Maharshi Dayanand College of Arts, Science and Commerce, Parel, Mumbai- 12.

Macro Economics

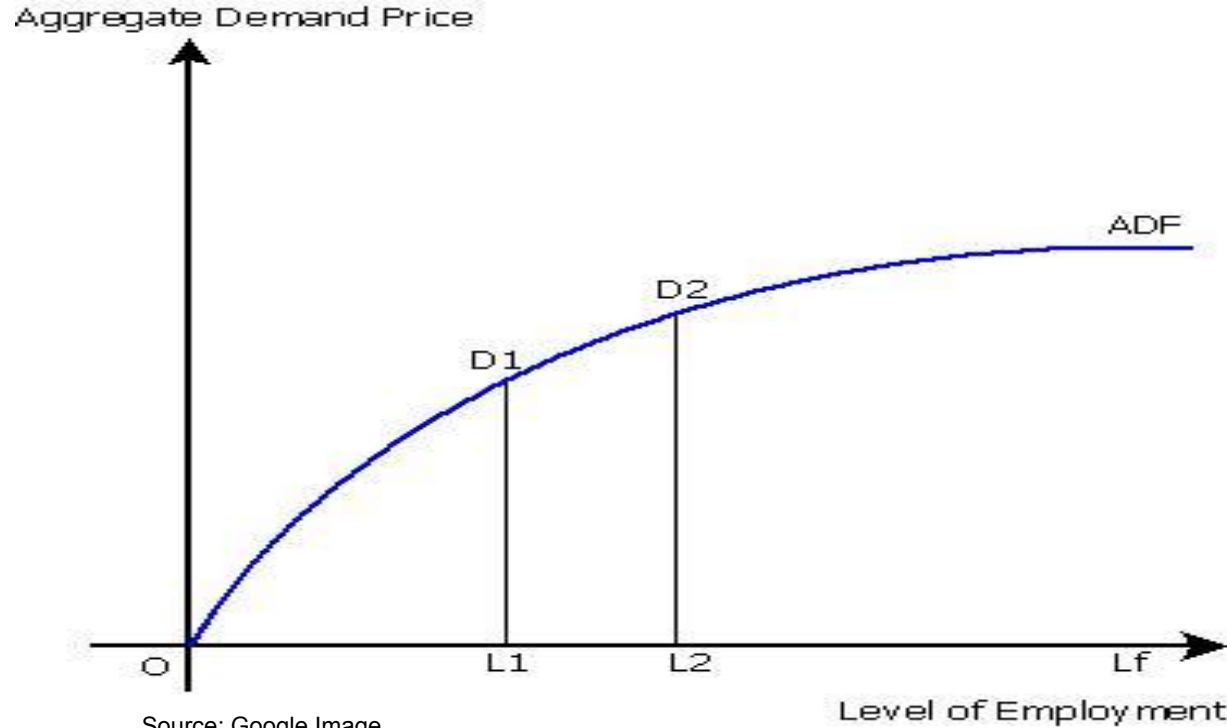Aggregate Demand, Aggregate Supply and Effective Demand

Introduction

The effective demand is an important principle in Keynes theory of employment. Effective demand implies the total spending of the commodity on consumption and investment goods. According to Keynes total employment depends upon effective demand. So **unemployment** is result of **lack of effective demand**. Higher the level of effective demand, the more the level of employment in the economy.

Effective demand depends upon 2 factors - Aggregate demand function and aggregate supply function.

1. **Aggregate demand function or Aggregate demand price**

- The aggregate demand price is the amount of money, which the entrepreneurs expect to receive from the sale of output produced at a particular level of employment.

- The aggregate demand curve or function is a schedule of the proceeds expected from the sale of the output at different levels of employment.

- The aggregate demand curve slopes upwards from left to right. It means that as the level of employment and income increase aggregate demand price also increases.

- With increase in income, people tend to spend a small amount of income on consumption goods.

- With increase in output and employment, aggregate demand price increases at a diminishing rate The slope of the curve diminishes as employment increases.

Aggregate Demand, Aggregate Supply and Effective Demand


Diagram: Aggregate Demand Price/Function

2. Aggregate Supply Price/ Function

- Entrepreneur needs profits.

- Employment of labour means entrepreneur will incur some costs.

- A certain minimum amount of proceeds will be necessary to induce employers to provide any given amount of employment.

- The supply price for any given quantity of commodity refers to that price at which the seller is willing or is induced to supply that amount in the market.

- If the seller does not get the minimum receipts, he will reduce output and employment.

- The **aggregate supply curve or function** is a schedule of the **minimum amount of proceeds** required to induce entrepreneurs to provide varying amount of employment. It shows the cost of producing a certain level of output or the minimum receipts which must be obtained if that level of output is to be maintained.

- The aggregate supply function slopes upwards. The shape of aggregate supply function depends entirely on technical conditions of production

Aggregate Demand, Aggregate Supply and Effective Demand

- **Aggregate supply curve or function curve** slopes **upward** in during short run. Figure (a).

- In the long run Aggregate supply function curve becomes vertical to X- Axis. Figure (b). Implying potential GDP growth has reached with given level of employment.
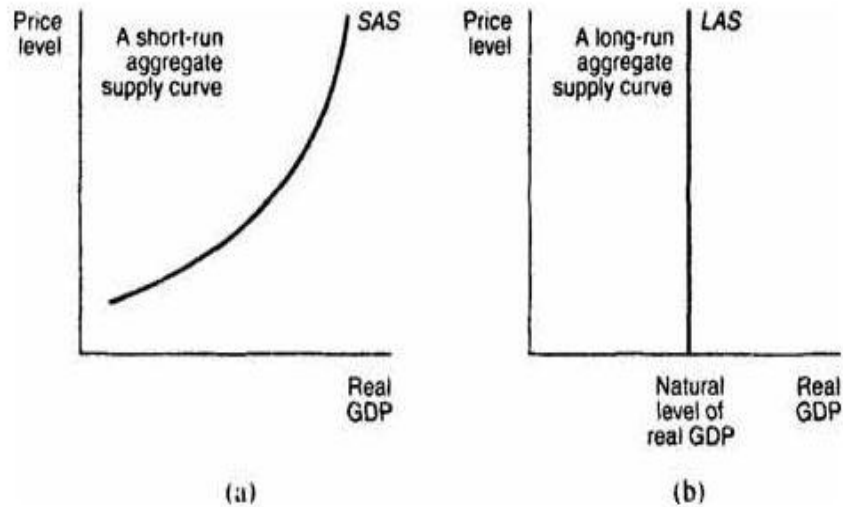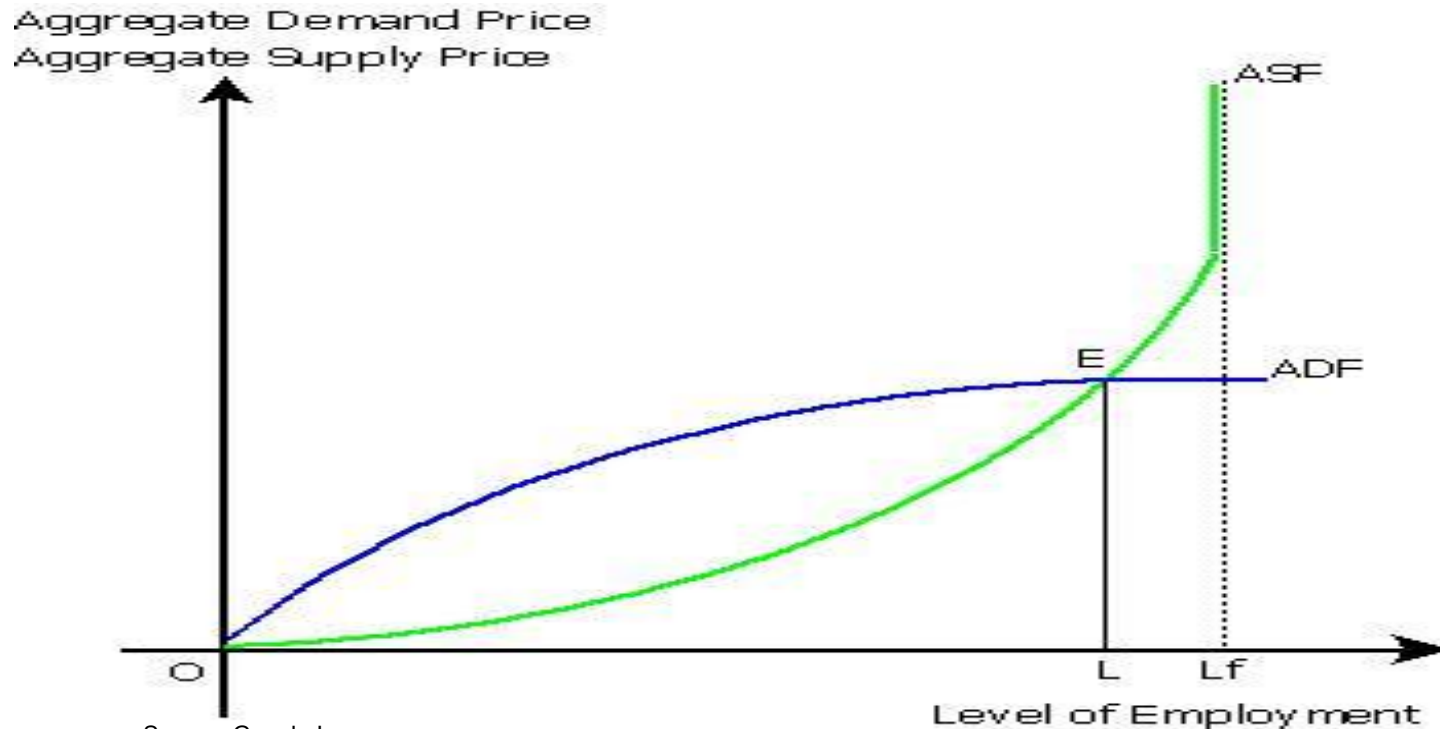

Source: Google Image

Aggregate Demand, Aggregate Supply and Effective Demand

Equilibrium Level of Employment

- The intersection of the aggregate demand function with aggregate supply function determines the level of income and employment.

- The aggregate supply schedule represents costs involved at each possible level of employment.

- The aggregate demand schedule represents the expectation of maximum receipts of the entrepreneur at each possible level of employment.

- As long as receipts exceed costs, the level of employment will go on increasing.

- The process will continue till receipts become equal to cost.

- At the point of equilibrium, the amount of sales proceeds which the entrepreneurs expect to receive is equal to what they must receive in order to just appropriate their total costs.

Aggregate Demand, Aggregate Supply and Effective Demand

• At point E, where the aggregate demand curve intersects the aggregate supply curve

• Its the point of effective demand with equilibrium level of employment OL. This is not necessarily full employment.

• If the level of employment is more or less than OL, the profits will be less than maximum.

• OLf level of employment is the full employment level in the diagram given below since at this level of employment the aggregate supply curve AS is vertical in shape.

Source: Google Image

Aggregate Demand, Aggregate Supply and Effective Demand

- For reaching full employment, employment level has to be increased. For this either the aggregate supply curve should be lowered or aggregate demand should be increased.

- Increasing the aggregate supply curve will require to increase in the productivity. This is a long run problem. Keynesian theory is concerned with short run analysis. Hence raising the aggregate demand is possible.

- In Keynes theory demand has been assigned the vital role.

Reference:

Mumbai University Study Material on Macro Economics.

- **Question to be Studied**

Q. 1. Discuss the two important functions which determine the level of effective demand.

Q.2 Write a note on Aggregate Demand.

Q.3 Write a Note on Aggregate Supply.

Dr. Saujanya Jagtap

THANKS