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Aggregate Demand and Aggregate Supply

1. INTRODUCTION

In Keynes' *General Theory*, the level of employment has been related to the effective demand. A higher level of effective demand implies a higher level of employment and vice-versa. The concept of effective demand, however, was not originally developed by J.M. Keynes. T.R. Mathus, first of all, explained the over-production and unemployment in a capitalistic economy through the deficiency of effective demand. The credit, however, goes to Keynes who modified it and made it a tool of the most logical and scientific analysis of variations in income, output and employment in a capitalistic economic system.

2. MEANING OF EFFECTIVE DEMAND

In Economics, demand for goods and services does not merely mean the desire or willingness to buy them. The consumers must also have the capacity to buy. The demand, in fact, denotes the effective desires involving both the willingness and capacity to buy. The latter is expressed through the amount actually spent on the purchase of goods and services. The term demand has been often employed to indicate the quantities of goods and services bought by a consumer or a group of consumers in one market at their different prices. The term 'effective demand' refers to the aggregate amount spent on goods and services by the whole community in a specified period. Thus effective demand

signifies the total spending of community.

Dillard, therefore, rightly defined effective demand in these words, "*Effective demand manifests itself in the spending of income.*"

According to Kurihara, "*Total demand is effective when consumption plus investment assumes a value equal to income.*"

This definition recognises that effective demand is equal to total expenditure which remains equal to total income. It elaborates upon the composition of total expenditure which is the sum of consumption expenditure and investment expenditure.

The above definitions suggest that effective demand is determined by total expenditure.

Effective Demand = Total Expenditure... (i)

If total expenditure increases, there is an increase, in effective demand and vice-versa. In any economic system, one man's expenditure is another man's income so that aggregate expenditure remains equal to aggregate income.

Total Expenditure = Total Income ... (ii)

The aggregate income in a country remains equal to the value of total output. As output rises, there is also a rise in income and vice-versa.

Total Income = Total Output ... (iii)

The level of output in a country is determined by the volume of employment. At a higher level

of employment, the output too is larger and vice-versa.

$$\text{Total Output} = \text{Total Employment} \dots (iv)$$

From (i), (ii), (iii) and (iv) it follows that :

$$\text{Effective Demand (E.D.)} = \text{Total Expenditure (E)}$$

$$= \text{Total Income (Y)}$$

$$= \text{Total Output (O)}$$

$$= \text{Total Employment (N)}$$

$$\text{E.D.} = \text{E} = \text{Y} = \text{O} = \text{N}$$

Thus the inference follows that the level of effective demand is the determinant of employment.

In a closed two-sector (households and business) economy, the total expenditure (E) is comprised of consumption expenditure, (C) and investment expenditure (I)

$$\text{E. D.} = \text{C} + \text{I}$$

In a three-sector system including household, business and government sectors, another component of aggregate spending is the government expenditure on goods and services (G). Therefore effective demand in such a system is the sum of consumption, investment and government expenditure.

$$\text{E. D.} = \text{C} + \text{I} + \text{G}$$

In a complete four-sector system including household, business, government and foreign sectors, the aggregate expenditure is the sum of consumption, investment, government expenditure and net foreign balance (X - M). X stands for the total receipts of the country from the foreign countries on account of the exports of goods, services and capital. M, on the other hand, stands for total payment made by the home country to the foreign countries. The net foreign balance is the excess of total receipts from abroad and total payment to abroad.

The net foreign balance (X - M) can be positive or negative. In a four-sector complete system, the effective demand can be expressed as

$$\text{E. D.} = \text{C} + \text{I} + \text{G} + (\text{X} - \text{M})$$

Some writers including Keynes himself have defined the concept of effective demand from the point of view of its *determination*. According to them, the effective demand is determined by an equality between aggregate demand and aggregate supply.

In the words to J.M. Keynes "The volume of D (Aggregate Demand) at the point of aggregate demand function, where it is intersected by aggregate supply function, will be called the Effective Demand."

According to Stonier and Hague, "The short run equilibrium level of aggregate demand and aggregate supply, which determines short run employment, can be called effective demand."

From this viewpoint, Dillard defines effective demand in these words, "The adjective effective is used to designate the point on the aggregate demand curve where it is intersected by the aggregate supply curve".

3. THE AGGREGATE DEMAND

There are two determinants of effective demand—the aggregate demand and the aggregate supply. In this section, we study the aggregate demand or the aggregate demand function.

The aggregate demand refers to sale proceeds expected by entrepreneurs at varying levels of employment. The amount of money expected by the entrepreneurs through the sale of goods produced at a specific level of employment is termed as the *aggregate demand price*. Suppose the entrepreneurs expect from sales an amount of Rs. 80 crore when 20,000 workers are employed, the expected sale proceed

of Rs. 80 price.

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