

4. SHIFTS IN AGGREGATE DEMAND

During the period of boom or expansion, the entrepreneurs expect to receive larger amounts by the sale of output at the same level of employment. It means the aggregate demand function shifts upwards (ADF_1), when larger sale proceeds are expected at the given levels of employment. On the opposite, when there is contraction or depression, all entrepreneurs have pessimistic expectations. They expect lower sale proceeds at the same level of employment. In such a situation, the aggregate demand function shifts downwards (as ADF_2 in Fig. 2) compared with the original aggregate demand function. Fig. 2 shows that shifts can take place in the aggregate demand function in the *short run* on account of shifts in entrepreneurial expectations.

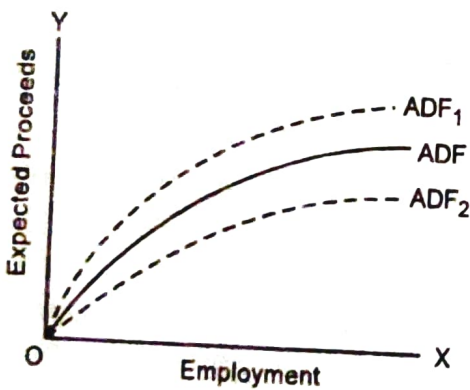


Fig. 2

The optimistic or pessimistic expectations of entrepreneurs or shifts therein are influenced by the following factors :

- (i) changes in consumer outlays.
- (ii) changes in private investment outlays.
- (iii) changes in government expenditure on goods, services and transfers.
- (iv) changes in taxes.
- (v) variations in money supply.
- (vi) changes in price level.

5. THE AGGREGATE SUPPLY

An entrepreneur must receive some minimum amount from the sale of product at a given level of employment, if that level of employment or output is to be worthwhile. The minimum amount which is necessary to be received is the cost of production. If the producers are not able to recover even that minimum amount, they will not maintain the supply. This amount of sale proceeds which the entrepreneurs must expect to receive so as to make the given level of supply or employment worth while, can be regarded as the aggregate supply price.

In the words of **Stonier and Hague**, "At any given level of employment of labour, aggregate supply price is the total amount of money which all the entrepreneurs in the economy, taken together, must expect to receive from the sale of output produced by that given number of men, if it is to be just worth employing them."

According to **Dillard**, "The minimum price or proceeds, which will just induce employment on a given scale is called the aggregate supply price of that amount of employment."

Keynes writes, "The aggregate supply price of the output of a given amount of employment is the expectation of proceeds which will just make it worth the while of the entrepreneurs to give that employment."

The aggregate supply function relates different amounts of minimum expected proceeds or aggregate supply prices to different levels of employment. The aggregate supply or aggregate supply function expresses the *functional relationship* between aggregate supply price (Z) or cost to the level of employment (N). This functional relationship can be stated as $Z = f(N)$.

The aggregate supply function or the aggregate supply schedule can be shown through Table 2.

Table 2—Aggregate Supply Schedule

Level of Employment (In Lakh Workers)	Minimum Expected Proceeds of Aggregate Supply price (In Crore Rs.)
0	0
2	180
4	360
6	540
8	720
8	900

Table 2 shows that there is direct relation between level of employment and the aggregate supply price. Initially at zero level of employment, the aggregate supply price is also supposed to be zero. As employment rises to 2, 4, 6 and 8 lakhs of workers, the aggregate supply prices or minimum expected proceeds which the employers must get are Rs. 180 crore, Rs. 360 crore, Rs. 540 crore and Rs. 720 crore respectively. After 8 lakh workers are employed, the level of employment remains unchanged signifying a state of *full employment*. Now at the same level of employment, the minimum expected proceeds or costs continue to increase. This happens because inflation starts after full employment and there is escalation of costs or aggregate supply prices even though there is no change in employment.

The aggregate supply curve or the aggregate supply function (ASF) is shown in Fig. 3.

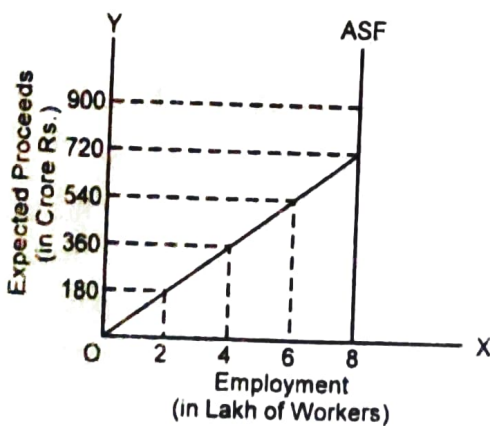


Fig. 3

In Fig. 3, employment is measured along horizontal scale and expected proceeds along the vertical scale. Given the levels of employment and corresponding minimum expected proceeds in Table 2, the aggregate supply function ASF has been drawn. It initially slopes upwards from left to right and at the level of full employment (8 lakh workers), it becomes parallel to vertical scale because the aggregate supply price alone now rises, while the level of employment remains fixed. In other words, the ASF is relatively more elastic before full employment and becomes perfectly inelastic after full employment.

Keynes regards aggregate supply function as fixed in the short period because supply is affected by such factors as machinery, equipment, organisation and techniques of production which can undergo changes only in the long run.

6. DETERMINATION OF EFFECTIVE DEMAND

The effective demand signifies the short run equilibrium between aggregate demand and aggregate supply. The point of effective demand is determined by the *intersection between the aggregate demand and the aggregate supply functions*. So long as the aggregate demand price is more than the aggregate supply price, the employers will tend to expand employment as they expect profits over costs. On the opposite, when the aggregate supply price is more than the aggregate demand price, the costs being in excess of expected sale proceeds, the volume of employment is likely to be reduced. When the aggregate demand price becomes exactly equal to the aggregate supply price, there

will neither be an expansion nor a contraction in the volume of employment. This equilibrium between aggregate demand and aggregate supply determines the effective demand. The determination of the point of effective demand can be explained through Table 3.

Table 3—Determination of Effective Demand

(In Crore Rs.)

Employment (In Lakh Workers)	ADP	ASP	
0	0	0	
2	200	180	ADP > ASP Expansion
4	380	360	
6	540	540	ADP = ASP Equilibrium
8	680	720	ADP < ASP Contraction
10	800	900	

Table 3 shows that the $ADP > ASP$ at the employment of 2 lakh workers. Since the entrepreneurs expect profits over cost, they will increase employment. The expansion in employment continues even when 4 lakh workers are employed because ADP (Rs. 380 crore) still exceeds the ASP (Rs. 360 crore). When 8 lakh workers are employed, the ADP (Rs. 680 crore) falls short of the ASP (Rs. 720 crore). In this situation, since there is an expectation of losses, the entrepreneurs will tend to reduce employment. When 6 lakh workers are employed, the ADP (Rs. 540 crore) is just equal to the ASP (Rs. 540 crore). In this situation, the entrepreneurs will have no tendency either to expand or to contract employment. This state of equilibrium determines the point of effective demand.

The point of effective demand can be shown with the help of Fig. 4.

In Fig. 4, employment is measured along horizontal scale and expected proceeds along

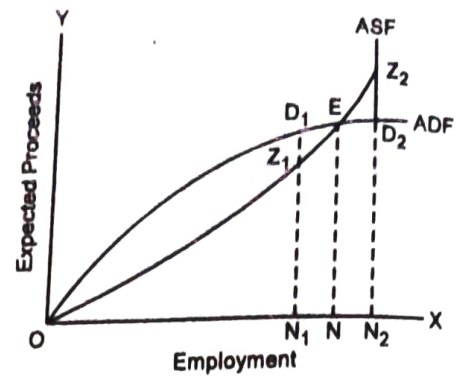


Fig. 4

vertical scale. ADF is the aggregate demand function and ASF is the aggregate supply function. The ASF becomes perfectly inelastic at the full employment level ON_2 . If employment is ON_1 , the aggregate demand price D_1N_1 is more than the aggregate supply price Z_1N_1 . Therefore, entrepreneurs will tend to expand employment. When ON_2 workers are employed, the aggregate supply price Z_2N_2 is more than the aggregate price D_2N_2 . Since the entrepreneurs in this case expect losses, they will tend to reduce employment. When ON workers are employed, the aggregate demand price (EN) is just equal to the aggregate supply price (EN). Since entrepreneurs neither expect excess profits nor losses, they will not either expand or contract employment. The point of intersection E between the aggregate demand function (ADF) and the aggregate supply function (ASF) is the *point of effective demand* and the equilibrium level of employment is ON .

7. EQUILIBRIUM NOT NECESSARILY AT FULL EMPLOYMENT

The classical economists held the belief that the economic system remains in a state of equilibrium at full employment. This raised the question whether the point of effective demand is determined only at the level of full employment. In this regard, Keynes explained