4.0 Interaction of Keynesian Aggregate Demand Function and Aggregate Supply Function & Determination of Real Income

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 Keynes theory is called 'General Theory' because it deals with all levels of employment i.e - Full employment, Less than Full employment, and more than Full employment. Keynes tries to Prove that Full employment is not the normal Feature of developed Countries. Equilibrium Can be achieved even Less than Full employment. According to him - Unemployment is found due to Lack of Effective Demand. Effective Demand is determined by Aggregate Demand

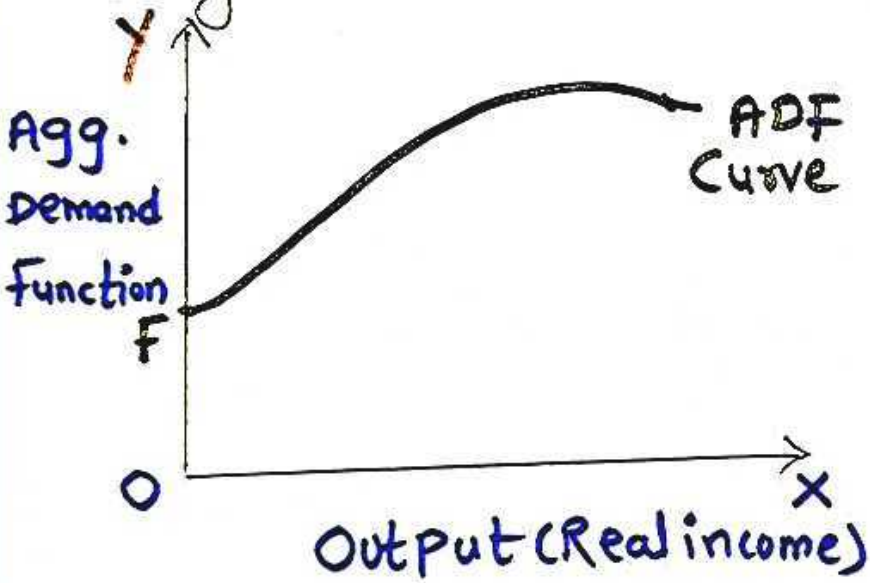
economicsguidance.com

Price and Aggregate Supply Price.

(B) Aggregate Demand Function :- J. M. Keynes-

" Aggregate Demand function is the amount of money which the entrepreneur expect to receive from the sale of out put 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) ADF is Agg. Demand Function Curve which is sloping upward From Left to right.

ii) It shows that as Agg. Demand is increasing, it will help to increase, Output, income and employment.

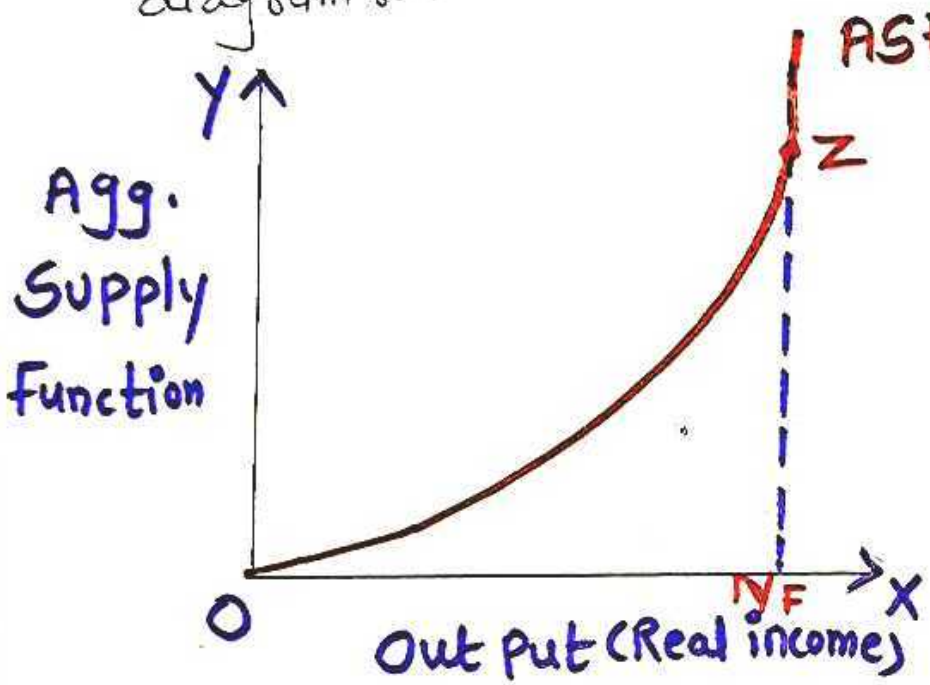
iii) As Output and employment increases but Aggregate Demand increases at diminishing Rate.

(C) Aggregate Supply Function (ASF) :-

" Aggregate Supply function is the total amount of money which all the entrepreneurs in the economy must receive From sale of out put at given level of employment. "

** Aggregate supply function means a schedule of different amount of revenues required by all the entrepreneurs at the given Level of employment"

Agg. supply Curve shows cost of producing goods at various levels of output shown in the following diagram :—



i) ASF is Agg. supply function curve sloping upward from Left to right.

ii) In beginning it rises slowly and then rapidly.

iii) Shape of supply curve depends upon Technical Conditions-

Example :- (a) Marginal Cost is positive, Agg. supply curve slopes upward.

(b) If Output increase at diminishing rate, Agg. supply Curve will rising more rapidly.

iv) At Full employment Level – N_F any increase in Cost will not increase any employment. So here ASF Curve becomes 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 :-

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.

(B) Meaning :-

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

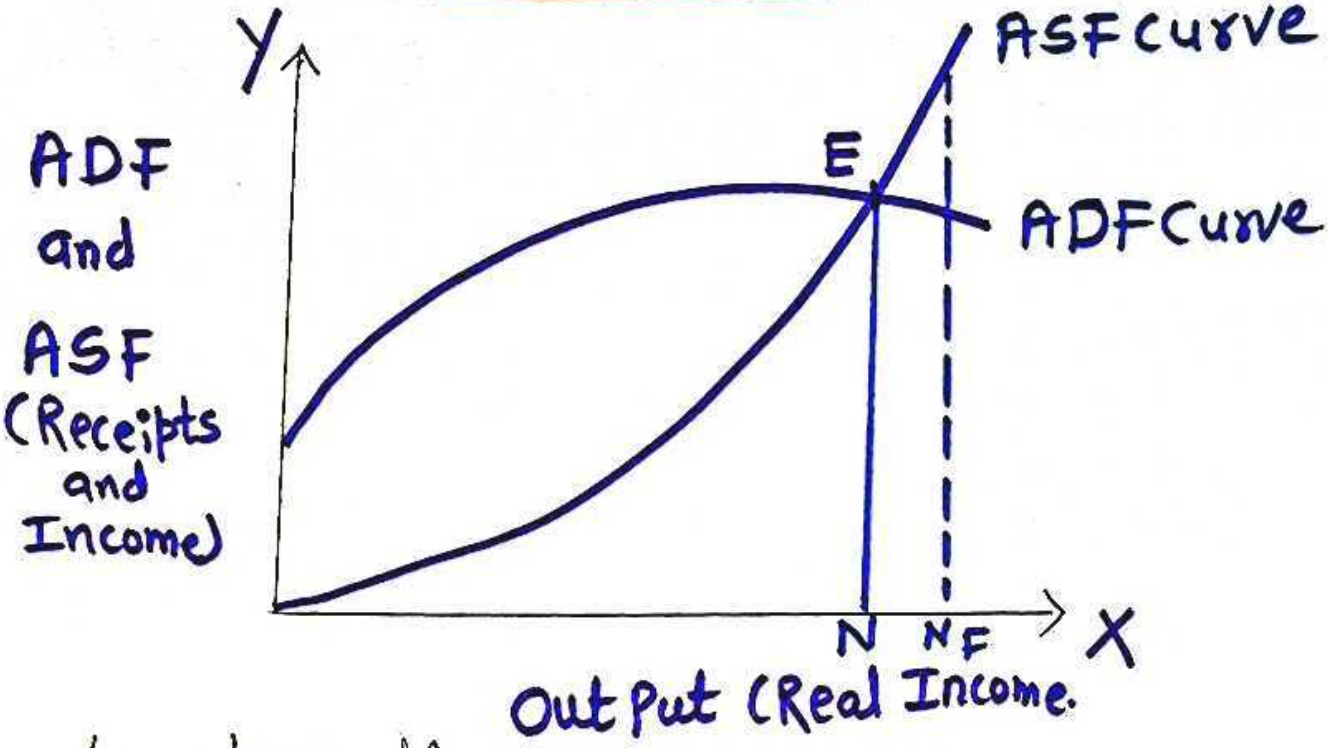
Effective Demand is determined where Agg. Demand Curve intersect Agg. Supply Curve

(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, Entrepreneur earn Normal Profit Thus Equilibrium level of Employment is determined where Agg. Demand Curve intersect Agg. Supply Curve Shown in following diagram :—



economicsguidance.com

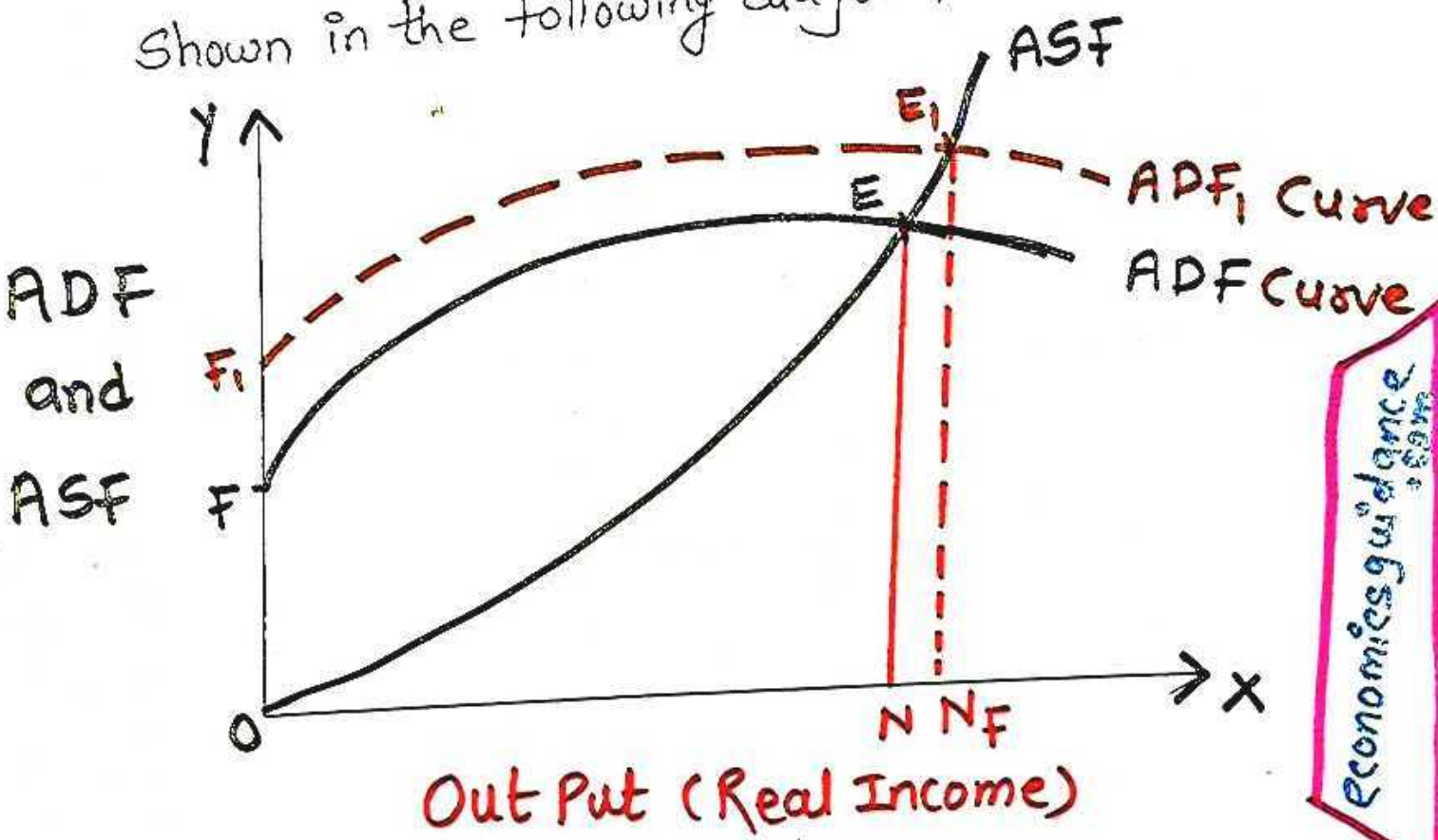
In above diagram we observe :-

1. ADF Curve intersect ASF 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 ASF Curve become Constant and take Vertical slope.
6. At Equilibrium Level NN_F level of Labours are Unemployed. So According to Keynes - Effective demand is determined Less than Full Employment. At Equilibrium **Agg. Demand = Agg. Supply**

7) Keynes assumed that Agg. Supply Function depends upon - Technical conditions like - Machineny equipments and availability of Raw materials which cannot change in Short-Period.

8) Keynes assumed to follow this effective demand theory in Short-Run only.

9) If we inerease Agg. Demand from ADF to ADF_1, It will intersect Agg. Supply Curve at Point- E_1 Shown in the Following diagram :—



In the above diagram we Observe —

1. ADF Curve intersect ASF Curve at Point E where Equilibrium level is determined.
2. At Equilibrium-E level - NN_F level of Labours are Unemployed. Thus according to Keynes- Equilibrium can be achieved Less than Full-Employment

Level.

3) Due to increase in Aggregate Demand, ADF Curve shift to ADF_1. Here we get New Equilibrium - E_1. Here we get Full employment of Resources upto NF level

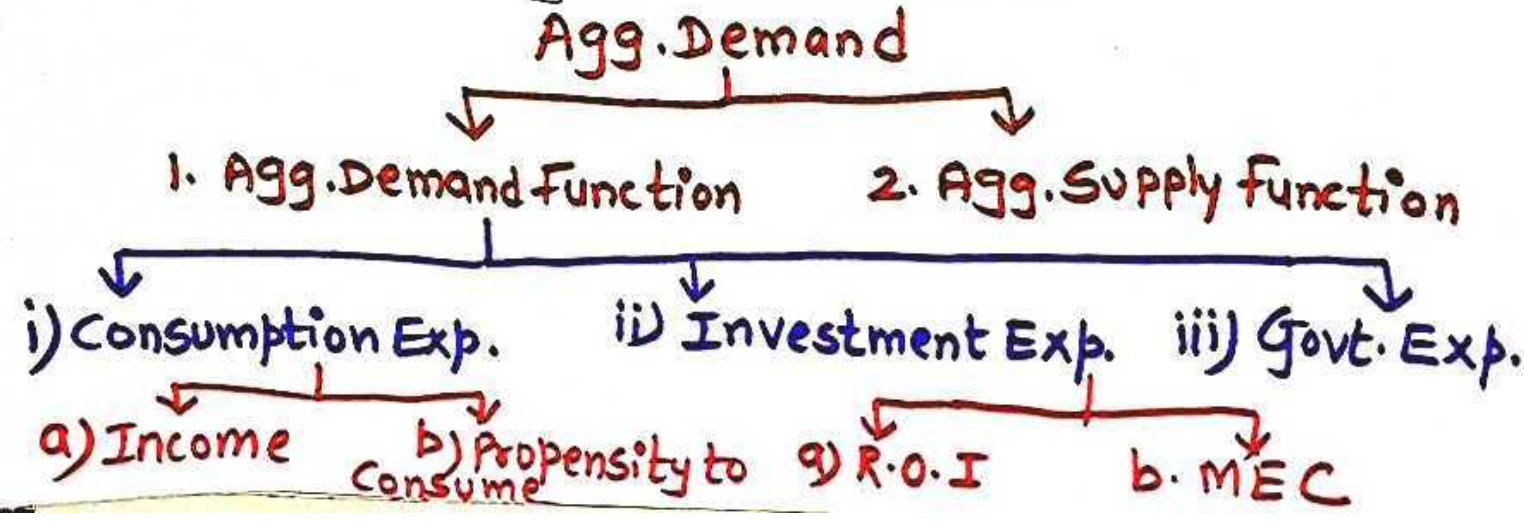
4) IF Agg. Demand increased After- E_1, it will result in IFlation.

5) Thus Aggregate demand is an important determinant OF Effective demand.

Q:3 Explain Determinants OF Aggregate Demand Function ? [OR] Give an Outline of Keynes Theory OF Income and Employment?

(A) Determinants OF Aggregate 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 theory OF Agg. Demand.



1) According to Keynes- Total employment depends upon Effective Demand where Agg. Demand = Agg. supply.

2) At Effective Demand, ADF Curve intersect ASF Curve where economy achieve equilibrium.

Equilibrium = ADF = ASF

4) Effective Demand = Total Expenditure = Agg. D. F

Agg. Demand function = Consumption Exp. + Investment Exp. + Govt. Exp.

$$ADF = C + I + G$$

5) **Consumption Function :-** It is determined by money income and Propensity to Consume. It remain stable in Short-run. But APC and MPC is determined by various subjective and objective Factors.

6) **Investment Function :-** Investment Function is determined by — i) Rate of Interest.
ii) Marginal Efficiency of Capital.

i) Rate of Interest is determined by supply of money and Demand for money.
Supply of money is controlled by monetary Authorities and it remain fixed.
But Demand for money is determined by — Transactionary Motive, Precautionary Motive and Speculative Motive.

economicsguidance.com

ii) Marginal Efficiency of Capital is determined by Supply Price and Prospective yield. According to Keynes MEC is highly Fluctuating phenomenon because it greatly depend on business psychology.

7. Net Exports (X-M):- It is Final Component of Aggregate demand. It shows the effects of domestic Spending on foreign goods (M) and Foreign spending on domestic goods (X). The difference between Export and Import is called Net Exports.

This Net Exports is determined by Domestic and Foreign incomes, Relative Prices and Exchange Rates.

Q:4 What is inflationary Gap? Explain it with the help of suitable diagrams?

(A) Inflationary Gap:- In 1940, the term inflationary gap was used by Keynes in his pamphlet - 'How to Pay for the war'

According to Keynes,- inflation is Found in Post-employment Period. Here we find more demand for goods and Services as Compare to its supply.

(B) Meaning:- " An inflationary gap is the amount by which the actual GDP exceeds Potential Full-employment GDP."

An inflationary gap measures the difference between the Current Level of Real GDP and GDP of the economy Operating at Full employment.

Inflationary Gap = Current Real GDP − Potential GDP

If Agg. Demand exceeds the Aggregate Value of output at the Full employment level then we observe inflationary gap in the economy.

It means $C+I+G+(X-M) > Y_F$ (Value of out put at Full employment level)

© Example :-

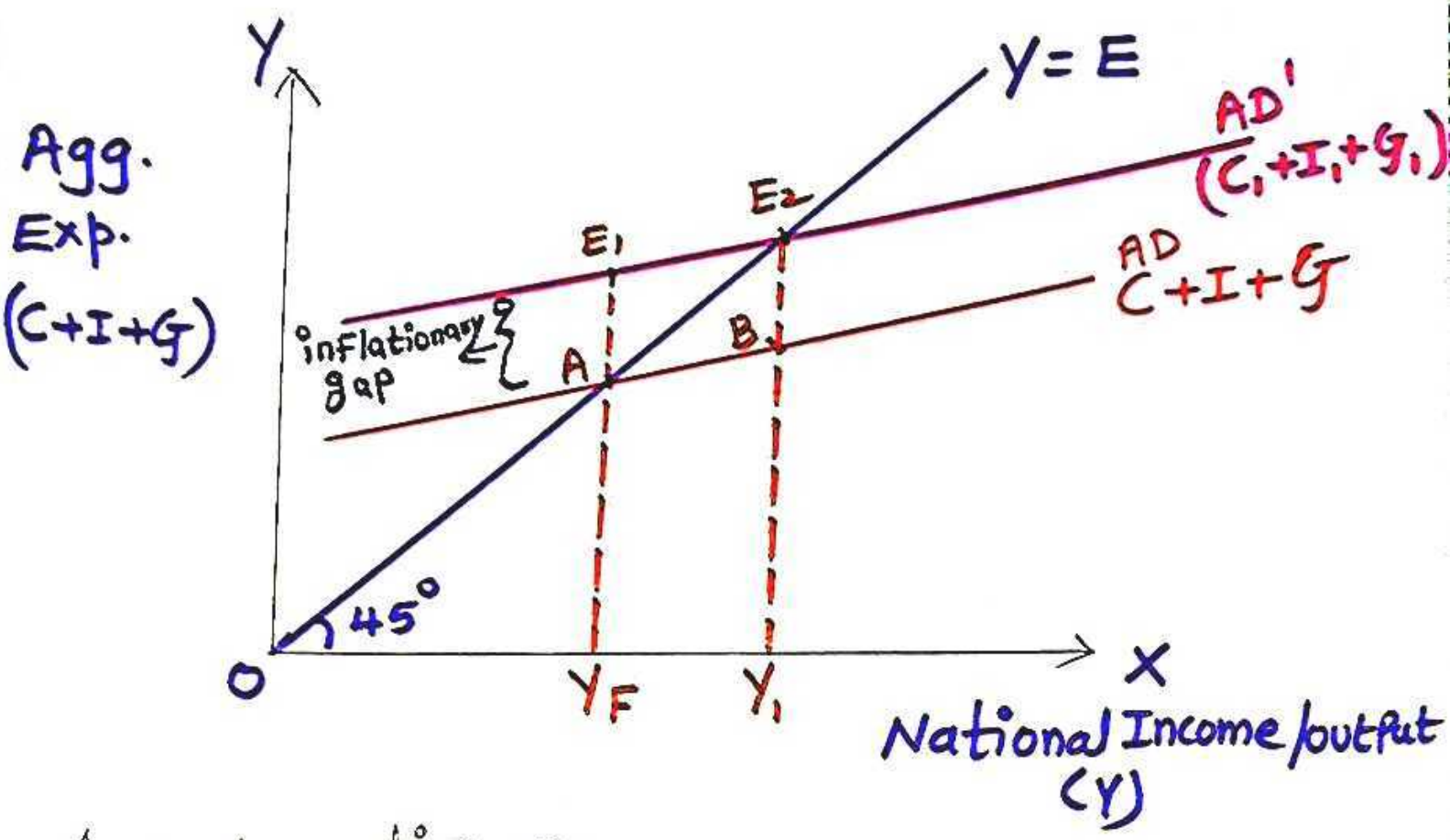
1. Total money income of People	Rs. 500 Crores
2. Net Agg. Value of out Put	Rs. 500 Crores.
Thus Price remain Stable as Total Exp = Total out Put.	
3. Let money income of People increase to	Rs. 800 Crores
4. Govt. Collect Taxes.	Rs. 50 Crores
5. People Save + invest	Rs. 100 Crores
6. Now Disposable income (800 − 50 − 100) →	Rs. 650 Crores
7. Now People have Excess Demand For	Rs. +150 Crores
Thus It Pull the Price and Create inflationary gap → 150 Crores	

Thus inFlationary gap is found when Agg. Demand is more than Aggregate supply.

economicsguidance.com

AD > AS ⟶ inFlationary gap.

It is clear with the help of Following diagram:—



In above diagram —

1) Income is shown on X-axis and Agg. Expenditure is shown on Y-axis.
2) A Line is drawn From Origin at 45°, which shows Income = Expenditure.
3) AD Curve (C+I+G) intersect line OY at Point-A. It is known as Equilibrium Point at Full employment level of Income - Y_F.
4) As the total expenditure increases, The Agg. Demand Curve is shifted Upward AD_1 $(C_1+I_1+G_1)$. Now Excess Demand = E_1A and Output available / Income = Y_FA.
5) New Demand Curve has intersect line OY at Point E_2.

Now Total Expenditure / Agg. Demand = $E_2 Y_1$

But output available ⟶ = $Y_F A$

Thus Inflationary gap $E_1 A = E_2 = B$

Q:5 Select the most appropriate answer from the alternative given and rewrite statement:—

1. The Point when ADF and ASF intersect is Called **b- Effective Demand**

a) Total Demand b) Effective Demand
c) Equilibrium Price d) Inflationary gap.

2) According to Keynes, in order to increase real income we have to increase Aggregate **b- Demand**

a) Supply b) demand c) employment d) Consumption.

3) The Curve which is a Schedule of minimum amount of Proceeds required to provide various levels of output is called **a- Aggregate Supply.**

a) Aggregate Supply b) Aggregate Demand
c) Employment d) Total Spending.

4) When there is excess of anticipated expenditure over the available output it gives rise to **b- Inflationary gap**

a) deflationary gap b) Inflationary gap.
c) Underemployed d) employment gap

Q:6 State whether the following statements are True or False with Reasons :—.

1. Keynes theory is called general theory.

Ans:- True. Reasons – Q:1 – A Part

2. The Aggregate demand function slopes upward from Left to right.

Ans:- True. Reasons – Q:1 – B – Part

3. The Aggregate supply function is the minimum amount the Producers in the economy must receive to provide any given Level of out put.

Ans:- True. Reasons – Q:1 – C Part

4. The Point where the ADF and ASF intersects give us the equilibrium level of Prices.

Ans:- False. Reasons Q:2 – C Part.

5. Inflationary gap exists when there is excess of anticipated expenditure over the available output.

Ans:- True. Reasons Q:4 – A Part