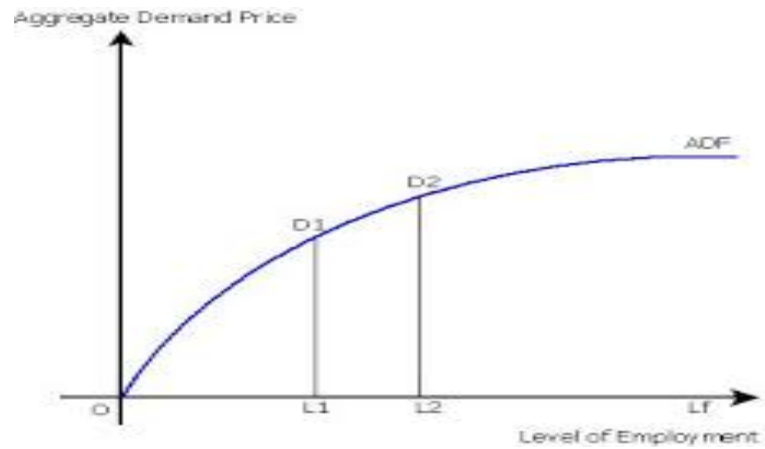
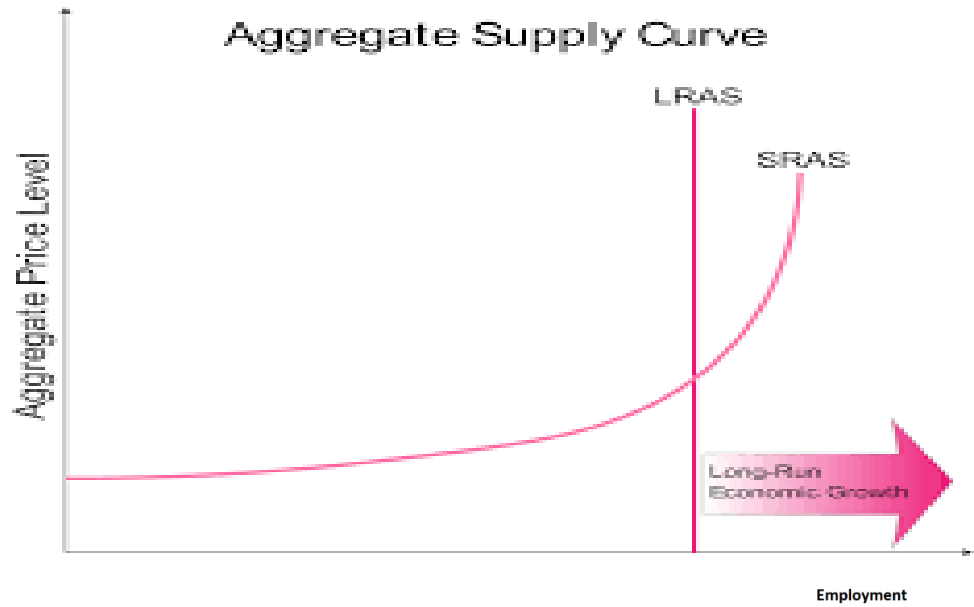


Principle of Effective Demand

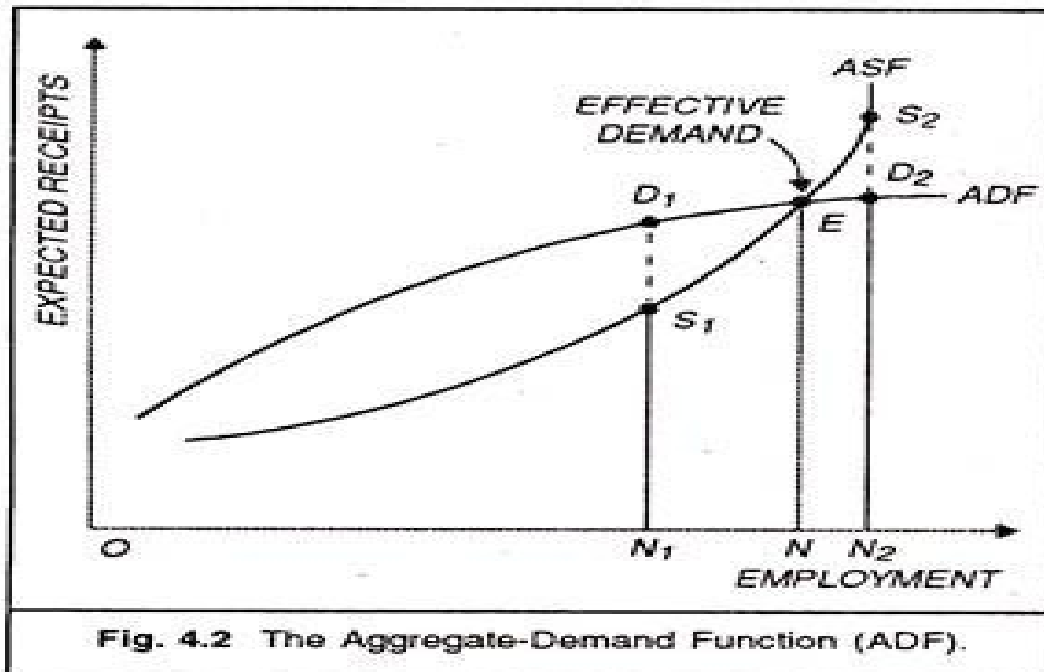
- Prior to Keynes, no satisfactory explanation was given of the factors determining the level of employment in the economy. Economists mostly assumed the prevalence of the state of full employment believing in Say's law of Markets, an old proposition claiming that all income is automatically spent or that the level of Effective Demand is always enough to lift all goods and services produced off the market.
- **Effective demand** refers to the willingness and ability of consumers to purchase goods at different prices. It shows the amount of goods that consumers are actually buying – supported by their ability to pay. In other words, it is total demand in the economy.
- In Keynes's macroeconomic theory, effective demand is the point of equilibrium where aggregate demand = aggregate supply.
- **Aggregate demand or aggregate demand price** is the amount of money or price which all entrepreneurs expect to receive from the sale of output produced by a given number of men employed.
- Or it refers to the expected revenue from the sale of output at a particular level of employment.
- Aggregate demand schedule shows the aggregate demand price at each level of employment.



- **Aggregate supply or aggregate supply price:** At any given level of employment of labour, aggregate supply price is the total amount of money that all entrepreneurs in the economy must receive from the sale of output produced by given number of labourers employed.
- For each particular level of employment, there is an aggregate supply price. Here, by 'price' we mean the amount of money received from the sale of output, i.e., sales proceeds.
- According to Keynes, aggregate supply function is an increasing function of the level of employment. Aggregate supply (AS) curve slopes upward from left to right because volume of employment increases with the increase in sale proceeds. But there is a limit to increase output level. This is called full employment level of output beyond which output cannot be increased; it is because of full employment that AS curve becomes vertical or perfectly inelastic. This means that the level of employment cannot exceed full employment (L_F) level even by increasing aggregate supply price.



- The level of employment in an economy is determined at that point where the aggregate supply price equals the aggregate demand price. In other words, the intersection of the aggregate supply function with the aggregate demand function determines the volume of income and employment in an economy.
- It is, thus, clear that so long as expected sales receipts of the entrepreneur (i.e., aggregate demand schedule) exceed costs (i.e., aggregate supply schedule), the level of employment should be increasing and the process will continue until expected receipts equal costs or aggregate demand curve intersects aggregate supply curve.

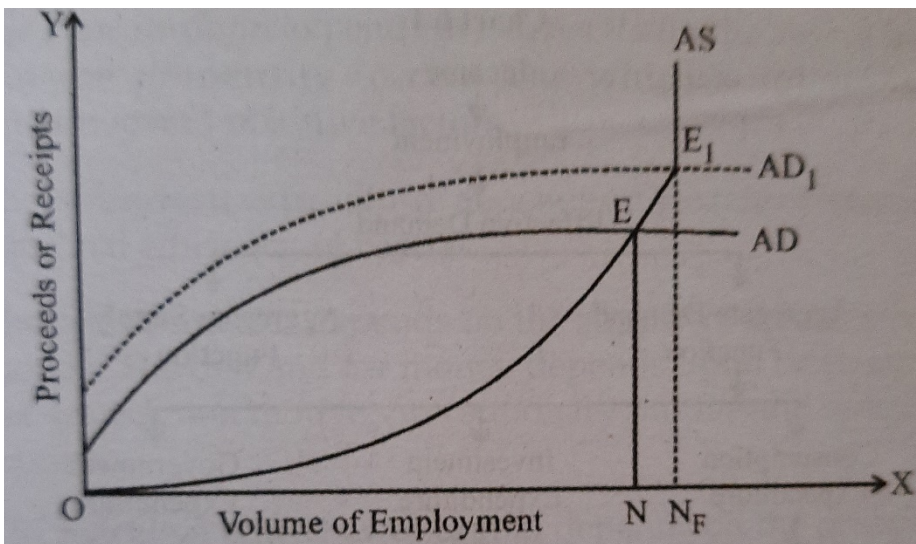


- The equilibrium level of employment is determined by the intersection of the AS and AD curves. This is the point of effective demand— point E in the diagram. Corresponding to this point, ON workers are employed. At the ON_1 level of employment, expected receipts exceed necessary costs by the amount D_1S_1 . Entrepreneurs will now go on hiring more labour till ON level of employment is reached.
- At this level of employment, entrepreneurs' expectations of profits are maximised. Employment beyond ON is unprofitable because costs exceed revenue. Thus, actual employment falls short of full employment (ON_2). Keynesian system shows two kinds of equilibria—actual employment equilibrium determined by AD and AS curves and underemployment equilibrium.

In order to increase employment and bring it to full employment level, we need to either lower the AS curve or raise the AD curve. The AS curve can be lowered (i.e. Aggregate supply can be increased) by increasing the productive capacity which is a long run phenomenon. Since Keynes is concerned with the short run he assumes AS function to be taken as given because it doesn't change in short run.

Thus, employment can be increased in the short run only by raising AD curve. In the following diagram, aggregate demand shifts to AD₁. Therefore, new equilibrium is achieved which is at full employment level.

Thus, AD is an important determinant of effective demand.



Factors Influencing Aggregate Demand:

Consumption expenditure, investment expenditure and government expenditure are the determinants of aggregate demand.