VIDYA BHAWAN BALIKA VIDYA PITH

शक्तिउत्थानआश्रमलखीसरायबिहार

Class 12 commerce   Sub. ECO/B Date 10.01.2021

Teacher name – Ajay Kumar Sharma

Income Determination Revised Notes

Q21. Define and represent inflationary gap on a diagram. Explain the role of the varying reserves requirement in removing the gap.

Ans. An inflationary gap is a macroeconomic concept that describes the difference between the current level of real gross domestic product (GDP) and the anticipated GDP that would be experienced if an economy is at full employment, also referred to as the potential GDP. An inflationary gap is always related to a business-cycle expansion and arises when the equilibrium level of an economy's aggregate output is greater than the output that could be produced at full employment. As per world dictionary, "The inflationary expenditure gap is an economic term that describes the difference between what an economy can produce at full employment and what the real GPD is." The theory can now be used to analyse the concept of 'inflationary gap'—a concept introduced first by Keynes. This concept may be used to measure the pressure of inflation. Aggregate demand or aggregate expenditure is composed of consumption expenditure (C), investment expenditure

(I), government expenditure (G) and the trade balance or the value of exports minus the value of imports (X – M). Inflationary gap is thus the result of excess demand. It may be defined as the excess of planned levels of expenditure over the available output at base prices. An example will help us to clear the meaning of the concept of inflationary gap.

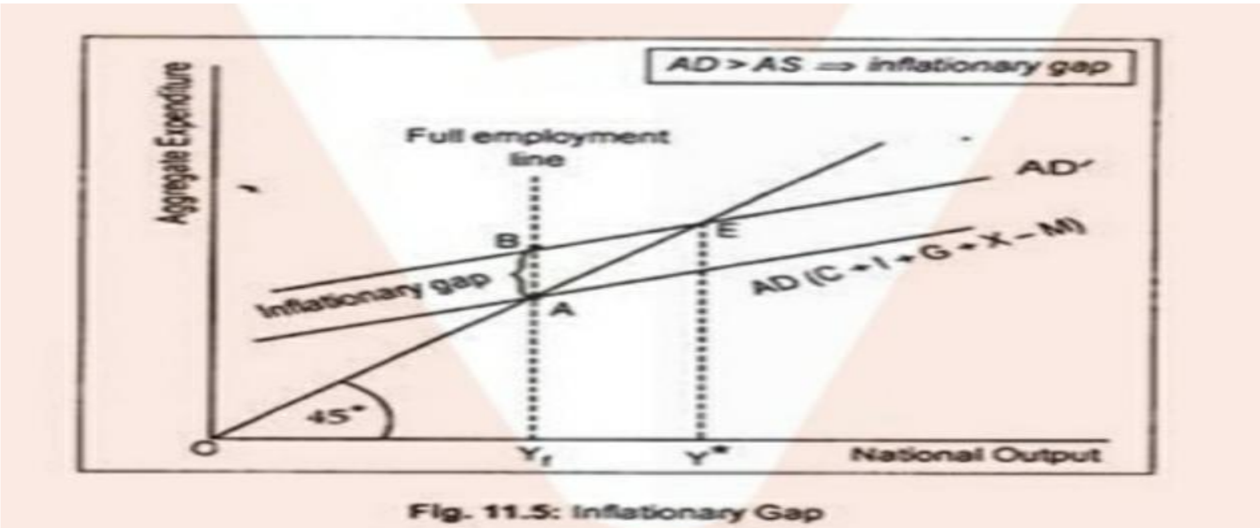

Fig. 11.5: Inflationary Gap

For removing gap, the following things can be useful:

• Cash Reserve Ratio (CRR) is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. CRR is set according to the guidelines of the central bank of a country. CRR means Cash Reserve Ratio and as per the guidelines issued by Reserve Bank of India, all banks are in a position to maintain cash at a certain percentage of their deposits in their accounts with RBI. Currency chests are maintained by the banks on behalf of RBI and the cash kept at currency chest is considered to be the cash kept with RBI for the purpose of CRR. When the RBI decides to increase the Cash Reserve Ratio, the amount of money that is available with the banks reduces.

This is the RBI’s way of controlling the excess supply of money.

• Statutory liquidity ratio (SLR) is the Indian government term for the reserve requirement that the commercial banks in India are required to maintain in the form of cash, gold reserves, government approved securities before providing credit to the customers. The statutory liquidity ratio is determined and maintained by the central bank to control the bank credit, ensure the solvency of commercial banks and compel banks to invest in the government securities. By changing the SLR, the flow of bank credit in the economy can be increased or decreased. Such as, when the central bank decides to curb the bank credit so as to control the inflation will raise the SLR. On the contrary, when the economy faces recession, and the central bank decides to increase the bank credit will cut down the SLR.