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CLASS – 12

ECONOMICS

Introductory Macroeconomics

CH-4 : Determination of Income and Employment

Part – 6

Excess and Deficient Demand

Vaishnavi Agrawal

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OVERVIEW

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1. Aggregate Demand and Supply
2. Consumption and Saving Function
3. Investment and Multiplier
4. Equilibrium Approaches
5. Excess and Deficient Demand
6. Monetary Policies
7. Fiscal Policies

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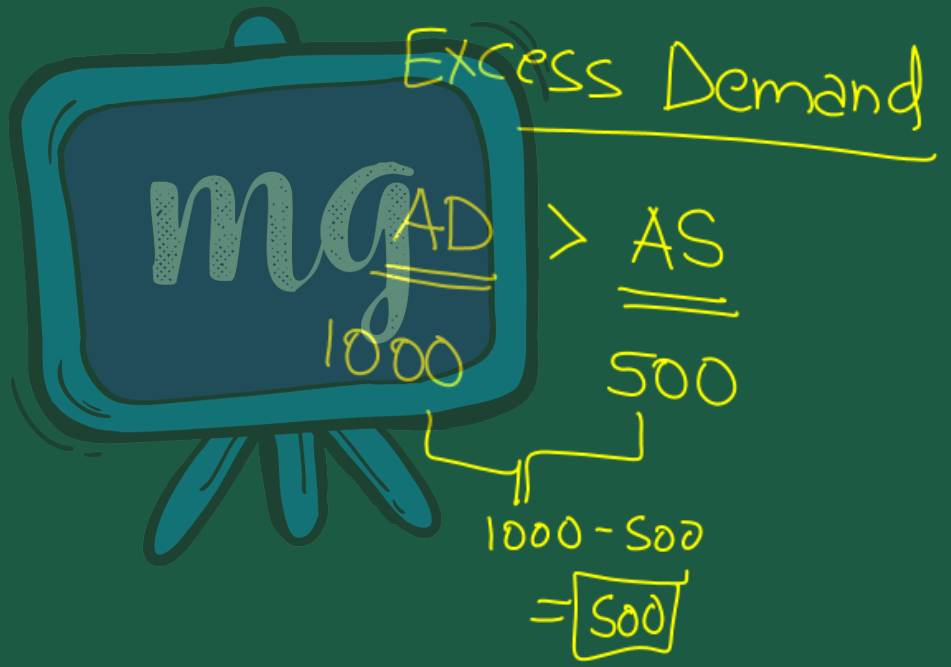

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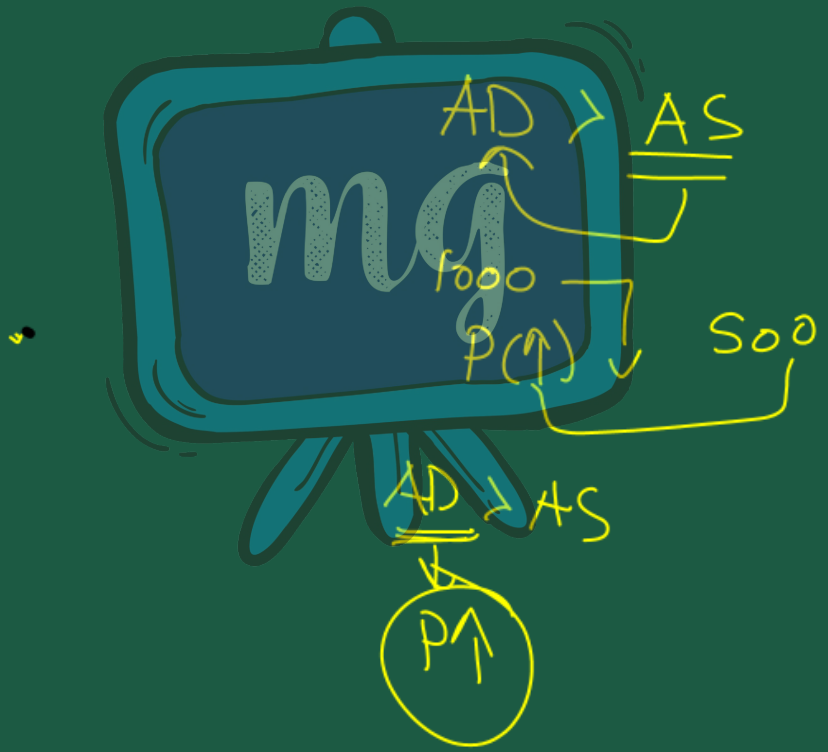

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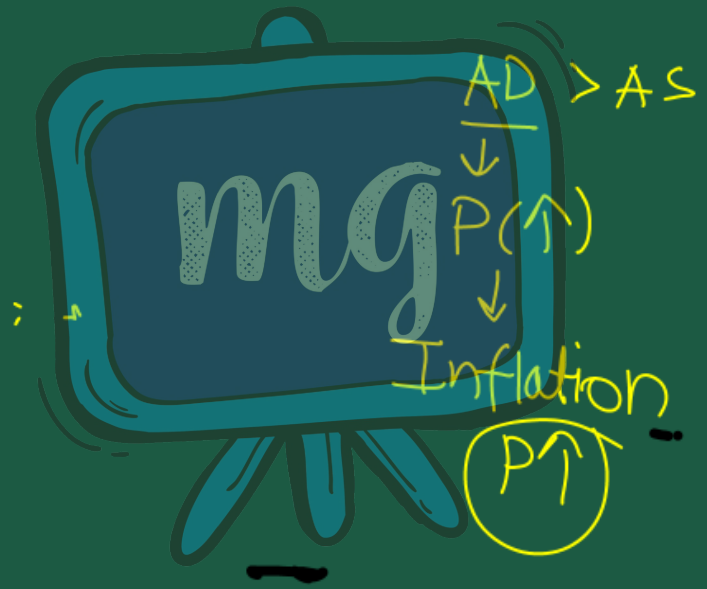

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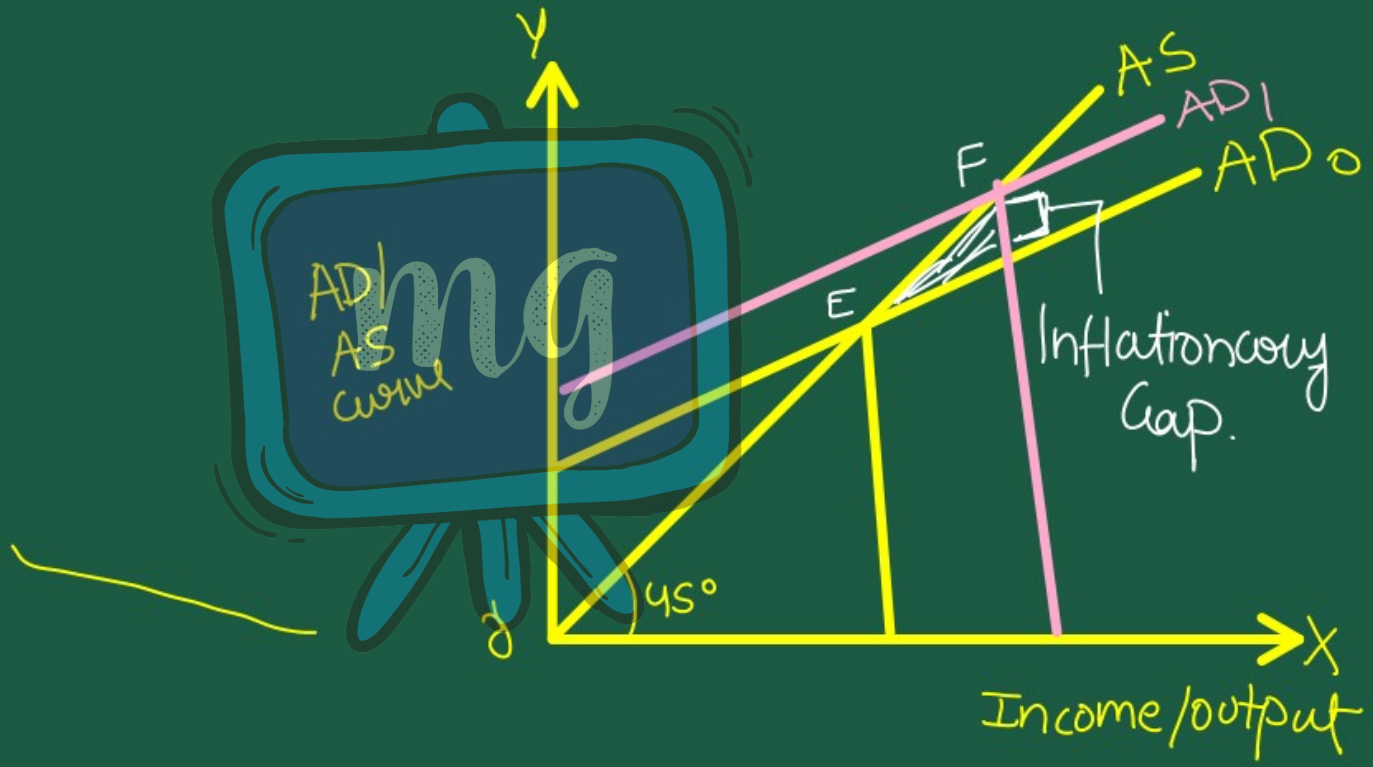

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EXCESS DEMAND

It refers to the situation when aggregate demand (AD) is more than the aggregate supply (AS) corresponding to full employment level of output in the economy.

AD > AS P ↑



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INFLATIONARY GAP



- The gap by which actual aggregate demand exceeds the planned aggregate demand required to establish full employment equilibrium.
- It is called inflationary because this leads to a rise in general price level of the economy.

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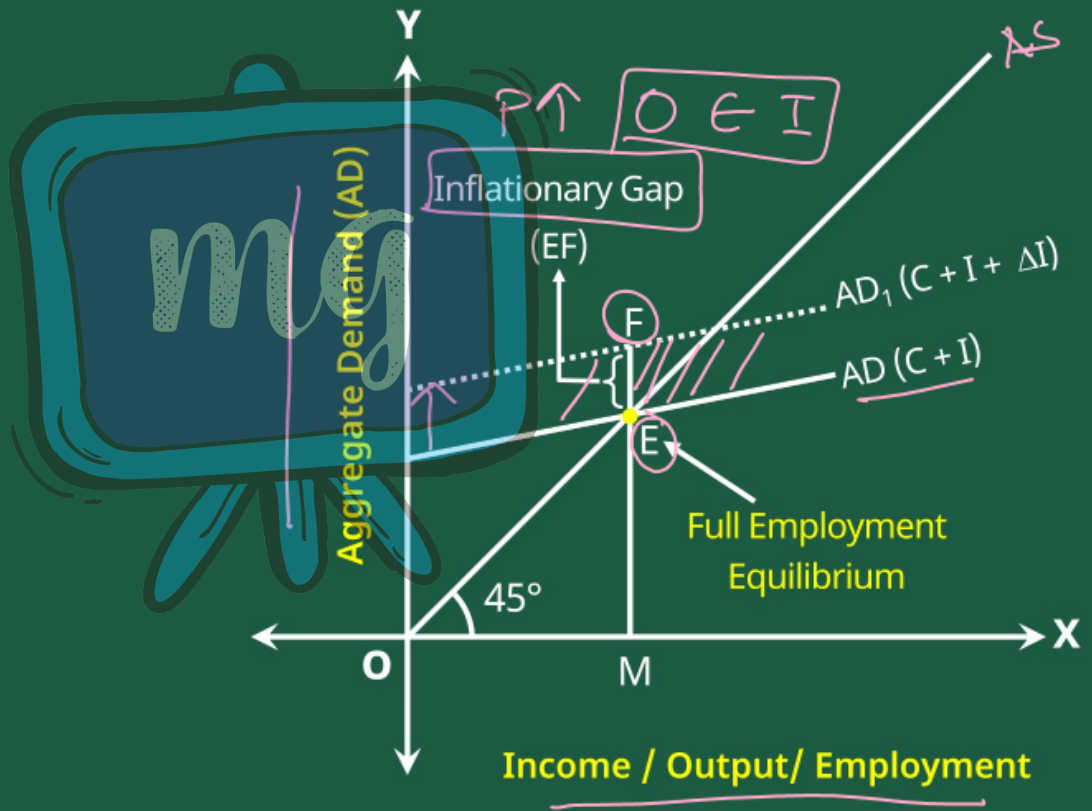
Excess Demand and Inflationary Gap



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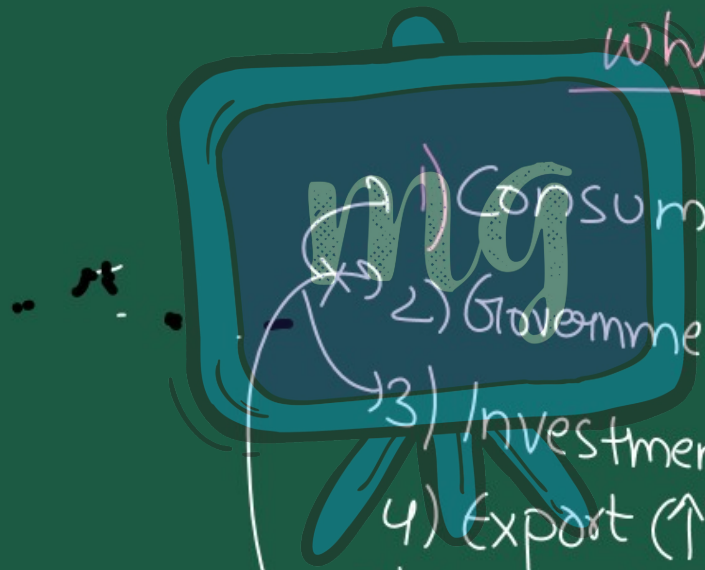

Why ?

1) Consumption exp (↑)
2) Government exp. (↑)
3) Investment exp (↑)
4) Export (↑)
5) Import (↓)
6) Tax (↓)
7) Deficit financing.

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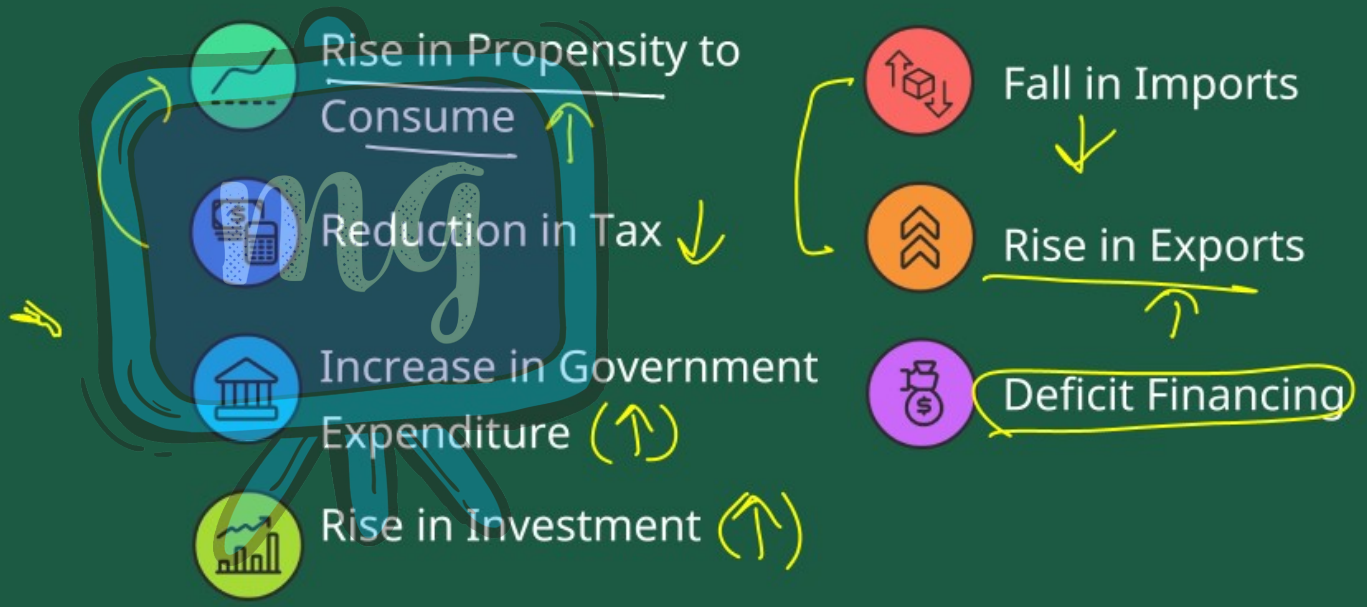
REASONS OF EXCESS DEMAND



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RISE IN THE PROPENSITY TO CONSUME

Excess demand may arise because of increase in consumption expenditure due to rise in the propensity to consume.



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REDUCTION IN TAXES

It may also occur due to increase in disposable income and consumption demand because of decrease in taxes.



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INCREASE IN GOVERNMENT EXPENDITURE

Increase in public expenditure due to rise in government demand for goods and services will also result in excess demand.



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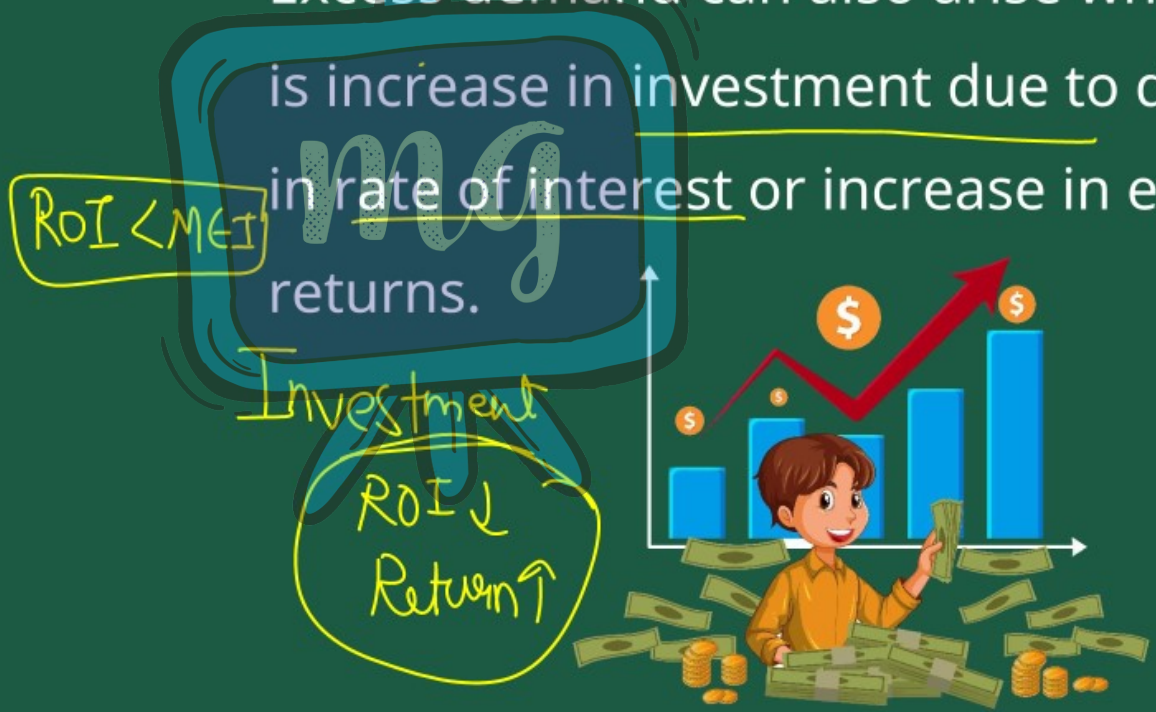
INCREASE IN INVESTMENT

Excess demand can also arise when there is increase in investment due to decrease in rate of interest or increase in expected returns.



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FALL IN IMPORTS

Decrease in imports due to higher international prices in comparison to domestic prices may also lead to excess demand.

Depreciate



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RISE IN EXPORTS

Excess demand may also arise when demand for exports increases due to comparatively lower prices of domestic goods or due to decrease in the exchange rate for domestic currency.



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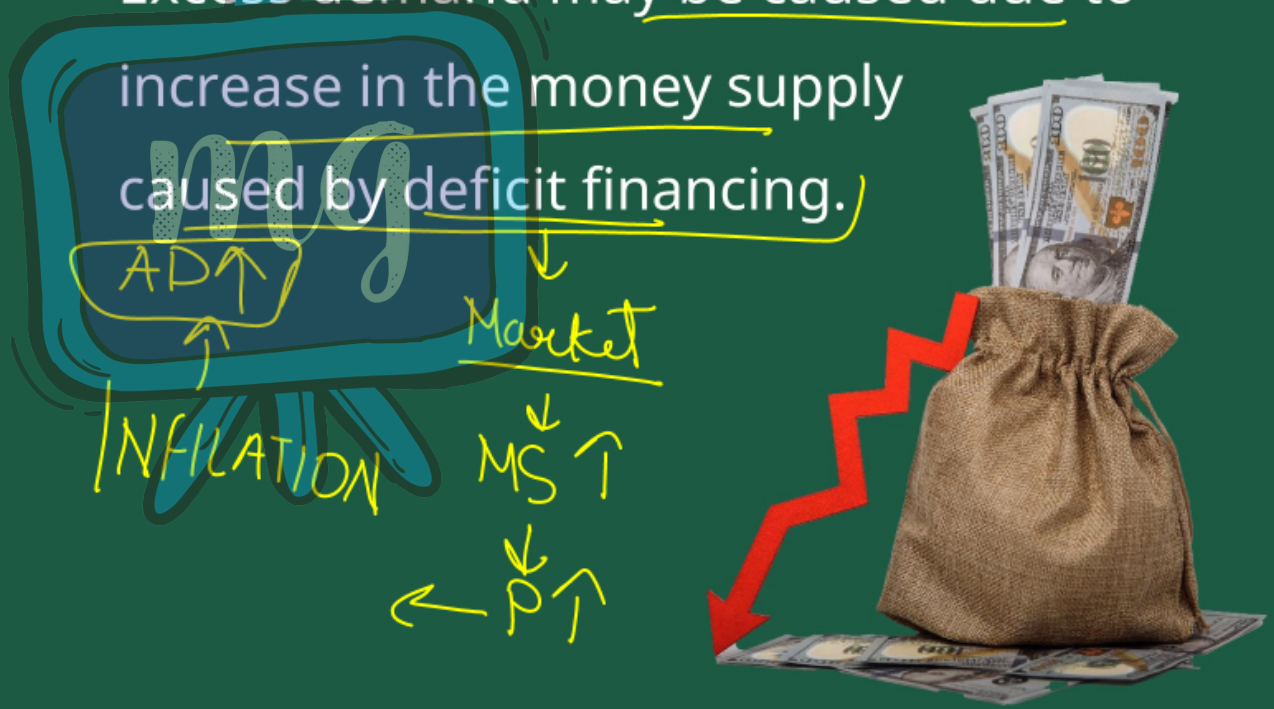
DEFICIT FINANCING

Excess demand may be caused due to increase in the money supply caused by deficit financing.



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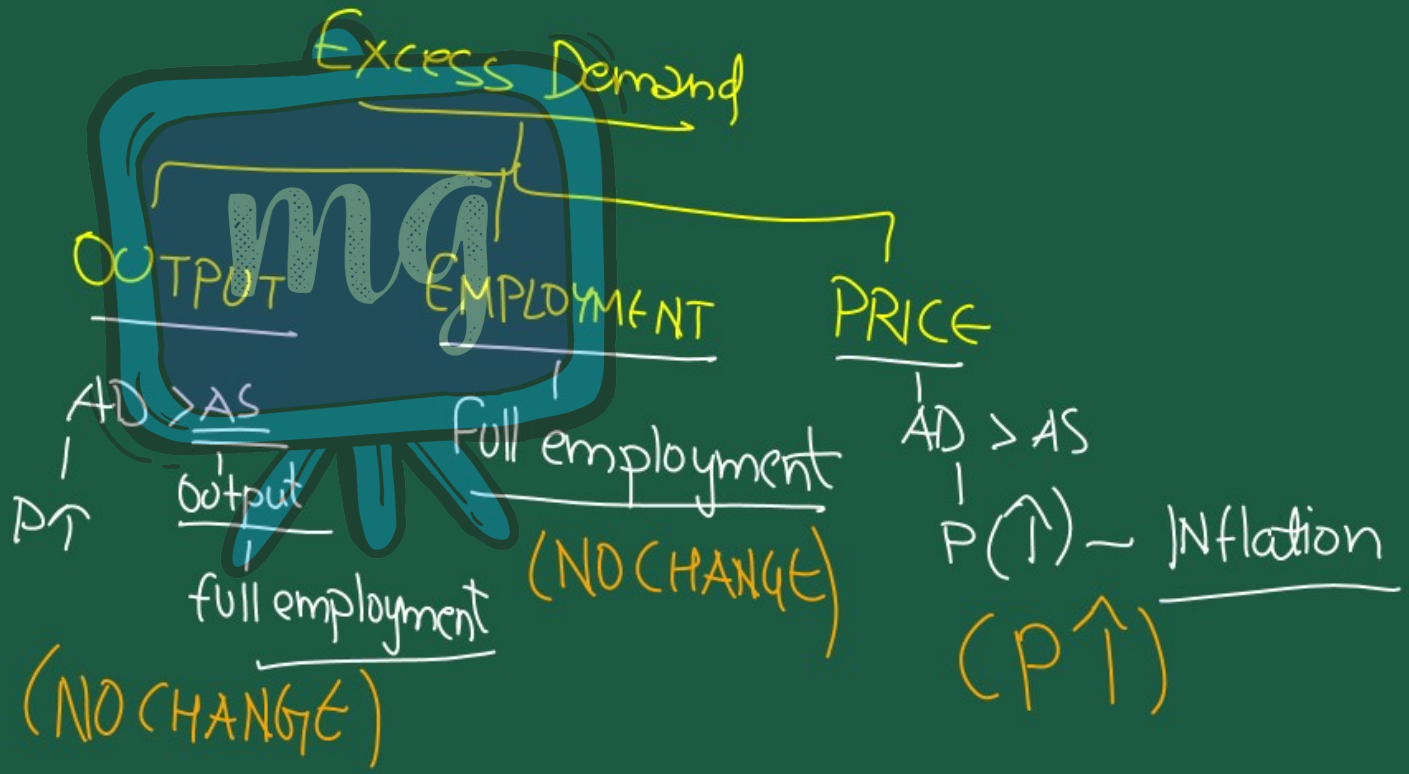

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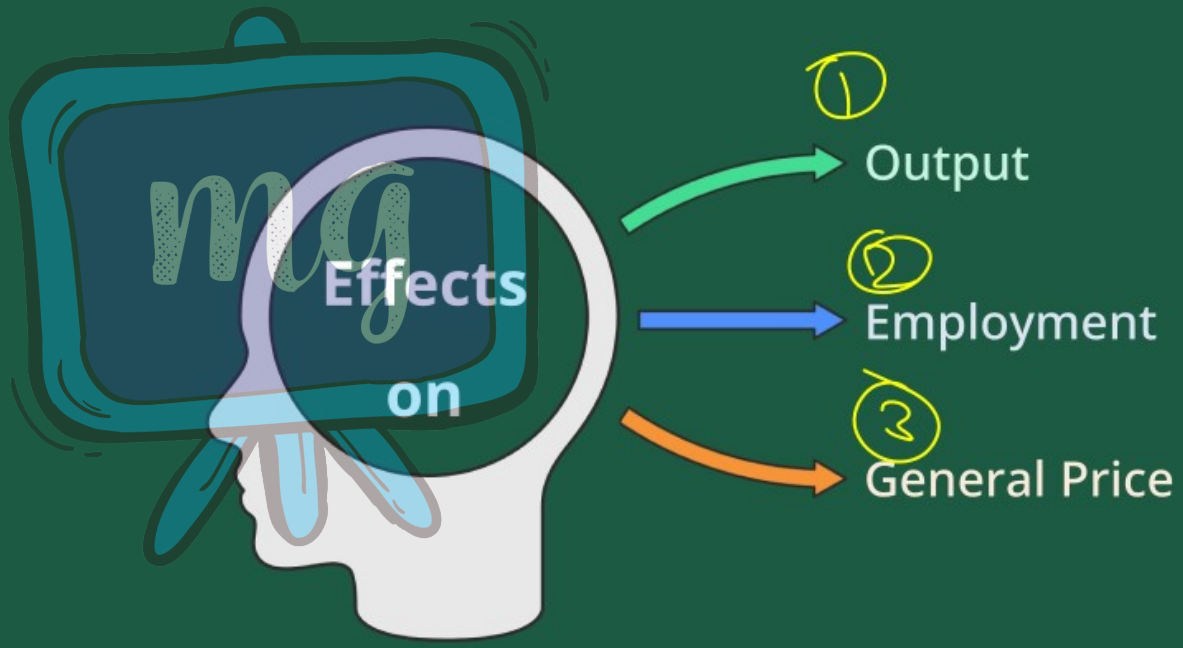
IMPACT OF EXCESS DEMAND



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EFFECTS ON OUTPUT

Excess demand does not affect the level of output because economy is already at full employment level and there is no idle capacity in the economy.



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EFFECTS ON EMPLOYMENT

There will be no change in the level of employment as the economy is already operating at full employment equilibrium and there is no involuntary unemployment.



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EFFECTS ON GENERAL PRICE

Excess demand leads to rise in the general price level "Inflation" as aggregate demand is more than aggregate supply.



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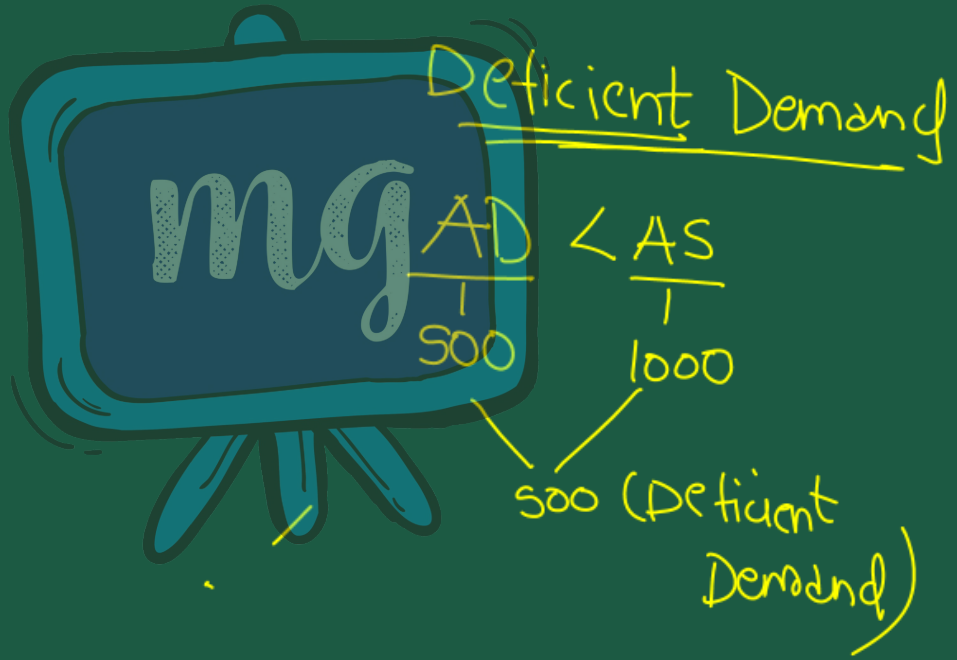

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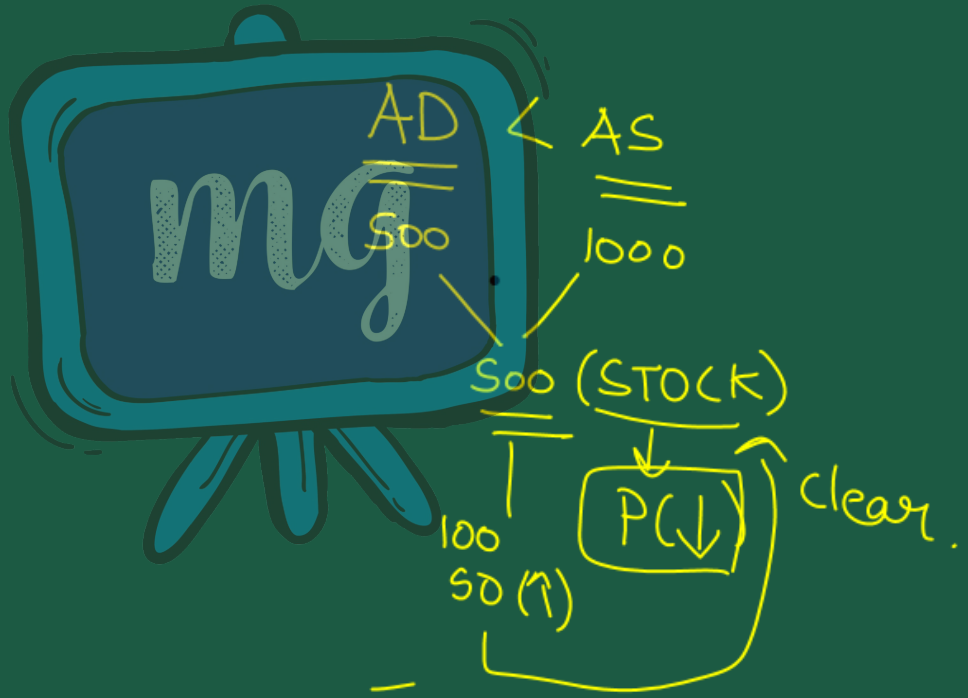

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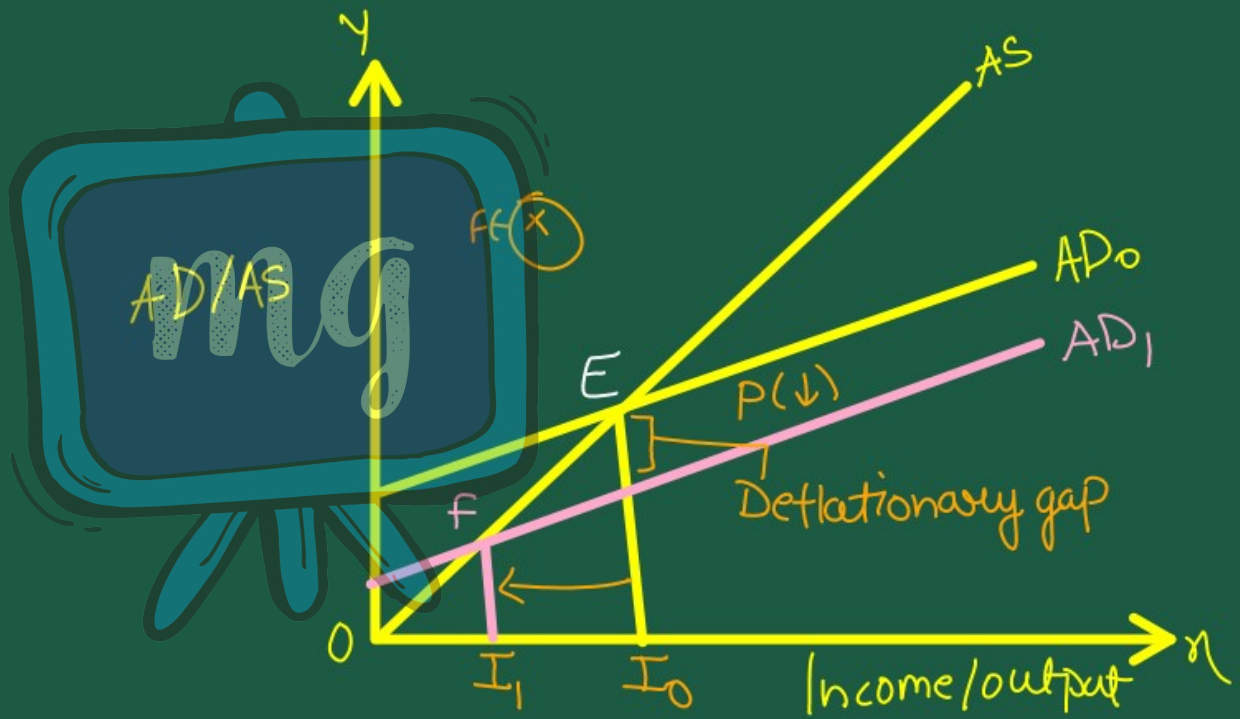

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DEFICIENT DEMAND

It refers to the situation when aggregate demand (AD) is less than the aggregate supply (AS) corresponding to full employment level of output in the economy.

$AD < AS$



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DEFLATIONARY GAP

The gap by which actual aggregate demand falls short of aggregate demand required to establish full employment equilibrium.

RAD



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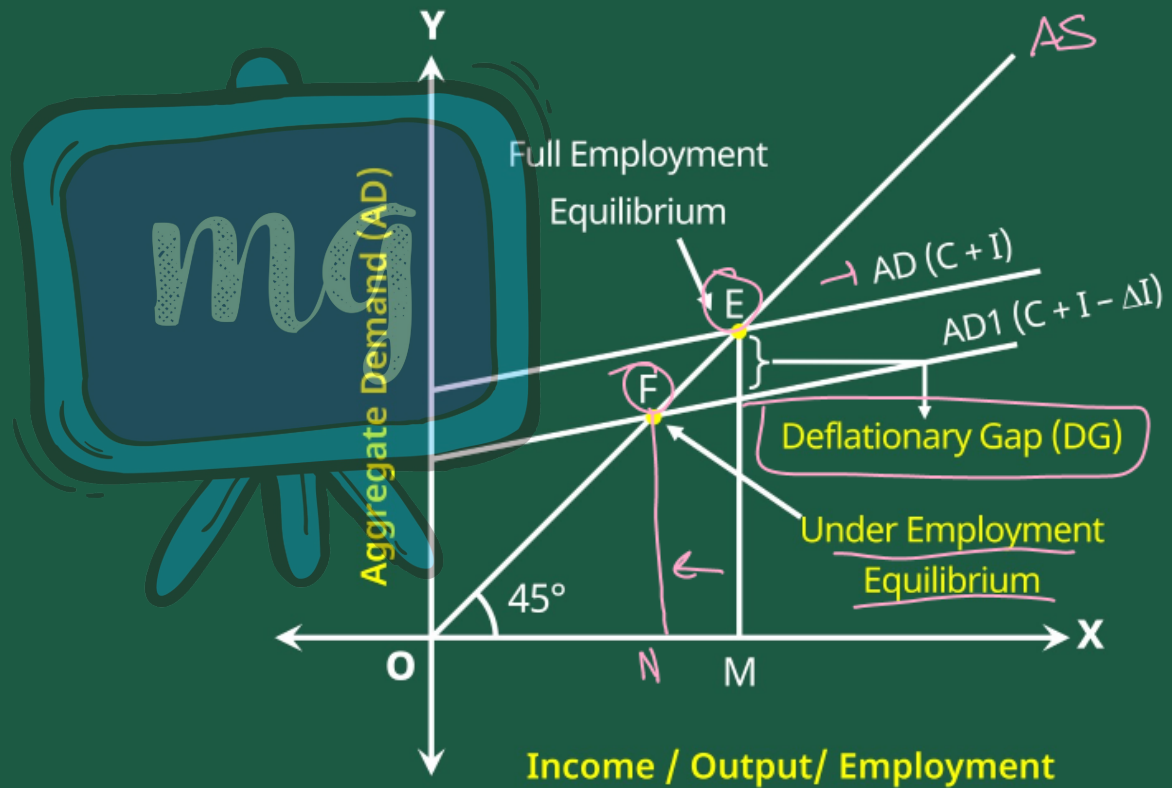
Deficient Demand and Deflationary Gap



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Deficient Demand

(Deflation)

MS (↓)

1) Consumption exp. (↓)
2) Government exp (↓)
3) Investment exp (↓) → RoI ↑ R ↓
4) Tax (↑)
5) Import (↑)
6) Export (↓)

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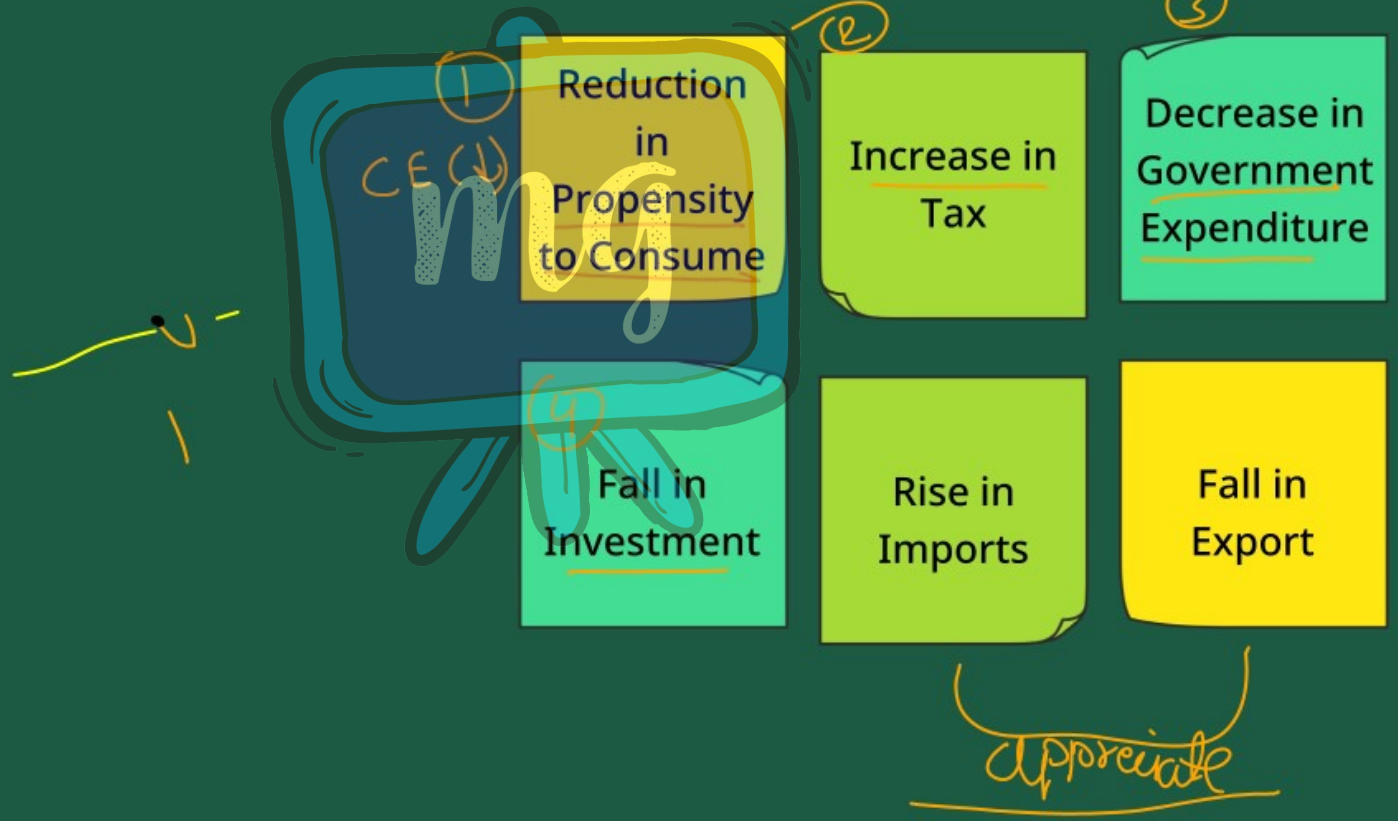
REASONS OF DEFICIENT DEMAND



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DECREASE IN PROPENSITY TO CONSUME

A decrease in consumption expenditure, due to fall in the propensity to consume, leads to deficient demand in the economy.



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INCREASE IN TAXES

AD may also fall due to imposition of higher taxes. It leads to decrease in disposable income and, as a result, the economy suffers from deficient demand. Expenditure (↓)



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DECREASE IN GOVERNMENT EXPENDITURE

When government reduces its demand for goods and services due to fall in public expenditure, it leads to deficient demand.



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FALL IN INVESTMENT EXPENDITURE

Increase in the rate of interest or fall in the expected returns lead to decrease in the investment expenditure. It reduces the AD and gives rise to deficient demand.



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RISE IN IMPORTS

When international prices are comparatively less than the domestic prices, then it may lead to a rise in imports, implying a cut in the aggregate demand.



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FALL IN EXPORTS

Exports may fall due to comparatively higher prices of domestic good or due to increase in the exchange rate for domestic currency. This will lead to deficient demand.



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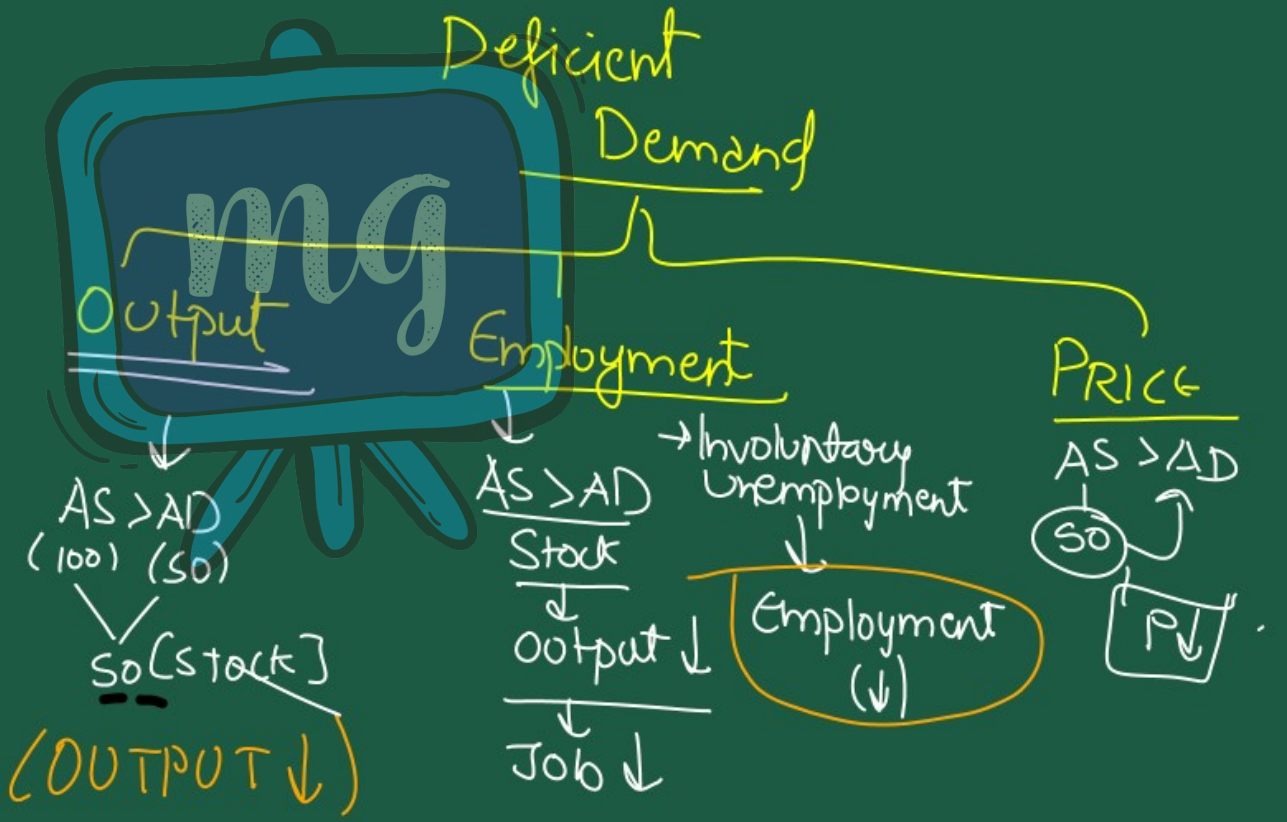

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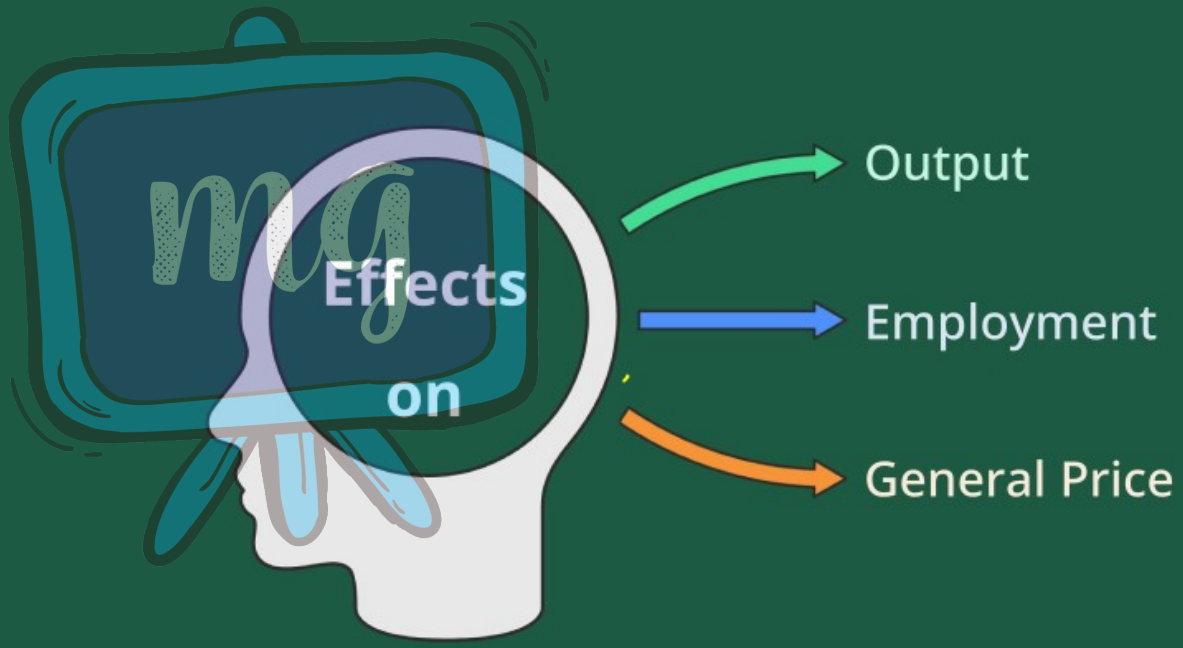
IMPACT OF DEFICIENT DEMAND



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EFFECTS ON OUTPUT



- Due to lack of sufficient aggregate demand, there will be an increase in the inventory stock.
- It will force the firms to plan for lesser production for the subsequent period.
- As a result, planned output will fall.

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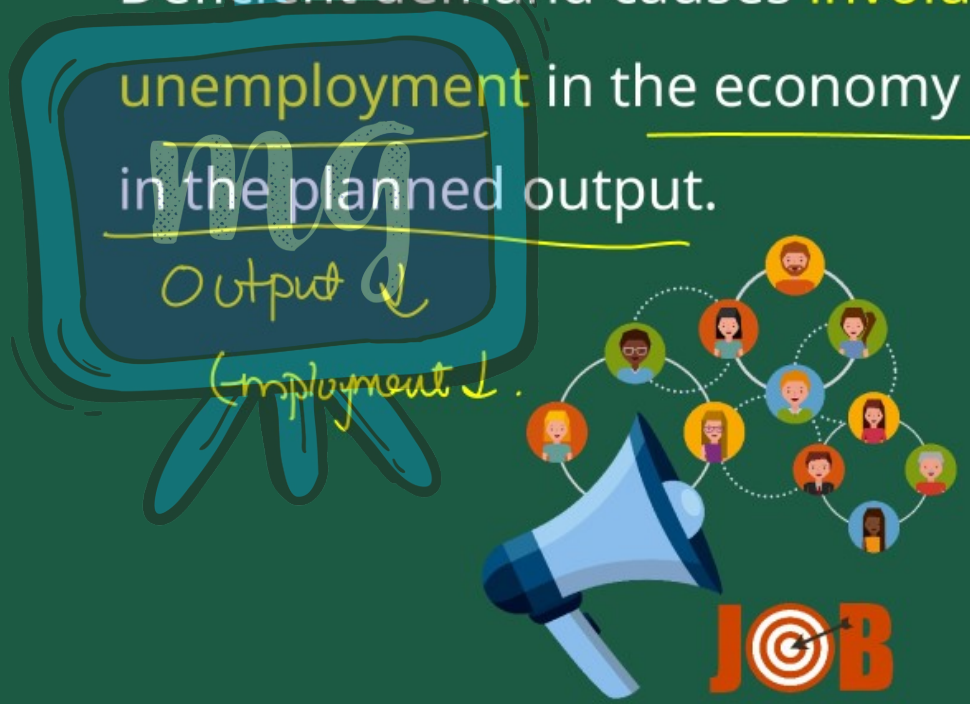
EFFECTS ON EMPLOYMENT

Deficient demand causes involuntary unemployment in the economy due to fall in the planned output.



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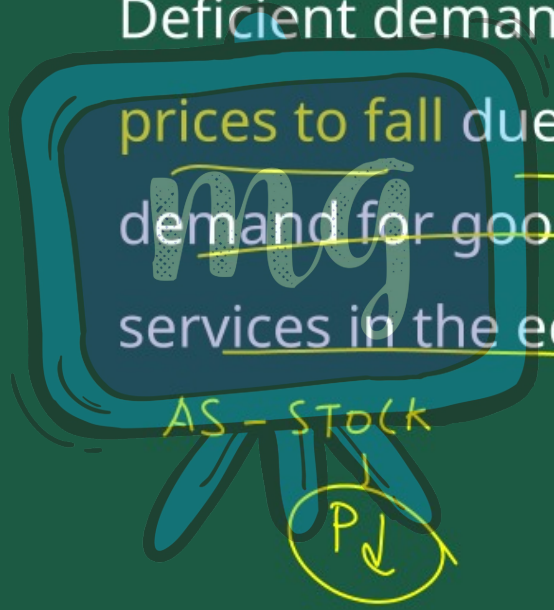
EFFECTS ON GENERAL PRICE

Deficient demand causes the general prices to fall due to lack of demand for goods and services in the economy.





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EXCESS DEMAND Vs DEFICIENT DEMAND

Basis	Excess Demand	Deficient Demand
Meaning	AD > AS	AD < AS
Inflationary or Deflationary Gap	It leads to Inflationary Gap.	It leads to Deflationary Gap.
Equilibrium level	Full employment equilibrium.	Under employment equilibrium.
Reason	It occurs due to excess of anticipated expenditure.	It occurs due to shortage of anticipated expenditure.

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EXCESS DEMAND Vs DEFICIENT DEMAND		
Basis	**Excess Demand**	**Deficient Demand**
Impact on Output Emplyoment	It does not affect the output and employment as economy is already operating at full employment level.	It leads to fall in output and employment due to shortage of aggregate demand.
Impact on Price	It leads to inflation. (Price level increases)	It leads to deflation. (Price level decreases)

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LEARNING OUTCOMES

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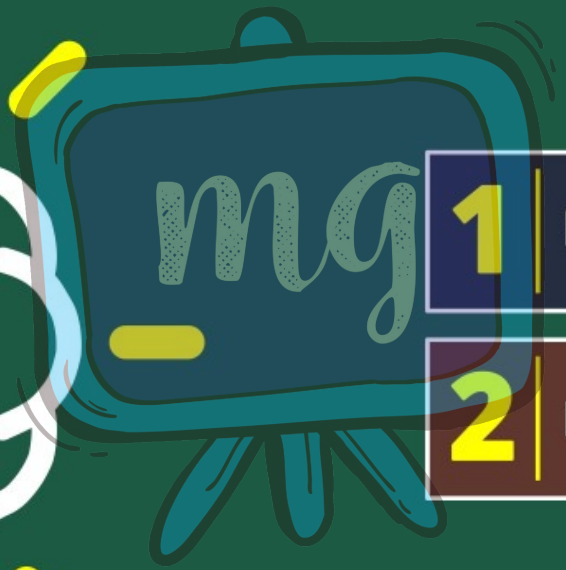

1. Excess Demand
2. Deficient Demand

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ASSESSMENT

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1 What is Excess Demand? AD > AS

- [x] A The amount by which aggregate supply exceeds aggregate demand.
- [✓] B The amount by which aggregate demand exceeds aggregate supply.
- [x] C The equilibrium level of national income
- [x] D The level of national income at which saving equals investment.

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2 What is Deficient Demand? AD < AS

A The amount by which aggregate demand exceeds aggregate supply.

B The amount by which aggregate supply exceeds aggregate demand. AS > AD

C The equilibrium level of national income.

D The level of national income at which saving equals investment.

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3 Excess demand curve intersects the aggregate supply curve at a point above the full employment level, resulting in an –

A Deflationary gap

B Inflationary gap

C Stagflation

D Recession

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4 Deficient demand curve intersects the aggregate supply curve at a point below the full employment level, resulting in a –

A Inflationary gap

B Deflationary gap

C Stagflation

D Recession