Objective type questions (1 mark each)

1. Q:- What is effective demand?

Ans:- Effective demand refers to the level of aggregate demand of the community which is met by aggregate supply.

2. Q:- What is aggregate demand function?

Ans:- The schedule of various aggregate demand prices corresponding to different levels of employment is called Aggregate Demand Function (ADF)

3. What is aggregate Supply function?

Ans:- A schedule showing the different levels of aggregate supply price corresponding to various levels of employment is called the Aggregate Supply function (ASF).

4. Q:- What are the determinants of effective demand?

Ans:- (i) Aggregate demand function

(ii) Aggregate supply function.

5. Q:- What are the major components of Aggregate demand?

Ans:- (i) Consumption demand

(ii) Investment demand.

6. Q:- On what factors the Consumption demand depends?

Ans:- (i) Disposable Personal income

(ii) Propensity to consume.

7. Q. Fill up the blank:-
Marginal Propensity to Consume is ____ but less than ____ .

Ans:- Marginal Propensity to Consume is Positive but less than Unity.

8. Q:- Mention two major weakness of Keynes theory of effective demand. (marks - 2)

Ans:- (I) Keynsian Theory is based on many Unrealistic assumption like perfect competition, absence of international trade etc. These assumptions reduce the applicability of this theory in actual practice.

(II) Keynsian theory deals with short run phenomenon and ignored long run problems of a dynamic economy.

9. Q:- Taking a two sector economy, explain briefly a simple Keynesian model of income determination. 5 marks

Ans:- To discuss a simple Keynesian model of income determination, we shall consider an economy with only two sectors, namely household sector and business sector. This two sector basic model of Keynes can be studied by two approaches.
(I) Aggregate income - Expenditure Approach
(II) Saving - Investment - Approach.

(I) Aggregate Income - Expenditure Approach
The level of equilibrium national income is

determined by the volume of aggregate demand in the economy. At a fixed price level 'Aggregate demand' is the total expenditure which household and firms in an economy want to make on goods and services in a particular time period corresponding to different levels of national income. In a two sector ~~econo~~ economy, aggregate demand consists of two components – Consumption demand and investment demand. Thus

Aggregate Demand (AD) = Consumption Demand (C) + Investment demand (I).

or. $AD = C + I$

As Aggregate demand also represents the Aggregate expenditure in the economy. Thus Aggregate Expenditure (AE) = Consumption Expenditure C + Investment expenditure (I).

or. $AE = C + I$

According to the Keynesian short run linear Consumption function, where Consumption depends on level of nation or income and propensity to consume. Symbolically –

$$C = a + by$$

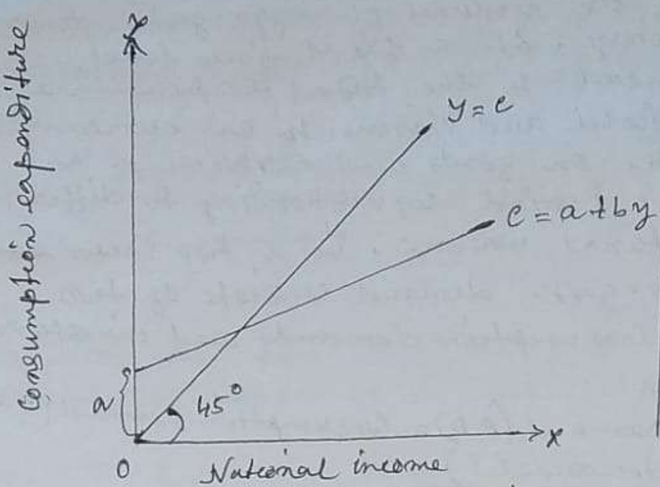
where – C is consumption demand or consumption expenditure.

y is the level of national income

a is autonomous consumption

and b is marginal propensity to consume.

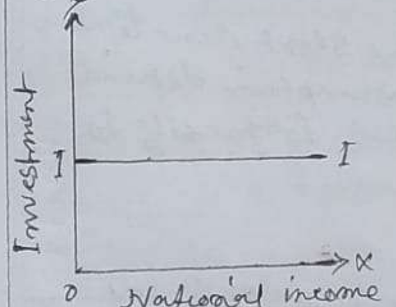
Diagramatically, the consumption function is shown in next page.



Here $C=a+by$ line represents the short run Consumption function.

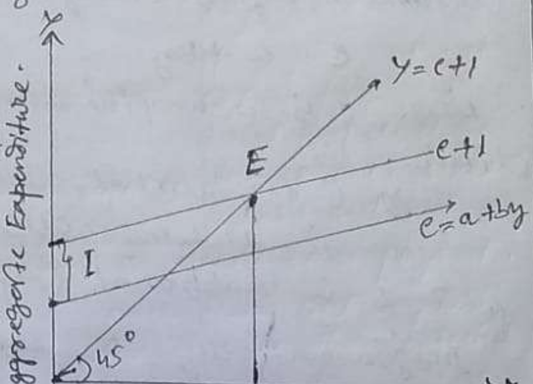
Consumption Demand

The other component of aggregate demand is investment which depends on marginal efficiency of capital and rate of interest. Investment is of autonomous nature. The automomus investment curve is shown in below.



Autonomasus Investment.

Combining the consumption function and investment function we get the aggregate demand or aggregate expenditure curve as shown in ~~dei~~ daigram given below:-



Determination of National income in a simple two sector basic Keynesian model.

In this daigram C+I line represents the aggregate demand or expenditure. It is parallel to the consumption curve which indicates that the level of investment is constant and does not change with the change in income.

The equilibrium income and output is determined at that point at which the total expenditure or aggregate demand curve (C+I curve) intersect the 45° line. The 45° line represents the aggregate supply curve. The aggregate expenditure curve C+I cuts the 45° line at the point E. Corresponding to this point OY, equilibrium income is determined.

10. Q:- Assuming a simple two sector economy Explain the Keynesian model of income determination. 10 marks

Ans:- See the Q-No-9

11. Q. Explain Keynes theory of Effective demand. How does it differ from classical theory of employment. (10 marks)

Ans:- Keynes attributes ~~are~~ Unemployment to a "lack of effective demand." Effective demand refers to the level of aggregate demand of the community which is met by aggregate supply.

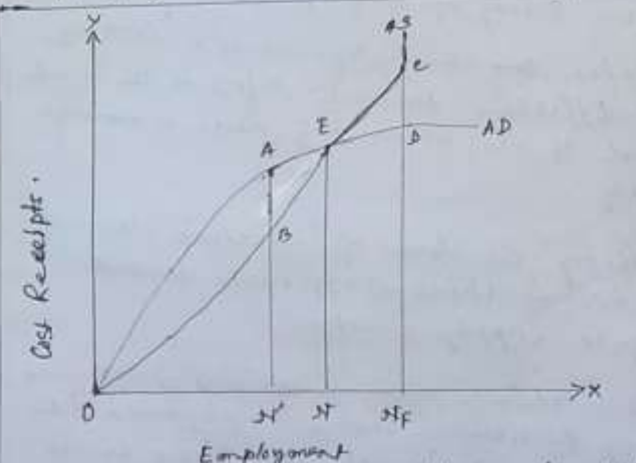
In Keynes theory, the level of effective demand is determined by two functions (a) aggregate demand function and (b) aggregate supply function

(a) Aggregate demand function:- Aggregate demand or aggregate demand price at any particular level of employment is the amount of total money which all the firms in the economy expect to receive from sale of output produced by the given number of employed workers. The schedule of various aggregate demand prices corresponding to different levels of employment is called aggregate demand function (ADF). Aggregate demand comprises of (i) Consumption demand and (ii) Investment demand.

(b) Aggregate supply function:- Aggregate supply price is the minimum sale proceed or revenue which all the entrepreneurs must earn at a particular level of employment. A schedule showing the different levels of aggregate supply price corresponding to various levels of employment is called the "Aggregate Supply function" (ASF). Aggregate supply price will rise as more labour is employed and the curve of aggregate supply ~~fun~~ function slopes upward to the right. Aggregate supply curve becomes vertical at the full employment state, because there is no more labour available for further employment.

Determination of equilibrium level of employment by effective demand :-

Equilibrium level of employment is determined by the intersection of aggregate demand function and aggregate supply function as shown in figure given below.



Determination of equilibrium level of employment.

It can be seen from the figure that AD curve and AS curve intersects each other at point E which is the point of effective demand. At effective demand E, ON is the equilibrium level of employment. At ON employment level profits of the entrepreneurs are maximised and there is no tendency to increase or decrease employment. For instance, if employment is lower than ON say ON', then expected receipts (AN') are greater than expected costs (BN') and this induces entrepreneurs to increase the level of employment. Again, if employment is more than the equilibrium level of employment say ON_F expected receipts (DN_F) are lower than expected costs (CN_F). So it is not rational for the entrepreneur to employ ON_F labour because it involves losses. Thus the equilibrium level of employment is ON which is determined by the point of effective demand or by the point of intersection of aggregate demand and aggregate supply function.