Keynes’ Theory of Employment: Concept of Effective Demand

(Note-Lecture is compiled from internet for teaching purpose)

Great Depression of 1930's created problems of increasing unemployment, reducing national income, declining prices and failing firms increased in intensity. The classical model miserably failed to explain and provide a workable solution for how to escape the depression.

Definition of a recession

A recession is characterized as a period of negative economic growth for two consecutive quarters. In a recession, unemployment will rise, output fall and government borrowing increase.

Definition of depression

A depression is a recession but much more severe and long lasting. There is no agreed upon definition of a depression. But generally a depression would have some of the following characteristics.

- Decline in output for a prolonged period e.g. greater than 2 years.
- A drop in output of 10% or greater.
- Unemployment rate touching 20% (rather than the 10% rate associated with recessions)

It was at that time when J. M. Keynes wrote his famous book 'General Theory'. In it he
presented an explanation of the Great Depression of 1930's and suggested measures for the solution. He also presented his own theory of income and employment. According to Keynes:

"In the short period, level of national income and so of employment is determined by aggregate demand and aggregate supply in the country. The equilibrium of national income occurs where aggregate demand is equal to aggregate supply. This equilibrium is also called effective demand point".

**What is Effective Demand?**

Keynes’ theory of employment is a demand-oriented theory. This means that Keynes visualized employment/unemployment from the demand side of the model. According to Keynes, the volume of employment in a country depends on the level of effective demand of people for goods and services. Unemployment is attributed to the deficiency of effective demand.

It is to be kept in mind that Keynes’ theory is a short run theory when population, labor force, technology, etc., do not change.

Keynes’ theory of employment is based on the principle of effective demand.

In order to understand the concept of effective demand we have to visualize two prices operating in the economy, viz., aggregate demand price and aggregate supply price.

**The aggregate demand price** refers to the level of price (aggregate or average) at which goods and services are actually sold, that is, the producers actually receive the price by selling their goods and services. In other words, this is the price which the consumers are prepared to pay for purchasing goods and services.

**Aggregate supply price** is the minimum price necessary for producers to carry on production of such foods and services. Below this minimum price no producer would be willing to cover production.

Now, in the short run, as long as the aggregate demand price is greater than the aggregate supply price, all producers will experience profits which would motivate them to increase output and employment. Only when the aggregate demand price is just equal to the aggregate supply price the producers find themselves in a state of indifference or ‘equilibrium. If this point is exceeded, i.e., if aggregate supply price is greater than the aggregate demand price so that producers are not able to receive their expected minimum price, they would rather be rethinking about continuing output and employment.

The point of equilibrium or equality between aggregate demand and aggregate supply prices has been defined as the **‘effective demand’**.

**GRAPHICAL EXPLANATION**

With the idea of aggregate demand and aggregate supply prices are associated two curves, aggregate demand curve and aggregate supply curve. While both the curves appear as upward
rising from left to right, the former (aggregate demand curve) lies above the latter aggregate supply curve). Also, while AD curve increases at a decreasing rate, the AS curve increases with an increasing rate.

The equilibrium in the economy and equilibrium level of employment occurs at point YE where AD = AS with equilibrium level of employment of OY. However, OY is not necessarily the full employment level even though economy is at equilibrium. This is what Keynes defined as an underemployment equilibrium.

In fact, the total available supply of labour is OY1, more than OY by YY1, suggesting the magnitude of involuntary unemployment.

**Why does such a situation of underemployment equilibrium develop in the economy?**

Keynes visualizes that the extent of aggregate demand (or, aggregate expenditures) falls short of the producers expectations (or, aggregate supply) or their minimum supply prices necessary to continue output and absorb the unemployed labour force. Clearly, the prescription suggested is to increase the level of aggregate demand.

In terms of Fig., it would possibly happen when the entire AD function shifts upward so much that AD intersects AS beyond E and employment increases so much to allow the producers to produce at the ‘potential level’, Y1, as shown in Figure by shifted AD curve and the ultimate equilibrium point of E. Thus, in terms of Keynesian analysis, economy may achieve ‘equilibrium’ but not necessarily at full employment output. It is a coincidence if that happens but the normal situation is that of underemployment equilibrium with potential output greater than the actual output.