# Macroeconomics Equilibrium

In a capitalist economy, the level of employment depends on effective demand. Thus unemployment results from a deficiency of effective demand and the level of employment can be raised by increasing the level of effective demand.

## Effective Demand:

In ordinary parlance, demand means desire. It becomes effective when income is spent in buying consumption goods and investment goods. Keynes used the term 'effective demand' to denote the total demand for goods and services at various levels of employment. Different levels of employment represent different levels of aggregate demand. But there can be a level of employment where aggregate demand equals aggregate supply.

This is the point of effective demand. In Keynes's words, "The value of D (Aggregate Demand) at the point of Aggregate Demand function, where it is intersected by the Aggregate Supply function, will be called the effective demand." Thus according to Keynes, the level of employment is determined by effective demand which, in turn, is determined by aggregate demand price and aggregate supply price.

Effective Demand refers to that amount of aggregate expenditure which being equal to aggregate supply or national income proves to be effective.

In the words of **Lord Keynes**, "The value of aggregate demand at the point of aggregate demand function where it is intersected by aggregate supply function will be called the effective demand."

By 'effective demand', Keynes meant the total demand for goods and services in an economy at various levels of employment. Total demand for goods and services by the people is the sum total of all demand meant for consumption and investment. In other words, the sum of consumption expenditures and investment expenditures constitute effective demand in a two-sector economy.

**Modem economists, therefore, define effective demand as:**

Effective demand = C + I = G, where,

C = Consumption expenditure of the households.

I = Investment expenditure of private firms.

G = Government's expenditure on consumption and investment goods.

Here we ignore government expenditure as a component of effective demand. According to Keynes, the level of employment is determined by the effective demand which, in turn, is determined by aggregate demand function or aggregate demand price and aggregate supply function or aggregate supply price. In Keynes' words; "The value of D (Aggregate Demand) at the point of Aggregate Demand function, where it is intersected by the Aggregate Supply function, will be called the effective demand."

Position of equilibrium between aggregate demand and aggregate supply signifies effective demand. With increase in effective demand there is increase both in aggregate demand and aggregate supply. Hence, level of employment also increases. On the contrary, with fall in effective demand there is fall both in aggregate demand and aggregate supply.

## Determinants of Effective Demand

1) Aggregate Demand

2) Aggregate Supply

## 1) Aggregate Demand

**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. Each level of employment is associated with a particular aggregate supply price and there are different aggregate demand prices for different levels of employment.

**Aggregate Demand Schedule** is a table showing various amounts of money which the entrepreneurs in an economy expect from the sale of their output at varying levels of employment.

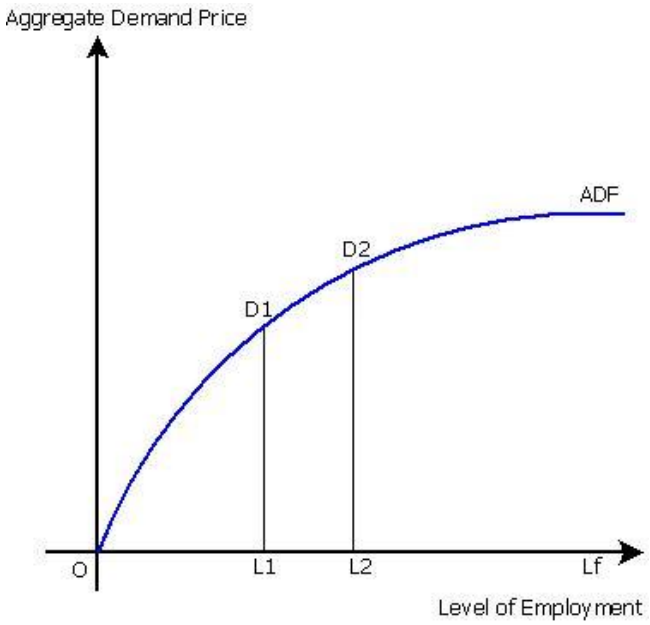
| Level of Employment (in lakh) | Aggregate Demand Price (in crore Rs.) |
|---|---|
| 0 | 100 |
| 10 | 360 |
| 20 | 420 |
| 30 | 480 |
| 40 | 540 |
| 50 | 600 |
| 50 | 640 |

Above table shows that as the level of employment goes on increasing, aggregate demand is also increasing. But, on reaching full employment situation aggregate demand tends to stabilize. It is so because ordinarily aggregate demand does not increase in the same proportion as the increase in income or employment.

**AD = f (N)**

**Aggregate demand (AD) is the function (f) of level of employment (N).**

**Aggregate Demand Curve** is a curve that expresses relationship between aggregate demand price and employment.




This curve slopes upward to the right. It shows that with increase in employment aggregate demand also increases.

**Determinants of Aggregate Demand**

Two main components of aggregate demand in a two sector economy are **Consumption-expenditure** and **Investment-expenditure**.

AD = C + I

Four components of aggregate demand in an open economy are **Consumption, Investment, Government-expenditure** and **Foreign Investments (**exports-imports**).**

AD = C + I + G + X - M

## 2) Aggregate Supply

**Aggregate Supply Price** refers to that minimum amount of money which all the entrepreneurs have to spend in order to produce the output at a given level of employment. OR aggregate supply refers to that minimum sale proceeds which all the entrepreneurs must get by selling a given output produced by a given level of employed persons.

**Aggregate Supply Schedule** refers to the entire table showing producer's minimum expected receipts from the sale of their output corresponding to the various levels of employment.

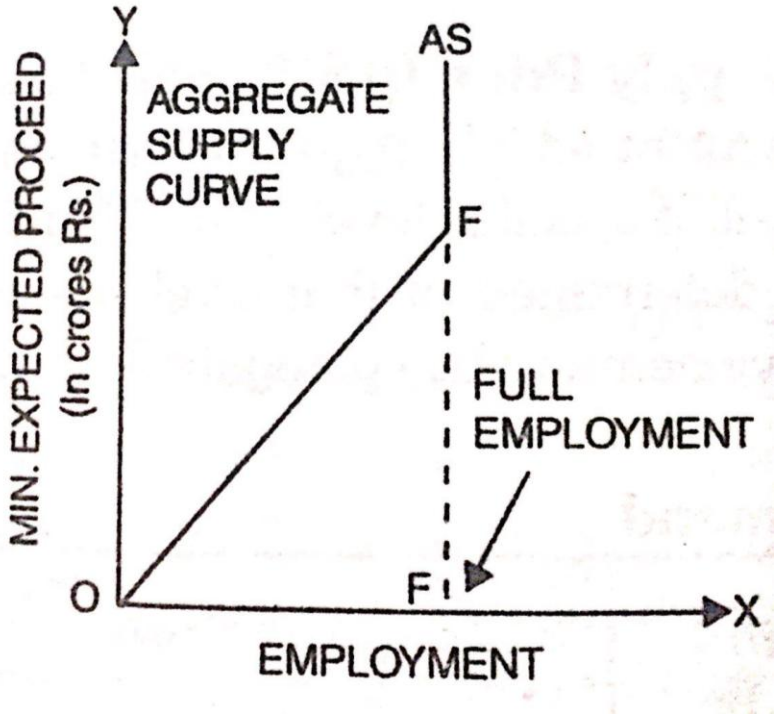
| Level of Employment (Lakh) | Aggregate Supply Price (Crore Rs.) |
|---|---|
| 0 | 0 |
| 10 | 120 |
| 20 | 240 |
| 30 | 360 |
| 40 | 480 |
| 50 | 600 |
| 50 | 720 (Full Employment) |

Above table shows that as the level of employment increases aggregate supply also increases. After reaching full employment situation, there will be no change in the level of employment but aggregate supply price will increase.

$$AS = f(N)$$

**Aggregate supply (AS) is the function (f) of employment (N).**

**Aggregate Supply Curve** is a curve that expresses relationship between aggregate supply price and level of employment.




In this figure, AS curve is sloping upwards up to point 'F'. But after point 'F', as a result of full employment situation, AS curve becomes a vertical line parallel to OY axis.

# Determination of Effective Demand

The level of employment at which aggregate demand becomes equal to aggregate supply (AD = AS) is called **equilibrium level** or **effective demand**. It depends on two factors:

1) **Aggregate Demand Price**
2) **Aggregate Supply Price**

| Employment (in lakh) | Aggregate Demand (in crore Rs.) | Aggregate Supply (in crore Rs.) | Equilibrium |
|---|---|---|---|
| 0 | 100 | 0 | Disequilibrium |
| 10 | 360 | 120 | AD > AS |
| 20 | 420 | 240 | AD > AS |
| 30 | 480 | 360 | AD > AS |
| 40 | 540 | 480 | AD > AS |
| **50** | **600** | **600** | **Effective Demand** |
| 50 | 640 | 720 | AD < AS |

Above table depicts that when level of employment is 50 lakhs, then both aggregate demand and aggregate supply are equal at Rs. 600 crore. It is an equilibrium situation. The aggregate demand under this situation is called effective demand. All situations excepting this level are situations of disequilibrium. Aggregate demand in these situations will not be called effective demand.

Aggregate Demand at point E is called effective demand. This point is also the point of equilibrium. Point E shows that in equilibrium position, level of employment is OQ and expected receipts OP. A change in the level of employment will ultimately make change in level of aggregate demand or supply price which will force the entrepreneurs to come back to the situation of equilibrium. Thus, effective demand is determined under equilibrium situation of employment because in this situation **aggregate demand = aggregate supply**.