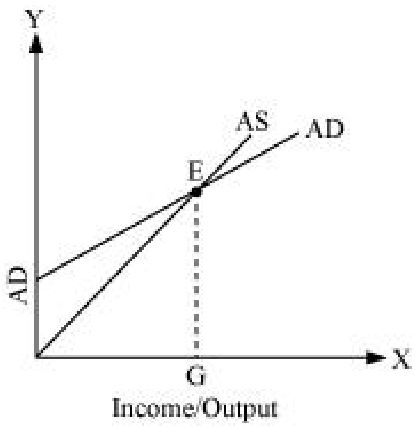
Q4. What is ‘effective demand’? How will you derive the autonomous expenditure multiplier when price of final goods and the rate of interest are given?

Ans. Effective demand refers to a situation in which equilibrium output is determined solely by the level of aggregate demand. This is because of the assumption that the supply is infinitely elastic and if there exists any inequality between the Aggregate Demand (AD) and the Aggregate Supply (AS), then the equilibrium output will only be influenced by AD. The concept of effective demand can be explained with the help of the given diagram.



The *x*-axis represents income/output level and *y*-axis represents the level of aggregate demand. E is the equilibrium point where the two curves AS and AD meet. EG is the effective demand and output level is determined by AD (assuming the elasticity of supply to be perfectly elastic).
Autonomous expenditure multiplier is derived as
Y = AD (at equilibrium)
Y = A + cY [Where AD = A + cY]
Y – cY = A
Y (1 – c) = A

$$Y = \frac{A}{1-c}$$

Where,
A = Autonomous expenditure
c = MPC
Y = level of income

$\frac{1}{1-c}$ = autonomous expenditure multiplier

So, the autonomous expenditure multiplier is dependent on the income and MPC.

*********** END **********