II - MODULE

6. THE PRINCIPLE OF EFFECTIVE DEMAND

Q:1 Explain Aggregate Demand and Aggregate Supply function ?

(A) Introduction :- Principle of Effective Demand is important part of Keynes Theory. He developed the theory of effective Demand in his book — "General Theory of Income and Employment" in 1936.

According to him — Unemployment is found due to Lack of Effective Demand.

Thus employment can be raised by increasing level of Effective Demand.

Effective Demand is determined by Aggregate Demand Price and Aggregate supply Price.

(B) Aggregate Demand :- According to Keynes —

"Effective Demand means Total Expenditure on Consumption goods and Investment goods at any Equilibrium Level of employment"

Agg. Demand in Two Sector economy = $AD = C + I$

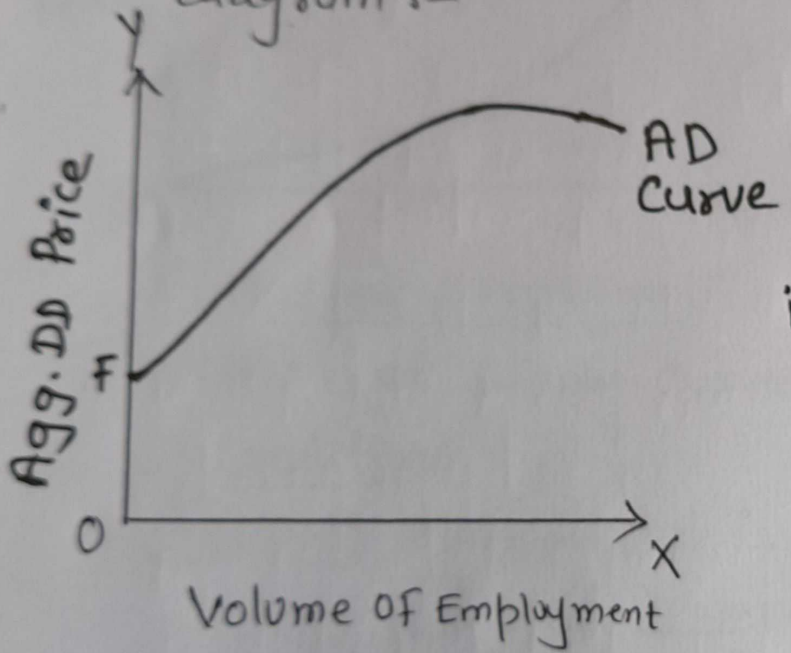
Agg. Demand in Three sector economy => $AD = C + I + G$

Agg. Demand in Four Sector economy → $C + I + G + (x - M)$

(C) Aggregate Demand Price :- J.M. Keynes

"Aggregate Demand Price is the amount of money which the entrepreneur expect to receive from the sale of output Produced at particular level of employment."

Aggregate Demand Curve is a schedule showing maximum Sales Proceeds by all entrepreneurs at Particular level of employment shown in following diagram :-



i) AD is Aggregate Demand Curve sloping upward From Left to right.

ii) It shows as level of income and employment increases, the Agg. Demand Price also rises

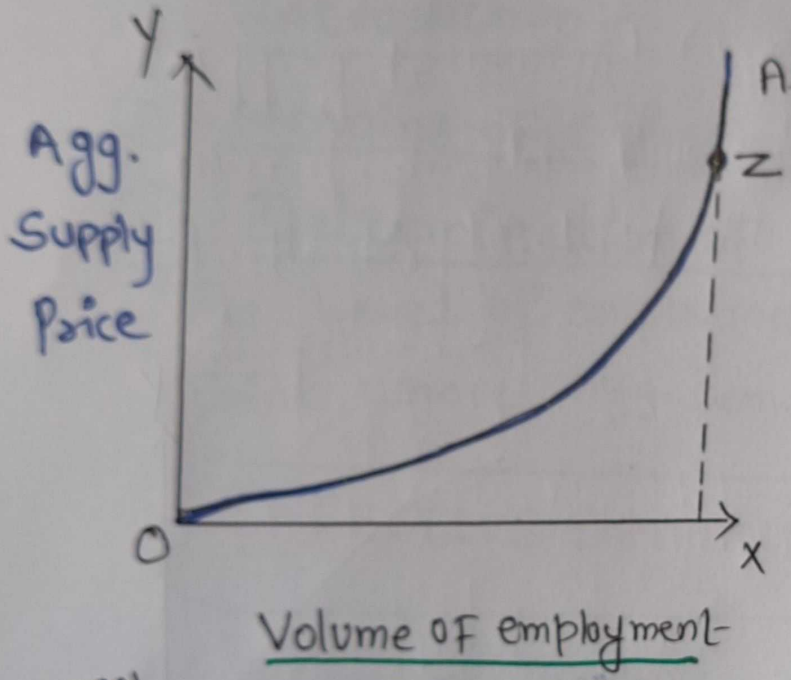
iii) As output and employment increases but Agg. Demand increases at diminishing rate.

(D) Aggregate Supply Price :-

"Aggregate Supply Price is the total amount of money which all the entrepreneurs in the economy must receive from sale of output at given Level of employment."

" Agg. Supply Function or Agg. Supply Curve means a Schedule of different amount of revenues required by all entrepreneurs at given Level of employment. "

Agg. Supply Curve shows cost of Producing goods at Various level of output shown in Following diagram:-



i) AS is Agg. Supply Curve Sloping Upward From left to right.

ii) In beginning it rises Slowly and then rapidly.

iii) Shape of Supply Curve depend Upon Technical Conditions.

(e.g) - (a) Marginal Cost is Positive, Agg. Supply Curve Slopes Upward

(b) IF Out Put increase at diminishing Rate, Agg. Supply Curve will rising more rapidly.

iV) At Full employment Level - N_F, any increase in in Cost will not increase employment. So AS Curve become Vertical at Z level and Full Employment at N_F level.

Q:2 " The intersection of Aggregate Supply and Aggregate Demand function determine the Equilibrium level of output and Employment." Explain.

OR What is Effective Demand? How it is determined by Agg. Demand and Agg. Supply Curves?

(A) **Introduction:-**

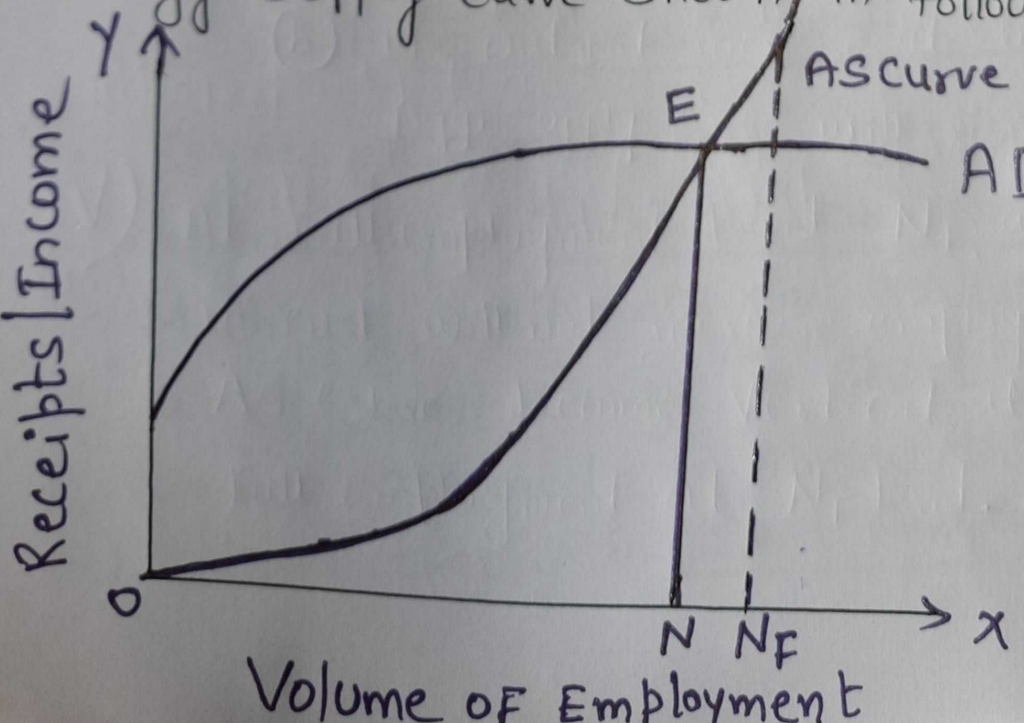
(B) **Meaning of Effective Demand:-** } Same From Q:1

(C) **Determination of Effective Demand:-**

The Level of employment is determined at the Point where Agg. Demand is equal to Agg. Supply.

EFFECTIVE DEMAND = Agg. Demand = Agg. Supply

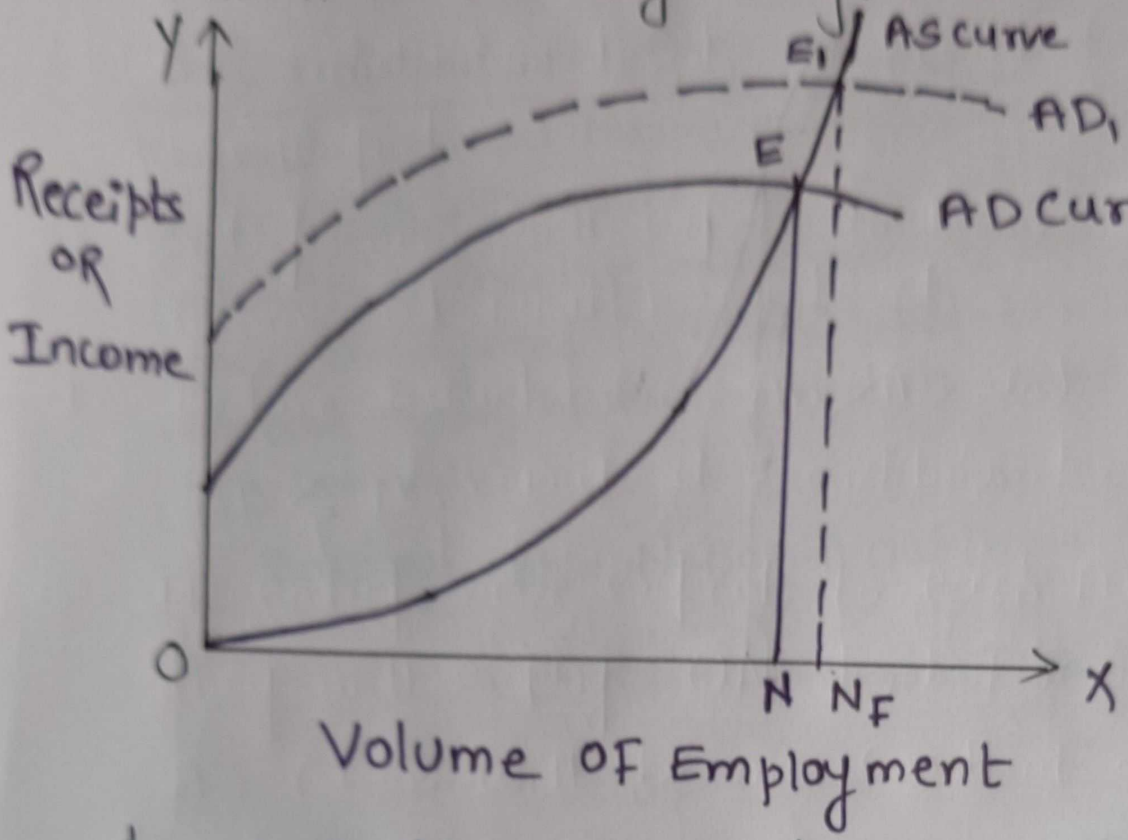
At effective Demand, Enterpreneur earns Normal Profit. Thus Equilibrium level of employment is determined where Agg. Demand Curve intersect Agg. Supply Curve shown in following diagram:-



In above diagram we observe :—

1. AD curve intersect AS curve at point E. It is called Point of Equilibrium or Effective Demand.
2. AT Equilibrium level, ON level of resources are employed.
3. Entrepreneurs will expect to Receive EN level of income at Equilibrium level.
4. Before Equilibrium AD > AS and After Equilibrium AD < AS. But at Equilibrium level AD = AS.
5. IF entrepreneur expect to earn Abnormal Profit, they will employ ON_F level of resources. Here AS curve will become Constant and take Vertical slope.
6. At Equilibrium level NN_F Level of labours are Unemployed. So According to Keynes — Agg. supply and Agg. Demand curve will intersect at Point E Less than Full Employment.
7. Keynes assumed that Agg. supply function depends upon Technical conditions like — Machinery, equipments and availability of Rawmaterials which cannot change in Short Period.
8. Keynes assumed to Follow this effective demand theory in Short Run only.

9. If we increase Agg. Demand from AD to AD_1, It will intersect Agg. supply curve at Point E_1, Shown in following diagram :—



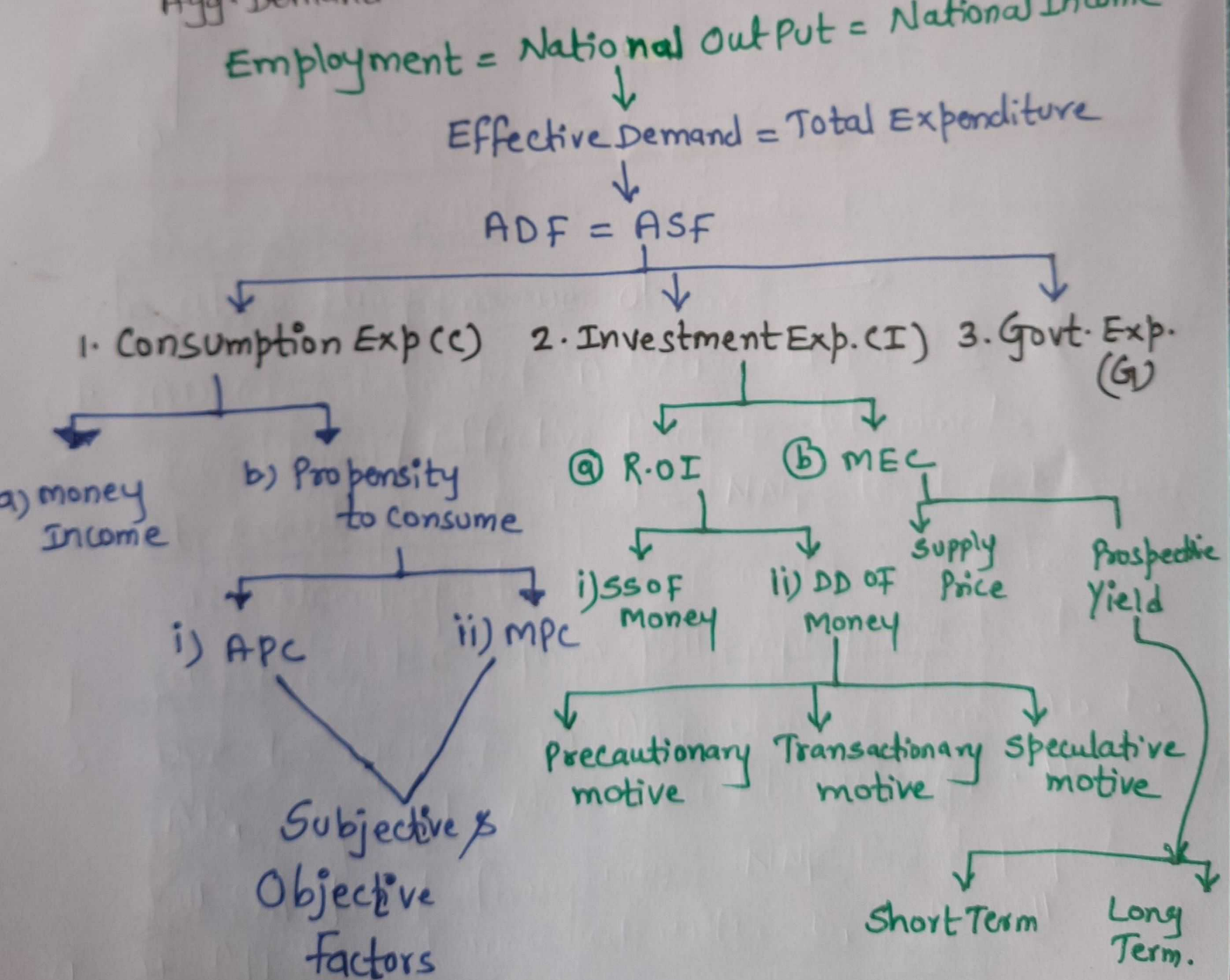
In above diagram we observe ⟶

1. AD Curve intersect AS Curve at Point E, where Ecquilibrium / Effective Point is determined.
2. At Ecquilibrium E level - NN_F level of labours are Unemployed. Thus Ecquilibrium can be achieved Less than Full employment level.
3. Due to increase in Agg. Demand from AD to AD_1 we get New Ecquilibrum - E_1. Here Full employment of resources NN_F are employed.
4. If Agg. Demand increased after - E_1, it will result in Inflation.
5. Thus Agg. Demand is important determinants of Effective Demand.

Q:3 Give an Outline of Keynes Theory of Income & Employment

OR Explain Determinants of Aggregate demand.

Determinants of Agg. Demand :- According to Keynes - General theory of employment is determined by Effective Demand. Agg. Demand depends upon - Propensity to consume and amount of investment. Since employment is depend upon total Demand. so General theory of employment is called a theory of Agg. Demand.



1. Total employment is depend upon total output which is equal to national Income.
   Thus Employment = National output = National Income.

2. Total Value of employment depend upon Effective Demand.
   Thus Effective Demand = Total Expenditure

3) Effective Demand is composed of ADF and ASF.
   Thus Equilibrium = ADF = ASF

4. Effective Demand = Total Expenditure &

Total Expenditure = Consumption Exp. + Investment Exp. + Govt. Exp.

AD = C + I + G1

5. Consumption Function is determined by Money Income & Propensity to Consume. It remain stable in the short-run. But APC and MPC is determined by Subjective and Objective Factors.

6. Investment Function is determined by Rate of Interest & Marginal Effeciency of Capital.
   R.O.I is determined by supply of money and Demand for money.
   Supply of money is issued by monetary Authority & remain Fixed.
   But Demand of money is determined by —
   Transactionary motive, Precaultionary motive & Speculative Motive.

7. MEC is determined by Supply Price and Prospective Yield. According to Keynes, MEC is highly Fluctuating phenomenon because it depends upon business psychology.

8. Thus According to Keynes — To raise the level of employment, effective demand should be raised. Increase in effective demand will result in more investment expenditure which increase income & employment Level.

— X —.