*' represents inflationary gap which means aggregate demand is more than aggregate supply corresponding to full employment level. Two fiscal measures to correct the situation of inflationary gap are

(i) **Revenue Policy** To correct the situation of inflationary gap, government raises the rate of all taxes. This reduces the purchasing power by reducing disposable income (i.e., after tax income) of the people which in turn will reduce the aggregate demand in the economy.

(ii) **Expenditure Policy** To correct the situation of inflationary gap, government should reduce its public expenditure. This reduces the purchasing power by reducing total income of the people which in turn will reduce the aggregate demand in the economy.

3. What is fiscal policy? What fiscal measures would you recommend to correct deficient demand?

Ans. Fiscal policy refers to the revenue and expenditure policy (or budgetary policy) of the government to correct the situations of excess or deficient demand.
Following fiscal measures are recommended to correct deficient demand

(i) The government should step up its expenditure on

(a) public works programmes

(b) education and public welfare

(c) subsidies to the producers

(d) defence and law and order

(ii) The government should reduce tax burden on the households and the producers, so that they are left with greater cash balances.

(iii) The government should raise more funds from the RBI so that there is a greater flow of liquidity in the economy. Higher liquidity implies higher level of AD.

(iv) The government should plan a cut in public borrowings, so that people are left with greater liquidity (or cash balances). Greater cash balances implies higher AD.

Briefly, deficient demand is corrected when the government steps up its own expenditure and ensures, that cash balances with the people are high.

4. Explain the role of government expenditure in correcting the situation of

(i) deficient demand in the economy

(ii) inflationary gap in an economy

Ans. (i) In a situation of deficient demand, aggregate demand (measured in terms of aggregate expenditure) is less than the aggregate supply corresponding to the full employment level in the economy.

Accordingly, aggregate demand needs to be raised. But because of poor market sentiments (a characteristic feature of the deficient demand), private expenditure remains low. It is in such a situation that the government expenditure (which is not driven by profit motive) can play a significant role. It will act as an injection of demand into the system and is expected to induce private expenditure. Accordingly, the situation of deficient demand will be corrected.

(ii) Inflationary gap refers to a situation of excess demand, when aggregate demand is greater than aggregate supply corresponding to full employment level in the economy.

During this situation, general price level tends to rise, causing a rise in the rate of interest and consequently, a fall in investment and a fall in the growth rate of GDP.

Correction of inflation gap calls for a cut in expenditure. But owing to rising prices, wage rate tends to rise (along with other factor cost) which stokes the rate of inflation. In such a situation, a cut in government's non-development expenditure like on defence, law and order and subsides will cause an overall cut in aggregate demand. So that excess aggregate demand is corrected and inflationary gap is eliminated.

Chapter Test

Multiple Choice Questions

1. In case of excess demand, RBI ...... the bank rate or interest rate which makes the credit dear.

(a) increases
(b) decreases
(c) deposit
(d) None of these

2. ...... is equal tothe difference between 'AD beyond full employment' and 'AD at full employment'.

(a) Recession
(b) Inflationary gap
(c) Deflationary gap
(d) None of these

3. Which of the following statements is/are true?

(a) Ex-ante savings is the actual level of savings in the economy.
(b) Ex-post investment is the planned investment at a given point of time.
(c) Ex-ante saving is always equal to ex-post savings.
(d) All of the above statements are false.

4. Which of the following can be used to correct the situation of deflationary gap?

(a) Increase in bank rate
(b) Increase in CRR
(c) Reduction in SLR
(d) Increase in margin requirement

5. By increasing the tax burden on the producers, the government intends to

(a) correct the situation of deficient demand
(b) correct the situation of inflationary gap
(c) correct the situation of excess demand
(d) Both (b) and (c)

Short Answer (SA) Type Questions

1. Define effective demand. Discuss how effective demand can be restored, if ex-ante Aggregate Demand (AD) is more than ex-ante Aggregate Supply (AS).

2. Explain three reasons by which deficit demand in an economy can be corrected.

3. Explain the 'varying reserve requirements' method of credit control by the central bank.

4. "To boost the falling demand in the economy, the reserve Bank of India recently reduced repo rate." Elaborate the rationale behind the steps taken by the central bank.

5. Read the following statements carefully. State true or false with an appropriate reason.

(i) Full employment implies there is zero unemployment in the economy.
(ii) Excess demand refers to the situation when AD> AS, corresponding to underemployment in the economy.

Long Answer (LA) Type Questions

1. Explain the concept of deflationary gap. Also, explain the role of margin requirement in reducing it.

2. What is monetary policy? Briefly state how monetary policy is used to correct deficient demand?

Answers

Multiple Choice Questions

1. (a) 2. (b) 3. (d) 4. (c) 5. (d)