18

AGGREGATE DEMAND AND AGGREGATE SUPPLY

MEANING OF AGGREGATE DEMAND

Aggregate demand refers to the total demand for all goods and services taken together. In other words, "it is the total volume of purchases that consumers, investors and government are willing to undertake." (Charles Schultze)

Thus, aggregate demand or aggregate expenditure consists of the following four components:

1. **Household consumption demand:** The total demand of goods and services for consumption purposes, by all households of the country is the household consumption demand. The level of consumption demand depends on the level of disposable income of household. If a households' disposable income increases, the total amount spent on consumption also increases. But consumption does not increase as fast as income. Saving also increases as result of increase in income of the household.
2. **Private investment demand:** Investment is the money spent on the creation of new capital assets. Private investment depends upon rate of interest and marginal efficiency of capital (expected rate of return of an additional unit of capital goods). An entrepreneur will continue to invest up to the point where rate of interest is equal to marginal efficiency of capital (MEC).
3. **Government demand for goods and services:** Today, government has become a prominent buyer of goods and services. Government demand these for meeting public needs such as roads, schools, health, irrigation, power and infrastructure, maintenance of law and order etc.
4. **Net export demand:** Net exports (exports minus imports) refer to foreign demand for goods and services produced by an economy. It is affected by many factors such as trade policy of the trading partners, relative prices of goods, incomes of the nations, foreign exchange rates etc.

Aggregate demand is, thus, composed of consumption expenditure/demand and investment expenditure/demand. In short,

$$Y = C + I$$

Where, Y = Income or aggregate demand; C = consumption demand and I = investment demand.

The aggregate demand schedule which shows levels of consumption and investment is shown as under:

Level of income (Y)	*Consumption expenditure (C)*	*Investment expenditure (I)*	*Aggregate expenditure (C + I)*
0	10	10	20
5	15	10	25
10	20	10	30
15	25	10	35
20	30	10	40
25	35	10	45
30	40	10	50

The Fig. 18.1 below shows aggregate demand curve.

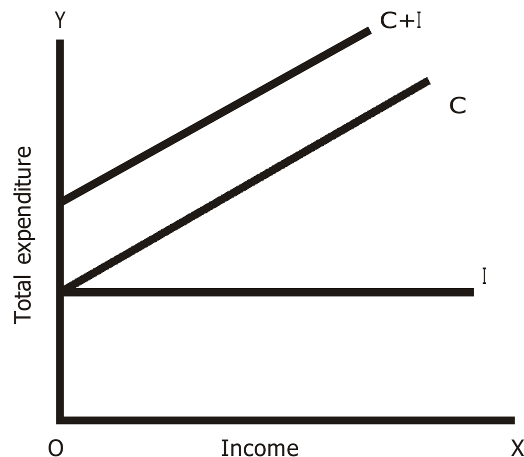

Fig. 18.1

MEANING OF AGGREGATE SUPPLY

It refers to the sum-total of goods and services produced in an economy during a certain period of time. It is nothing but net national product. Thus, aggregate supply is the aggregate cost of producing the output, which goes to factors as income in the form of wages, rent, interest and profits. The producers must receive the cost of producing the output in the economy. Thus,

$$\text{Aggregate Supply} = \text{Consumption} + \text{Saving}$$

$$Y = C + S$$

Where, Y is total factor income, or domestic product, C is consumption, and S is saving.

The aggregate supply schedule shows levels of consumption and investment, which is shown as under:

Level of income (Y)	*Consumption expenditure (C)*	*Saving (S)*	*Aggregate Supply (C + S)*
0	20	–20	0
10	25	–15	10
20	30	10	20
30	35	–5	30
40	40	0	40
50	45	5	50
60	50	10	60

The Fig. 18.2 below represents aggregate supply curve. The aggregate supply curve as shown above is a straight line, originating from the origin, which makes it to form 45° angle.

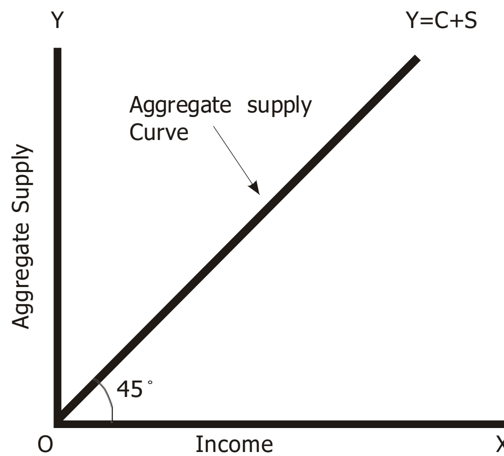

Fig. 18.2

Questions for Review

1. What is effective demand?
2. What is aggregate demand? State its components.

UNIT-8

19 DETERMINATION OF INCOME AND EMPLOYMENT

In macro economics, income and employment are used synonymously because in the short period national income depends on the total employment in the economy. Determination of income and employment is a major issue that economists have dealt with from time to time. It is necessary to first understand how classical economists have analyzed the determination of income and employment and then analyse the modern version of the theory of employment propounded by J.M. Keynes in his book, "General theory of Employment, Interest and money."

CLASSICAL THEORY OF EMPLOYMENT

Classical theory of employment assumes full employment of labour and other productive resources. The classical economists also opined that it is the flexibility of prices and wages which brings about full employment in the economy.

According to classical economists, general over-production which results in general unemployment is impossible. There may be temporary instability in the economy but it is restored within a short period. Thus, they believed that there will always be a stable equilibrium at full employment. Any disturbances in the full employment situation may be due to government interference or any other causes in the free market economy. As government does not interfere in free market activities, there is no possibility of general unemployment or instability in the normal situation, i.e., stable equilibrium at the full employment level. According to classical theorists, it is market forces of demand and supply which determines how to allocate resources and what rewards the factor resources should get.

Prices and wages, classical economists say, are flexible. This helps in bringing full employment by itself. In a situation when there is general over production in the economy; it would result in depression (a situation when all business activities are at very low level) and hence large scale unemployment. Thus, prices would go down. This in turn results in increase in demand which would push prices up and in this way business activities will get a boost and unemployment would disappear. Wages can also help in increasing unemployment if it is flexible. For example, wages are lowered to increase demand for labour.

Jean-Baptiste Say (Jan 5, 1767—Nov 15, 1832) was a French economist and businessman. He had liberal views and argued in favour of competition, free trade and lifting restraints on business.

Say is well known for Say's Law, often summarised as "Aggregate supply creates its own aggregate demand". He argued that production and sale of goods in an economy automatically produces an income for the producers of the same value, which would then be reinjected into the economy and create enough demand to buy the goods. Thus production is determined by the supply of goods rather than demand. Unemployment of men, land or other resources would not be possible unless it were by choice, or due to some kind of restraint on trade.

He was also among the first to argue that money was neutral in its effect on the economy. Money is not desired for its own sake, but for what it can purchase. An increase in the amount of money in circulation would increase the price of other goods in terms of money (causing inflation), but would not change the relative prices of goods or the quantity produced. This idea was later developed by economists into the Quantity theory of money. Say's ideas helped to inspire neoclassical economics which arose later in the 19th century.

SAY'S LAW OF MARKETS

French economist Prof. J.B. Say's law of markets is the foundation of classical theory of employment and income. This law states that there is no possibility of general overproduction and hence general unemployment in the economy. According to Say, "It is production which creates market for goods; for selling is at the same time buying and more of production, more of creating demand for other goods. Every producer finds a buyer". Thus, whatever is supplied in the economy, demand for it is automatically generated so that there is no general overproduction. Hence, it is said, 'supply creates its own demand'. When production takes place, it generates incomes for factor resources. The income so generated is spent on goods produced in the economy. Thus income is generated at the same time when goods are produced in the economy. It is therefore production which creates market for goods or demand.

According to say's law, there would always be adequate amount of expenditure on goods so that there is full employment of resources. Factor resources spend their income on goods and a part of it is saved. But savings so generated is invested on capital goods. Thus, classical economists assumed savings and investments to be equal. Since, there is no possibility of any break in the flow of income stream; supply would always create its own demand. Any difference between savings and investment would be brought to equality by the prevailing market rate of interest.

Assumptions of Say's Law

The important assumptions of Say's law of markets are the following:

1. There is free exchange economy and there is no government intervention. It follows the policy of laissez-faire. Buyers and sellers are free to buy and sell goods as they wish.
2. There is perfect competition prevailing in the market.
3. There is no break in the flow of income. Whatever income is received is spent. Savings and investments are also assumed to be equal.
4. The size of the market is limited by the volume of production.

J.M. Keynes vehemently criticized the classical theory on the ground that supply does not create its own demand and that cut in wage rate cannot increase employment during depression.

Saving is the leakage in the income stream, which breaks the flow of income and expenditure in the economy. It does not allow the whole income earned to be spent on what is produced. Unless investors are willing to invest an equal amount of intended savings, the total effective demand will not be adequate to absorb the entire available supply of output. Effective demand is the demand for consumers' goods and producers' goods. Thus there will be general overproduction and unemployment.

Savers have different reasons for their savings. Likewise, investors have different reasons for their investment. Thus there is no mechanism which ensures that intended saving and intended investment are equal because these are undertaken by different persons for different reasons. Savings is the function of income. It depends on income of a person. On the other hand, investment demand depends in the short run, primarily, on marginal efficiency of capital and rate of interest. Changes in technology and growth in population in a country are the long run factors which affects investment demand. Marginal efficiency of capital (MEC) is the yield expected from a new capital asset. Inducement to invest of a businessman depends on marginal efficiency of capital. High marginal efficiency of capital induces investment.

Keynes argued that a general cut in wages will not increase employment because wages are income to a large section of population. When purchasing power gets reduced, their demand for goods and services also falls. Employment in the economy depends on effective demand (aggregate spending) and not on wage level.

According to Keynes, the implication of Say's "law" is that a free-market economy is always at what the Keynesian economists call full employment. Thus, Say's law is part of the general world-view of laissez-faire economics, i.e., that free markets can solve the economy's problems automatically (here the problems are recessions, stagnation, and involuntary unemployment). There is no need for any intervention by the government or the central bank to help the economy attain full employment.

In fact, modern proponents of Say's law argue that such intervention is always counterproductive. Consider Keynesian-type policies aimed at stimulating the economy. Increased government purchases of goods (or lowered taxes) merely "crowds out" the private sector's production and purchase of goods. From a modern macroeconomic viewpoint Say's law is subject to dispute. John Maynard Keynes and many other critics of Say's law have paraphrased it as saying that "supply creates its own demand". Under this definition, once a producer has created a supply of a product, consumers will inevitably start to demand it. This interpretation allowed for Keynes to introduce his alternative perspective that "demand creates its own supply" (up to, but not beyond, full employment). Some call this "Keynes' law".

KEYNES VS. SAY

Keynsian economics places central importance on demand, believing that on the macroeconomic level, the amount supplied is primarily determined by effective demand or aggregate demand. For example, without sufficient demand for the products of labor, the availability of jobs will be low; without enough jobs, working people will receive inadequate income, implying insufficient