Chapter 4: Determination of Income And Employment

Introduction

This chapter gives an insight into the constructive key role of J.M. Keynes (John Maynard Keynes) during the period of 1929-1933 towards the rectification of great depression in America, emphasizing mainly on aggregate demand, aggregate supply, propensity to consume and save and its types; including related Numerical.

Book Name: General Theory of Employment, Interest and Money

Published on 1936

Theory Name- Theory of Employment

Father or Macroeconomics- J.M. Keynes

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Aggregate Demand

Aggregate demand is the total amount of final goods and services which all the sectors are planning to buy in an economy at a given level of income over a given period of time. For example, consumer goods, services, and capital goods.

Aggregate demand of the economy depends upon the level of employment. There is direct or positive relationship between the level of employment or output in the economy and the Aggregate Demand.

It signifies that aggregate expenditure will increase with rise in the level of employment and fall with the decline in the level of employment.

Aggregate Demand is the summation of consumption and investment.

Aggregate Demand = Consumption Expenditure+ Investment Expenditure

So,

$$AD = C + I$$

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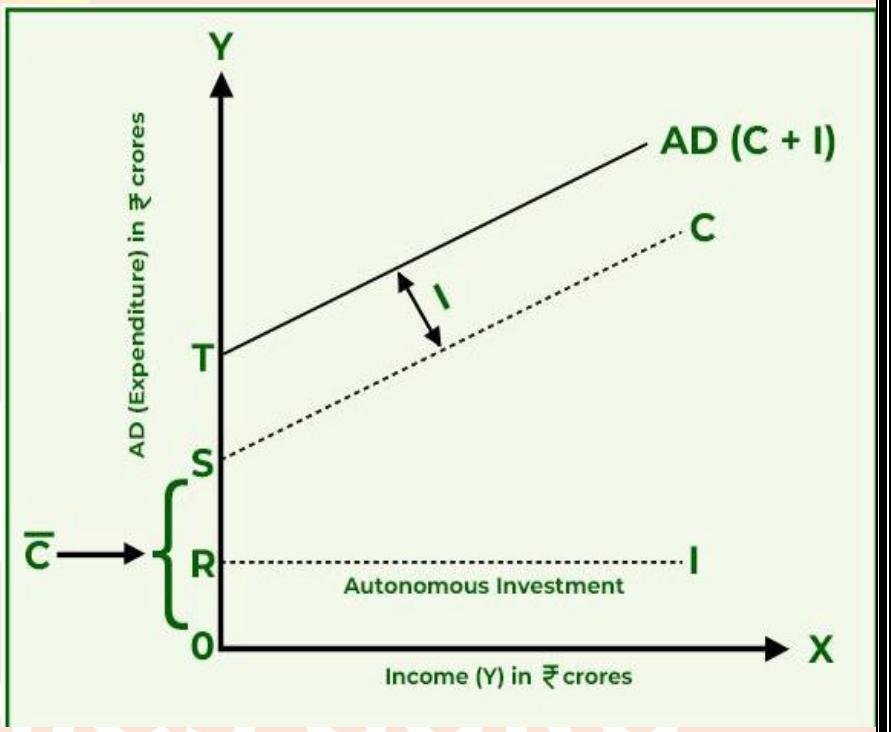
Note:

- **Ex- ante measure –** Planned values of the variables, consumption, investment or output of final goods are termed as ex-ante measures.
- **Ex-post measures –** Actual or accounting values of various variables within the economy during a year are termed as ex-post measures**.**

Example:

Income (Y)	Consumption (C)	Investment (I)	Aggregate Demand (C+I)
0	100	100	200
200	200	100	300
400	300	100	400
600	400	100	500
800	500	100	600
1000	600	100	700



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Components Of Aggregate Demand

There are four components in Aggregate Demand

- **Private Consumption Expenditure (C)**
- **Investment Expenditure(I)**
- **Government Expenditure(G)**
- **Net Exports (X-M)**

Aggregate Demand = C+I+G+(X-M)

Private consumption expenditure (C) or Household consumption expenditure

It refers to the expenditure on the final consumer's goods and services by the households to satisfy their wants.

Investment expenditure (I)

It refers to the expenditure incurred on capital goods by private firms to increase their production capacity. These capital goods are in the form of machinery, building, land, etc.

Government expenditure (G)

refers to the expenditure incurred by the government on the purchase of goods and services to meet the needs of the people in the economy.

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Net Exports (X-M)

It refers to the difference between exports and imports i.e., X-M

Where X stands for Exports and M stands for Imports.

Aggregate Supply

Aggregate Supply is the value of all final goods and services that all the producers are planning to supply over a period of time.

Output produced in an economy is always equal to the income generated. Aggregate Supply is equal to all final goods and services produced in the economy which is equal to the national income.

Aggregate Supply = OUTPUT =Y

Components Of Aggregate Supply

NATIONAL INCOME (Y) = CONSUMPTION (C) + SAVINGS (S)

So, Aggregate Supply = CONSUMPTION (C) + SAVINGS (S) (AS = C + S)

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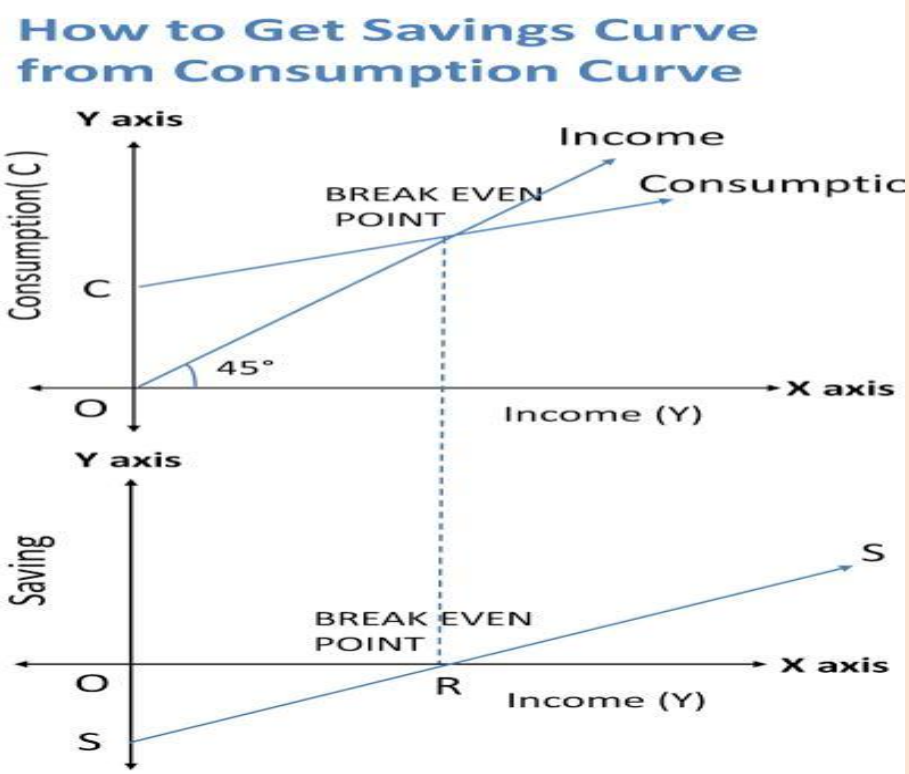
Income (Y)	Consumption (C)	Savings (S)	Aggregate Supply (C+S)
0	100	-100	0
200	200	0	200
400	300	100	400
600	400	200	600
800	500	300	800
1000	600	400	1000
1200	700	500	1200



Consumption Function or Propensity to Consume

Consumption function or propensity to consume is the functional relationship between consumption and income.

It shows level of consumption (C) with respect to a given level of income (Y).

C= f (Y)

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Types Of Propensity

- Average Propensity to Consume (APC)
- Marginal Propensity to) Consume (MPC)

Average Propensity to Consume (APC)

APC is the ratio of total consumption to total income.

Other words,

The Ratio between the total consumption expenditure (C) and total income (Y) at a given level of income, is called Average Propensity to Consume (APC).

$$\text{Average Propensity to Consume} = \frac{C}{Y}$$

Example:

Income of the economy is ₹1000 cr and Consumption is ₹800. So APC will be:

$$\text{APC} = \frac{C}{Y} = \frac{800}{1000} = 0.8$$

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Important Concepts About APC

- APC can never be zero as consumption can never be zero.
- At the break-even point, APC is equal to 1.
- Before the break-even point, APC is less than 1.
- After the break-even point, APC is more than 1.
- APC falls with an increase in income.

Marginal Propensity to Consume

MPC is the ratio between the change in consumption (ΔC) and the change in income (ΔY) is called Marginal Propensity to Consume (MPC).

$$\text{MPC} = \frac{\Delta C}{\Delta Y}$$

Example:

The income of the economy increased from ₹1000cr. to ₹1500 cr. So, the Consumption is increased from ₹800 to ₹1200. Them MPC will be:

$$\text{MPC} = \frac{\Delta C}{\Delta Y} = \frac{400}{500} = 0.8 \qquad [\Delta C = 1200 - 800 = 400;\ \Delta Y = 1500 - 1000 = 500]$$

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Important Concepts About MPC

- The value of MPC can never be greater than 1.
- The value of MPC is 1 when the entire additional income is spent on consumption
- The value of MPC is 0 when the entire additional income is saved.
- The value of MPC lies between 0 to 1.

Savings Function or Propensity To Save

Savings function or propensity to save is the functional relationship between savings and income.

$$S = f(Y)$$

Types Of Propensity to Save

- **Average Propensity to Save (APS)**
- **Marginal Propensity to Save (MPS)**

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Average Propensity to Save (APS)

APS is the ratio of total savings (S) to total income (Y).

$$APS = \frac{S}{Y}$$

Example:

When Income of the economy is ₹1000 cr. Then Saving will be ₹200cr. Find APS.

$$APS = \frac{S}{Y} = \frac{200}{1000} = 0.2$$

Important Concepts About APS

- APS is zero at the break-even point.
- APS can never be equals to 1 or more than 1.
- APS can be negative or less than when.

Marginal Propensity to Save (MPS)

MPS is the ratio of change in savings (ΔS) to change in income (ΔY).

$$MPS = \frac{\Delta S}{\Delta Y}$$

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Example:

Increased in income of an economy from ₹1000cr to ₹1500 cr. and the Savings increased from ₹200 to ₹300 cr. Find MPS.

$$\text{MPC} = \frac{\Delta S}{\Delta Y} = \frac{100}{500} = 0.2 \qquad [\Delta S = 300 - 200 = 100;\ \Delta Y = 1500 - 1000 = 500]$$

Important Concepts About MPS

- The value of MPS varies between 0 and 1.
- If the entire increased income is saved the value of MPS will be 1.
- If the entire increased income is consumed the value of MPS will be 0.

Consumption Function:

Household income is the most important determinant of consumption demand.

The relationship between consumption and income is described by a consumption function.

The most basic consumption function assumes that consumption changes at the same rate as income.

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Equation of Consumption Function

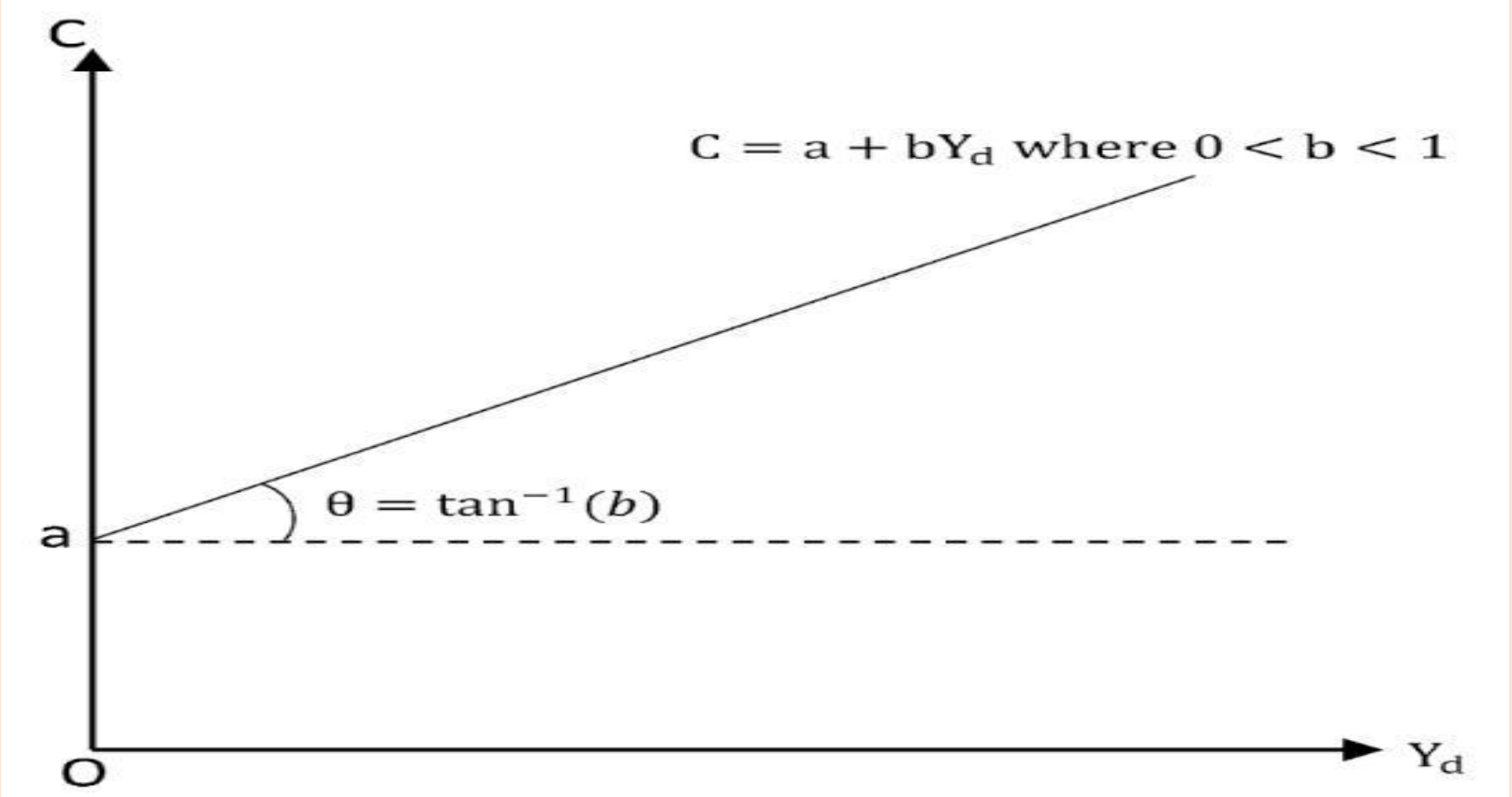
$C=\bar{C}+cY$

C = Consumption

$\bar{C}$ = Autonomous consumption

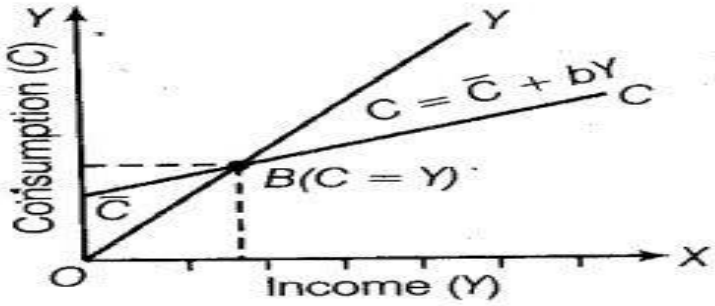
cY = Induced consumption

Y= Income



The consumption curve starts from the Y axis because, even when the income is zero, there is some consumption.

Income (Y)	Consumption (C)	APC $\left(\frac{C}{Y}\right)$	ΔC	ΔY	MPC $\left(\frac{\Delta C}{\Delta Y}\right)$
0	100	–	–	–	–
100	170	1.7	70	100	0.7
200	240	1.2	70	100	0.7
300	310	1.33	70	100	0.7
400	380	0.95	70	100	0.7
500	450	0.9	70	100	0.7



Diagrammatic presentation of consumption function

Autonomous Consumption:

- Autonomous consumption is denoted by $\bar{C}$ And represents consumption that is unaffected by income.

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- When consumption occurs even when income is zero, it is due to autonomous consumption.
- Hence this consumption is independent of income.

Induced Consumption:

- The induced component of consumption, cY, demonstrates consumption's dependence based on earnings/ income.
- Hence, this consumption is dependent on income.

Saving Function:

The functional relationship between saving and national income is referred to as the saving function.

Equation of saving function,

$$S = f(y)$$

Were,

S = Saving, Y = National Income, F = Functional relationship.

$$S = -a + (1 - b)\, y$$

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Relation between APC and APS

The addition of APC and APS equals one.

It can be demonstrated as follows:

$$APC + APS = 1.$$

$$Y = C + S$$

Dividing both side by Y, we get

$$Y/Y=C/Y+S/Y$$

That is,

$$1= APC + APS$$

Relation between MPC and MPS

We know MPC + MPS = 1

Also, Y = C +S

Hence

$$\Delta Y=\Delta C+\Delta S$$

(i)Where, ΔC= change in consumption

ΔY= Change in income; ΔS= Change in savings

$$1 = MPC + MPS$$

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Calculate MPC and MPS from the following schedule:

Income (Y)	100	200	300	400	500
Consumption (C)	85	160	235	310	400

Solution

Income (Y)	100	200	300	400	500
Consumption (C)	85	160	235	310	400
Savings(S)	15	40	65	90	100
MPC	-	7.5	7.5	7.5	9
MPS	-	2.5	2.5	2.5	1

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Short Run Equilibrium Output

Equilibrium Output

↓

Equilibrium Employment

↓

Equilibrium Income level

Concept of Short-run:

The short run is a concept that states that, within a certain period in the future, at least one input is fixed while others are variable.

In macroeconomics, short run may be defined as a period of time when 'technology' As a factor remains constant.

Or

Short run in an economy can be defined as the period of time during which, level of output is determined only by the level of employment.

Higher the level of employment, higher would be the level of output and vice-versa.

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Concept of Equilibrium Output

Equilibrium Output It refers to the level of output where the Aggregate Demand is equal to the Aggregate Supply (AD = AS) in an economy. It signifies that whatever the producers intend to produce during the year is exactly equal to what the buyers intend to buy during the year.

A situation where,

Aggregate Demand = Aggregate Supply.

Here,

Aggregate Demand = Consumption+ Investment

AD = C + I

And

Aggregate Supply= Consumption+ Saving

AS = C + S

SO,

EQUILIBRIUM OUTPUT= AD = AS

C+I = C+S

I = S

Determination of Equilibrium Output

1. **AD = AS Approach**
2. **S= I Approach**

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1. AD = AS APPROACH

According to aggregate demand-aggregate supply approach, the equilibrium is reached only when aggregate demand (AD) is equals to aggregate supply (AS) because at this level there is no tendency for income and output to change.

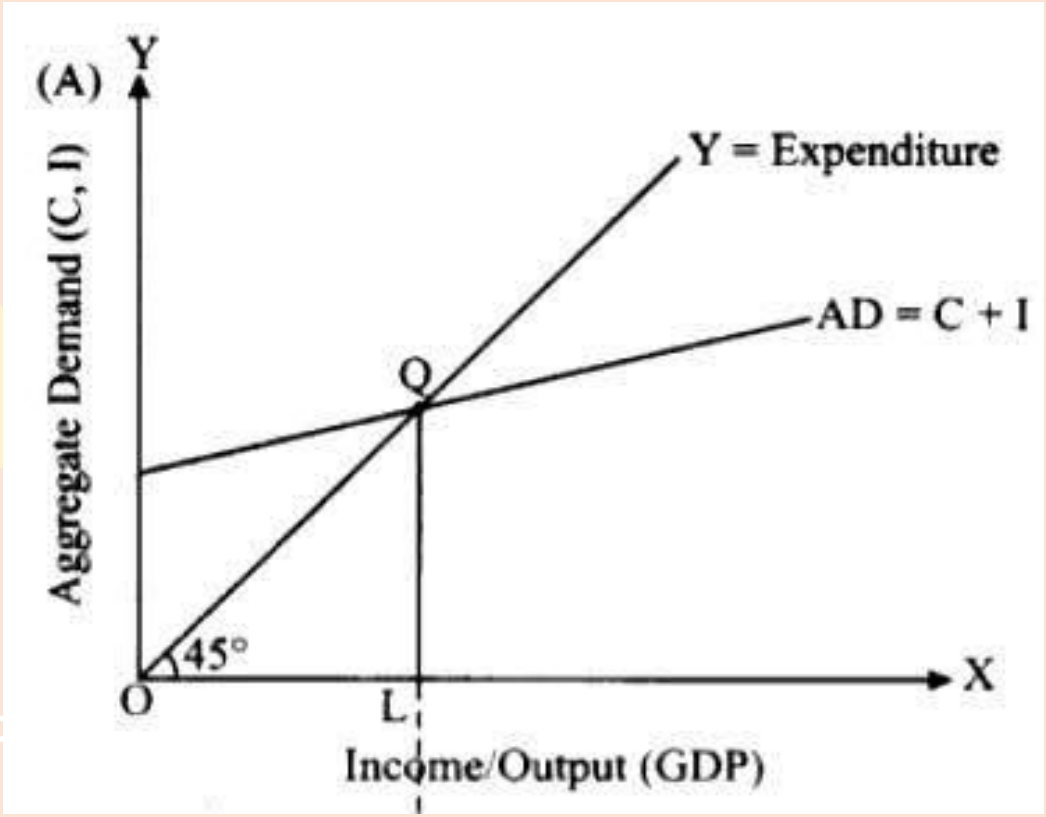
Equilibrium output

AD = AS

C+I = C+ S

Example:

Income (Y)	Aggregate Demand (AD)	Aggregate Supply (AS)
0	100	0
100	150	100
200	200	200
300	250	300
400	300	400
500	350	500



S = I Approach

According to this approach, the equilibrium level of income is determined at a level, when planned saving (S) is equal to planned investment (I).

Equilibrium output

S = I

Saving= Investment

How,

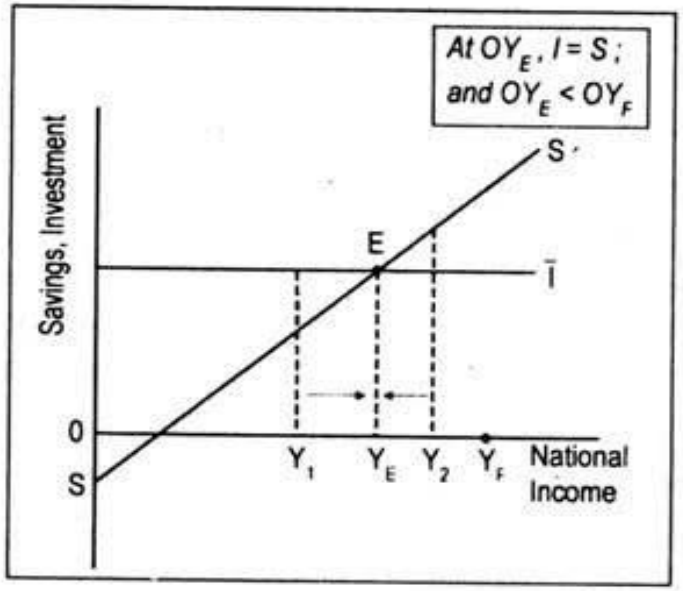
AD = AS

C+ I = C+ S

I = S

Example:

Income	Consumption	Saving	Investment
0	50	-50	50
100	100	0	50
200	150	50	50
300	200	100	50
400	250	150	50
500	300	200	50



Full Employment

Full employment level of equilibrium refers to the situation where aggregate demand is equal to the aggregate supply when there is full employment in the economy i.e. all willing and capable people get job at the existing wage rate.

Difference between Full Employment and Under-Employment Equilibrium

(i) Full Employment Equilibrium:

Full employment equilibrium refers to the equilibrium where all resources in the economy are fully utilised (employed).

Simply put, when equilibrium between AD and AS takes place at full employment of resources, it is called full employment equilibrium. There are no unused resources. There is no involuntary unemployment.

(ii) Under-employment equilibrium:

Under-employment equilibrium means equality between aggregate demand and 'aggregate supply but at less than full employment'. It is a state of equilibrium where level of demand is less than full employment level of output'. In other words, in producing the output, economy's all resources are not fully employed, i.e., some resources are underemployed.

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Unemployment

Unemployment refers to those individuals who are constantly looking to find a job but can't find one. There are many reasons why those people can't find a job. This often includes skills, certifications, the overall economic environment, etc. All of these reasons make different types of unemployment.

Definition:

Unemployment occurs when an individual is actively looking for employment but is not able to find work.

Voluntary Unemployment

Voluntary unemployment occurs when the wage doesn't provide enough incentive for the unemployed to work, so they choose to claim unemployment benefits instead.

Involuntary Unemployment

Involuntary unemployment occurs when workers would be willing to work at the current wage, but they can't find a job.

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Investment Multiplier and its mechanism

Investment multiplier investment multiplier refers to the increase in the aggregate income of the economy as a result of an increase in the investments done by the government in the form of new projects.

In other words,

Investment multiplier or output multiplier refers to the number which change in investment (ΔI) multiplies to become change in income (ΔY).

It is measured as the ratio between change in output/income and change in investment.

$$K = \Delta Y / \Delta I$$

K = Multiplier

ΔY = Change in output/ Income; ΔI =Change in Investment

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Example:

Investment of an economy increased by ₹1000 cr. and National Income Increased by ₹5000 cr. Investment Multiplier will be?

Solution:

$$K = \frac{\Delta Y}{\Delta I} = \frac{5000}{1000} = 5$$

Relationship between Investment multiplier and Marginal Propensity to Consume (MPC)

There is a direct relationship between investment multiplier and MPC.

Higher the value of MPC, higher the multiplier and vice versa.

K = 1/ 1- MPC

And,

k = 1/ MPS

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Deficient Demand and Excess Demand

According to Keynesian theory, an equilibrium income level might correspond to full employment, underemployment, or over the employment of resources. Similarly, when the economy is not at full employment, there will be instances of surplus demand and deficit demand. Excess demand and deficit demand are the two situations of disequilibrium.

There are two situations of disequilibrium

- **Deficient Demand**
- **Excess Demand**

Deficient Demand

It refers to the situation when aggregate demand (AD) is short of aggregate supply (AS) corresponding to full employment in the economy.

AD<AS

In other words, AD in the economy is less than what is required to maintain full employment. deficient demand leads to fall in general price level and results in deflation

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Deflationary Gap

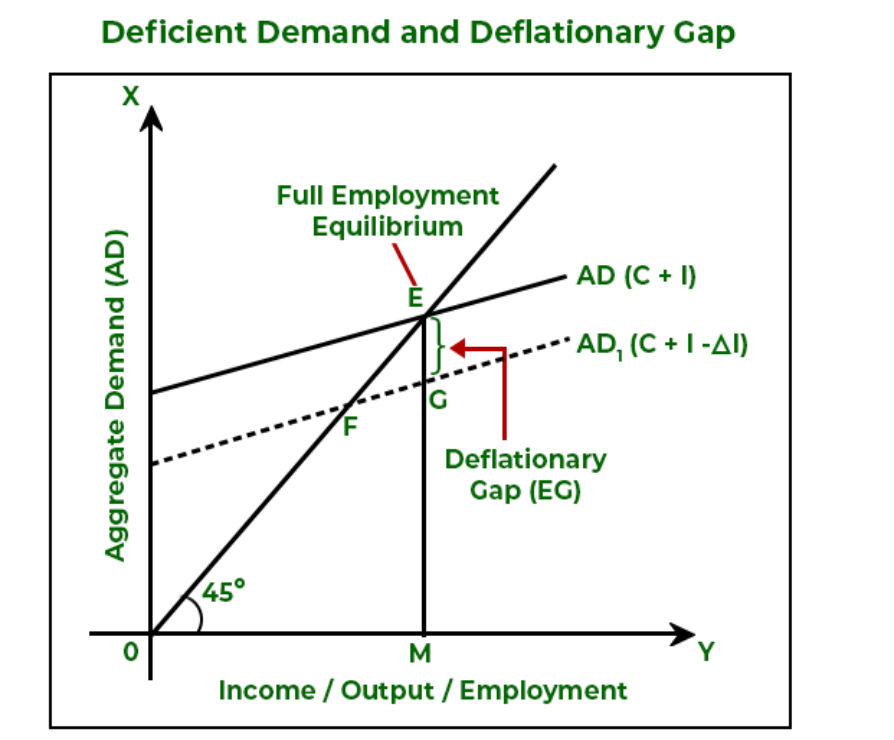
The extent to which current aggregate demand falls short of the actual aggregate demand required for full employment level, is termed as deflationary gap.

Deflationary Gap = Required Aggregate demand - Actual Aggregate Demand

Deflationary gap is equal to the difference between the actual level of aggregate demand and the level of aggregate demand to establish full employment equilibrium.

It measures the size of deficient demand.

Deflationary gap causes the economy's income, output employment and price to decline, hence pushing the economy into under employment equilibrium.



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Impact of Deficient Demand

1. ***Impact on Output:***

There will be an increase in inventory stock due to a lack of sufficient aggregate demand. The businesses will be compelled to plan for lower production within the following time frame. The anticipated output will therefore decrease.

2. ***Impact on Employment:***

As the level of investment decreases in the economy, there is a decrease in the anticipated output. It reduces the level of employment in the country. Thus, deficient demand leads to involuntary unemployment in the economy.

3. ***Impact on the General Price Level:***

Due to a lack of demand for goods and services in the economy, deficient demand leads general prices to decline. The prices tend to decrease, which leads to deflation.

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Excess Demand

it refers to the situation when aggregate demand (AD) is in excess of aggregate supply (AS) corresponding to full employment in the economy.

$$AD > AS$$

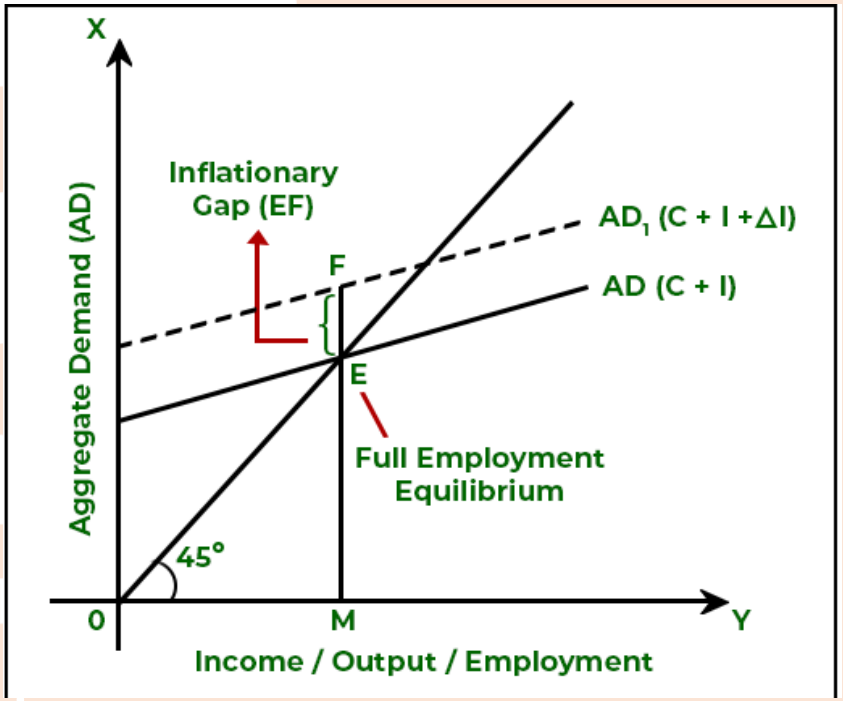
Excess demand gives rise to inflation.

Inflationary gap

The extent to which current aggregate demand becomes higher than the aggregate demand required for full employment, it is termed as inflationary gap.

Inflationary gap is equal to the difference between the actual level of aggregate demand and the level of the aggregate demand required to establish full employment equilibrium. it measures the size of excess demand.

Inflationary gap causes a rise in price level or inflationary because full employment has already been attained, hence output and income level cannot be increased.



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Impact of Excess Demand

Excess demand is undesirable because it does not result in an increase in aggregate supply because the economy is already at full employment. The following impacts on output, employment, and the general price level are caused by excess demand:

1. ***Impact on Output:***

As the economy is already at full employment and there is no idle capacity in the economy, excess demand has no impact on the level of output.

2. ***Impact on Employment:***

As the economy is currently functioning at full employment equilibrium and there is no involuntary unemployment, there will be no change in the level of employment.

3. ***Impact on the General Price Level:***

In case of excess demand, aggregate demand exceeds the aggregate supply, which results in an increase in the general price level of goods and services.

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Measures to correct deficient demand and excess demand

There are two policy measures to solve the problem of excess demand and deficient demand which are as follows:

Monetary measures

In a situation of excess and deficient demand, RBI use various instruments of monetary policy. It refers to the economic policy of the government relating to currency and credit money.

The instruments of monetary policy are:

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I) Quantitative instruments

- **Bank Rate Policy:**

it is the rate at which commercial banks borrow from central bank for a period more than 90 days in a situation of deficient demand, the RBI reduces the bank rates or market interest rate. It makes the credit cheaper. It encourages people to borrow money from the banks. It is also called cheap money policy.

- **Open market operations:**

It refers to the buying and selling of government approved securities in the open market by RBI to general public and commercial banks. In the situation of deficient demand, the aim of RBI is to encourage investment activities, it buys securities from the open market and releases funds for the banks and the individual s. This increases the investment activities in an economy. In a situation of excess demand, RBI sells the eligible securities in its possession to commercial banks. So that, commercial bank's cash is blocked with them send their capacity to offer loan be reduced.

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- **Cash Reserve Ratio (CRR):**

It is fraction of total deposits that each commercial bank must keep with RBI as a part of frictional reserve system during deficient demand, RBI reduces the CRR the result of

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reducing CRR will increase cash reserve with the banks which cwm be offered for credit. The bank credit creation power increases. In the situation of excess demand RBI raises and the CRR. This will reduce the cash deposits left with commercial banks to be loaned out.

- **Statutory liquidity ratio (SLR):**

It refers to the fraction of the total deposits which each commercial banks must keep with itself in liquid assets like gold, government securities, ECT. RBI reduces SLR in situation of deficient demand. This will have expansionary effect on the credit positions of the bank. In a situation of excess demand, RBI raises the SLR it results in reduction of surplus cash reserves of the commercial banks which can be offered for credit. This will discourage credit in the economy.

II) Qualitative Instruments:

- **Marginal Requirements:**

It is the difference between the market value of securities provided by the borrower and the amount of loan granted to him there will be reduction in marginal requirement in a situation of deficient demand it implies that borrowers will get more credit against their securities. It will encourage borrowings. Margin requirement is raised to correct the

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situations of excess demand. Higher margin requirement acts as a disincentive to borrow

- **Moral Suasion:**

In this, RBI issues directives to bank to follow rules and regulations. During deficient demand, the RBI issues instructions to member banks to increase the availability of credit to borrowers for non-essential purposes also. But, in case of excess demand, RBI imposes restrictions on commercial banks on granting loans.

- **Selective credit control:**

It refers to a method in which the central banks directions to other banks to give or not to give credit for certain purposes to particular sectors. It imposes rationing of credit to prevent excessive flow of credit.

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Methods	To Correct Excess Demand	To Correct Deficient Demand
	(Inflationary Gap)	(Deflationary Gap)
Bank Rate	Increase	Decrease
Open Market Operations	Increase	Decrease
Cash Reserve Ratio (CRR)	Increase	Decrease
Statutory Liquidity Ratio (SLR)	Increase	Decrease
Repo Rate	Increase	Decrease
Reverse Repo Rate	Increase	Decrease
Margin Requirements	Increase	Decrease

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2.Fiscal Measures

Fiscal policy is the government's revenue and expenditure policy. In a situation of excess demand, government uses various instruments of fiscal policy to reduce budgetary deficit. Budgetary deficit is excess of government expenditure over government revenue

The instruments of fiscal policy used to control deficient and excess demand see:

- **Revenue Policy**: In a situation of deficient demand, the government should reduce taxes it will increase disposable income of buyers and hence the purchasing power of the people and they will spend more on consumption of goods and services. Thus, aggregate demand will rise. In a situation of excess Demand government raises the rates of all taxes. This reduces the power of the people and reduces both consumption and investment expenditure.

- **Expenditure Policy**:
  in the situation of deficient demand, the government should raise its expenditure. This will raise the level of employment. It will in turn, increase the wages and the purchasing power. Thus, aggregate demand will rise. In a situation of excess Demand, government reduces its public expenditure. It will result in falling demand for goods and services. The fall in government expenditures should be equal to the inflationary gap.

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- **Deficit Financing:**
  To correct deficient demand, government should take resort to deficit financing or printing of notes to increase purchasing power of the economy. In order to correct excess demand, government should reduce the deficit financing or printing of notes to bring the excess demand down.

	Monetary Policy	Fiscal Policy
Tool	Interest rates	Tax and government spending
Effect	Cost of borrowing/mortgages	Budget deficit
Distribution	Higher interest rates hit homeowners but benefit savers	Depends which taxes you raise.
Exchange rate	Higher interest rates cause appreciation	No effect on exchange rate
Supply-side	Limited impact	Higher taxes may affect incentives to work
Politics	Monetary policy set by independent Central Bank	Changing tax and government spending highly political.
Liquidity trap	Cuts in interest rates may not work in liquidity trap	Fiscal policy advised in very deep recessions

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धन्यवाद

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