

Chapter 10: Determinants of Aggregates

Question: 1

Fill in the blank with appropriate alternatives given below

The General Theory of Employment, Interest and Money was written by _____.

Options

- David Ricardo
- Adam Smith
- J.M.Keynes
- Alfred Marshal

Solution

The general theory of employment interest and money was written by **J.M. Keynes**.

Explanation : J.M.Keynes, a British economist, wrote the book 'General theory of employment, interest and money', where he introduced the general theory of employment, which was a criticism of the classical theory of full employment.

Question: 2

Fill in the blank with appropriate alternatives given below

That part of income, which is not spent on consumption, is called _____.

Options

- expenditure
- saving
- investment
- publicdebt

Solution

That part of income, which is not spent on consumption, is called **saving**.

Explanation:

Individuals incur expenditure on consumption from the income. However, not

all of the income is spent on consumption, rather a part of it remains unspent. This unspent part of the income is called as savings.

Saving = Income – Consumption

Question: 3

Fill in the blank with appropriate alternatives given below

Intersection between aggregate demand and aggregate supply curves determines the point of _____ demand.

Options

- composite
- complementary
- joint
- effective

Solution

Intersection between aggregate demand and aggregate supply curves determine the point of **effective** demand.

Explanation:

Effective demand is the actual demand for goods and services by the people in an economy. It is determined at the point where aggregate demand intersects aggregate supply.

Question: 4

Fill in the blank with appropriate alternatives given below

_____ consumption cannot be zero.

Options

- Induced
- Autonomous
- Government
- Private

Solution

Autonomous consumption cannot be zero.

Explanation:

Autonomous consumption is the minimum consumption expenditure that an individual incurs irrespective of his income. It is the consumption of basic goods and services i.e consumption of those goods and services that are essential for living. For example, food, medicines, clothes etc. Such a consumption cannot fall to zero as it is essential for survival.

Question: 4

Fill in the blank with appropriate alternatives given below

Investment made by the government is _____ investment.

Options

- induced
- autonomous
- gross
- unplanned

Solution

Investment made by the government is **autonomous** investment.

Explanation:

Autonomous investment is that investment which is independent of the profit motive i.e. which is made without an aim of earning some profit on that investment. Government investment on public welfare is an example of an autonomous investment. Governments investment in railways, electricity, construction of dams, roads etc for the welfare of the public rather than profit.

Question: 5

Match the following Group:

Group A		Group B	
1)	Aggregate Supply	a)	Expected receipts
2)	Autonomous Investment	b)	Lord J. M. Keynes
3)	Consumption	c)	Government Investment
4)	A.P.C.	d)	$\Delta C/\Delta Y$
5)	Investment	e)	C/Y
		f)	Addition to stock of capital
		g)	Destruction of utility

Solution

Group A		Group B	
1)	Aggregate Supply	a)	Expected receipts
2)	Autonomous Investment	c)	Government Investment
3)	Consumption	b)	Lord J. M. Keynes
4)	A.P.C.	e)	C/Y
5)	Investment	f)	Addition to stock of capital

Explanations:

1) Aggregate supply is defined as the minimum amount of sales receipts which an entrepreneur expects to receive from his sales proceedings to continue production at a given point of employment.

2) Autonomous investment is that investment which is independent of profit as a motive i.e. which is made without an aim of maximising the returns. Government investments on transportation, communication, defence which are aimed at public welfare are some examples of such an investment.

3) J.M.Keynes was the first economist who propounded the 'Psychological Law of Consumption', in which he explained the relationship between consumption and income.

4) Average propensity to consume is the consumption per unit income. It shows the ratio of consumption expenditure to the level of income.
Algebraically,
 $APC = C/Y$

5) Investment is defined as the addition made to the physical stock of the capital of a country. The physical stock of the capital may include land, building, machinery, tools, inventories etc.

Question: 6

State whether the following statement is true or false.

Consumption expenditure is the only component of aggregate demand.

Options

- True
- False

Solution

False. The components of aggregate demand include consumption, investment, government expenditure and net earnings from foreign transactions. So, as per the definition, aggregate demand consists of the following components.

Demand by households - Private consumption expenditure (C)

Demand by firms - Private investment expenditure (I)

Demand by government - Government expenditure (G)

Demand by foreign sector- Net exports (X – M)

Where, X is exports and M is imports.

Thus, $AD = C + I + G + (X - M)$

Question: 7

State whether the following statement is true or false.

The difference between a country's exports and imports is termed as net earnings from foreign transactions.

Options

- True
- False

Solution

True. Net earnings from foreign transactions of a country refers to the difference between the demand for domestically produced goods and services by the rest of the world (exports) and the demand for goods and services produced abroad by the residents of that country. In other words, it is the difference between the exports and imports. That is,

Net earnings from foreign transactions = Total exports – Total imports

Question: 8

State whether the following statement is true or false.

Autonomous consumption is income elastic.

Options

- True
- False

Solution

False. Autonomous consumption is that consumption which is independent of income. This is the minimum level of consumption irrespective of whether a

person earns or not. Hence, it is correct to say that the autonomous consumption is income inelastic.

Question: 9

State whether the following statement is true or false.

The equality between aggregate demand and aggregate supply determines the equilibrium level of employment.

Options

- True
- False

Solution

True. The equality between aggregate demand and aggregate supply determines the equilibrium level of income and prices, which in turn determine the equilibrium level of employment.

Question: 10

State whether the following statement is true or false.

At breakeven point Consumption (C) is equal to income (Y).

Options

- True
- False

Solution

True. Breakeven point is a point where the consumption curve intersects the supply curve. At this point, consumption (autonomous + induced) is equal to income, accordingly, saving is equal to zero.

Question: 11

Define or Explain the following concept:

Autonomous Consumption

Solution

Autonomous consumption: Autonomous consumption refers to the consumption that is independent of income. In other words, expenditure on such consumption is undertaken irrespective of the level of income. It includes consumption of such items as food, clothing, shelter, etc. Such an expenditure

cannot fall to zero. This part of consumption expenditure is symbolically denoted by $\bar{C}$. The bar over C represents the constant consumption expenditure. In other words, it remains the same irrespective of the level of income.

Question: 12

Define or Explain the following concept:

Aggregate Demand

Solution

Aggregate demand: Aggregate demand implies the total demand of final goods and services by various individuals in all the sectors in an economy. It expresses the total demand in terms of money. In this manner, it can be defined as the actual aggregate expenditure incurred by all the people in an economy on different goods and services.

$$AD = C + I + G + (X - M)$$

Where,

Demand by households - Private consumption expenditure (C)

Demand by firms - Private investment expenditure (I)

Demand by government - Government expenditure (G)

Demand by foreign sector- Net exports (X – M)

Where, X is exports and M is imports.

Question: 13

Define or Explain the following concept:

Aggregate Supply

Solution

Aggregate supply: Aggregate supply refers to the aggregate production planned by all the producers during an accounting year. In other words, aggregate supply indicates the total amount of goods and services produced within an economy at a given general (or overall) price level during an accounting period. The aggregate supply function is represented as follows.

$$AS = f(\bar{N}, \bar{L}, \bar{K}, \bar{T})$$

where,

AS = Aggregate supply

N = Natural resources

L = Labour

K = Stock of capital

T = State of technology

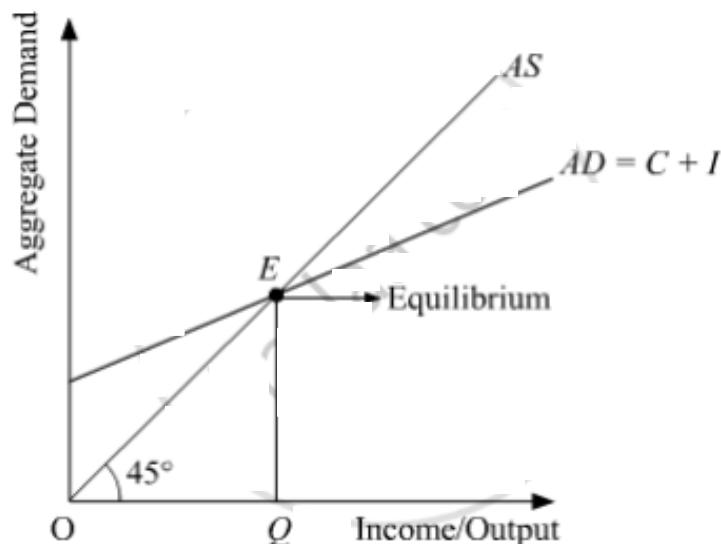
Question: 14

Define or Explain the following concept:

Effective Demand

Solution

Effective demand: Effective demand is defined as the total expenditure incurred by all people in an economy on the various goods and services produced in the economy over a given period of time. Effective demand is determined by the intersection of aggregate demand and aggregate supply. The concept of effective demand can be explained with the help of the given diagram.



The x-axis represents the income/output level and the y-axis represents the level of aggregate demand. E is the equilibrium point where the two curves (AS and AD) meet. EQ is the effective demand and the output level as determined by AD (assuming the elasticity of supply to be perfectly elastic).

Question: 15

Give reason or explain.

Investment demand is not the sole determinant of aggregate demand.

Solution

Investment demand is not the sole determinant of aggregate demand. Apart from investment demand, consumption demand, government demand, exports and imports are also the components of aggregate demand.

$$AD = C + I + G + (X - M)$$

Where,

Demand by households - Private consumption expenditure (C)

Demand by firms - Private investment expenditure (I)

Demand by government - Government expenditure (G)

Demand by foreign sector- Net exports ($X - M$)
Where, X is exports and M is imports.

Question: 16

Give reason or explain.

Saving may be used in future for unforeseen contingencies.

Solution

Savings are that part of the income which are not consumed and are kept aside to be used in the future. For any financial contingencies, savings can act as a helpful source of finance. Savings also act as a vital source of funds at the time of future emergencies.

Question: 17

Give reason or explain.

There are many subjective factors determining consumption function.

Solution

Consumption function is affected by many subjective factors or the psychological factors. Such factors vary from person to person and are based on a person's personal decisions. According to Keynes, there are eight subjective motives which prevent an individual from current consumption.

i. Motive of precaution: People save money for the future in order to meet unexpected expenditure.

ii. Motive of foresightedness: People cut down their spending in order to meet future requirements for money. For examples, requirements for higher education, marriage, buying a house etc.

iii. Motive of improvement: Individuals cut down their expenditure to improve their standard of living.

iv. Motive of independence: As per this motive, man saves more in order to depict more power and independence.

v. Motive of pride: Another motive that prevents people from spending is the wish to maintain the same economic standard in the future. Providing some wealth to their future generations or making donations gives them a feeling of pride.

vi. Motive of enterprise: People prevent current consumption and save for the purpose of investing. Under this motive, people save to invest in a profitable enterprise.

vii. Motive of calculation: Under this motive, people save to invest in shares and debentures in order to increase their income.

viii. Motive of avarice: Some people have a habit of not spending even on necessities. As a result, the consumption function decreases.

Question: 18

Give reason or explain.

Aggregate demand is a positive function of the level of employment and output.

Solution

Aggregate demand or Aggregate Demand Function (ADF) is a positive function of the level of employment and output as, when the level of employment and output increases, it results in an increase in the income of workers. This increase in income leads to an increase in expenditure of workers and thereby increases the aggregate demand.

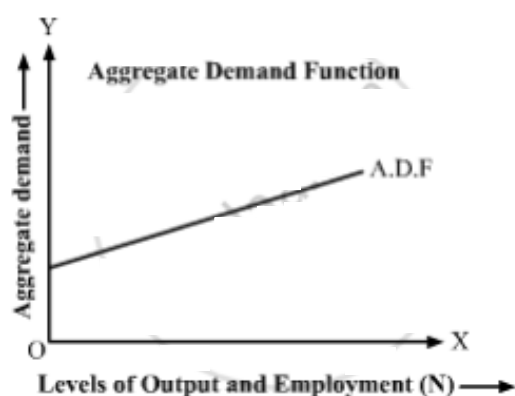
Aggregate demand function or aggregate demand can be written as $AD = f(N)$ where,

AD is Aggregate Demand

N is employment and output

f represents the functional relationship between the aggregate demand and the level of output and employment.

The following diagram depicts the positive relationship between aggregate demand, employment and output.



Question: 19

Give reason or explain.

The Propensity to Consume means consumption function.

Solution

Consumption function is also known as 'Propensity to Consume'. It depicts a relation between the consumption and the income, which means that it depicts how a change in the income causes a change in the consumption pattern of an individual.

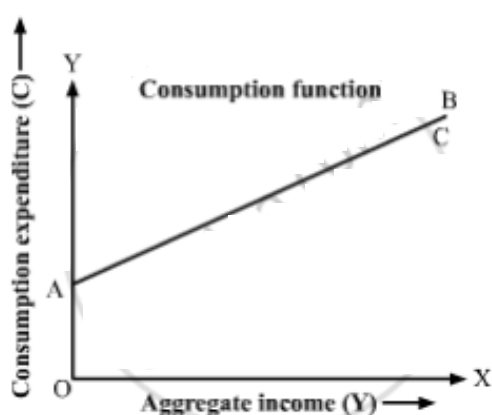
$$C = f(Y)$$

Where,

C represents consumption expenditure

Y represents aggregate income; and

f represents the functional relationship between the consumption expenditure and the level of the disposable income.



Question: 20

Distinguish between:

Aggregate Demand and Aggregate Supply

Solution

Aggregate Demand	Aggregate Supply
Aggregate demand implies the total demand of final goods and services by all the people in an economy.	Aggregate supply refers to the aggregate production planned by all the producers during an accounting year.
The important components of aggregate demand are consumption expenditure, investment, government expenditure, net exports etc.	Consumption and savings are the two main components of aggregate supply.
It is measured with the help of aggregate demand price (minimum sales proceeds that are expected)	It is measured with the help of aggregate supply price.

Question: 21

Distinguish between:

Autonomous Investment and Induced Investment

Solution

Autonomous Investment	Induced Investment
It represents that part of investment, which is independent of the income level and interest rate.	It is a dependent function of the income and interest rate.
It is income inelastic.	It is not income inelastic.
It remains constant throughout all levels of incomes and interest rates.	It is a positive function of income but is a negative function of the rate of interest.

Question: 22

Distinguish between:

Exports and Imports

Solution

Exports	Imports
It is the selling of domestically produced goods and services to any foreign country.	It is the buying of internationally produced goods and services by the domestic country.
In exports, goods flow out of the economy.	In imports, goods flow into the economy.
Here, foreign exchange is earned by the economy.	Here, foreign exchange flows out of the economy.

Question: 23

Distinguish between:

Consumption and Saving

Solution

Consumption	Savings
Consumption is that part of the income that is spent on buying goods and services.	This is the unspent part of the income.
It is the expenditure incurred by households on the gross domestic product.	The savings are used for investment in business enterprises.
Example: Expenditure incurred on purchase	Example: Amount deposited in

of food, clothes etc

fixed deposits.

Question: 24

Distinguish between:

Consumption Function and Saving Function

Solution

Consumption Function	Savings Function
It depicts the relationship between consumption expenditure and the level of disposable income	It depicts the relationship between savings and the level of disposable income.
$C = f(Y_d)$, where C represents consumption expenditure Y_d represents disposable income.	$S = -\bar{S} + sY_d$ Where, $\bar{S}$ represents autonomous saving* s represents marginal propensity to save (MPS) Y_d represents disposable income.
It shows how a change in income influences the consumption pattern.	It shows how a change in income influences savings.

Question: 25

Write Short note on:

Effective Demand

Solution

Effective demand is defined as the total expenditure incurred by all people in an economy on the various goods and services produced in an economy over a given period of time. It is determined by the intersection of aggregate demand and aggregate supply.

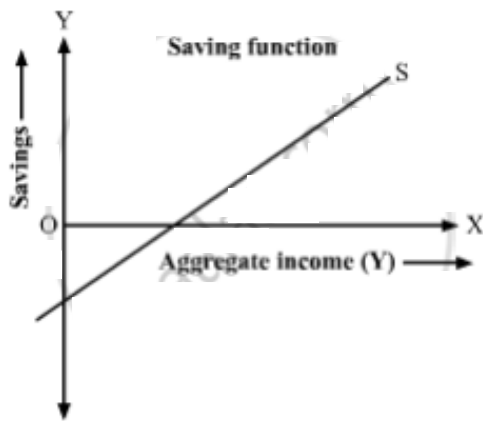
Question: 26

Write Short note on:

Saving Function

Solution

The consumer does not spend the entire increase in his income on consumption. Rather, a portion (generally fixed) of the increase in income is kept as savings. Thus, as the income increases, savings also increase. This relationship between the savings and income is depicted in a functional form by the savings function. The savings function can be expressed as:

$$S = f(y)$$


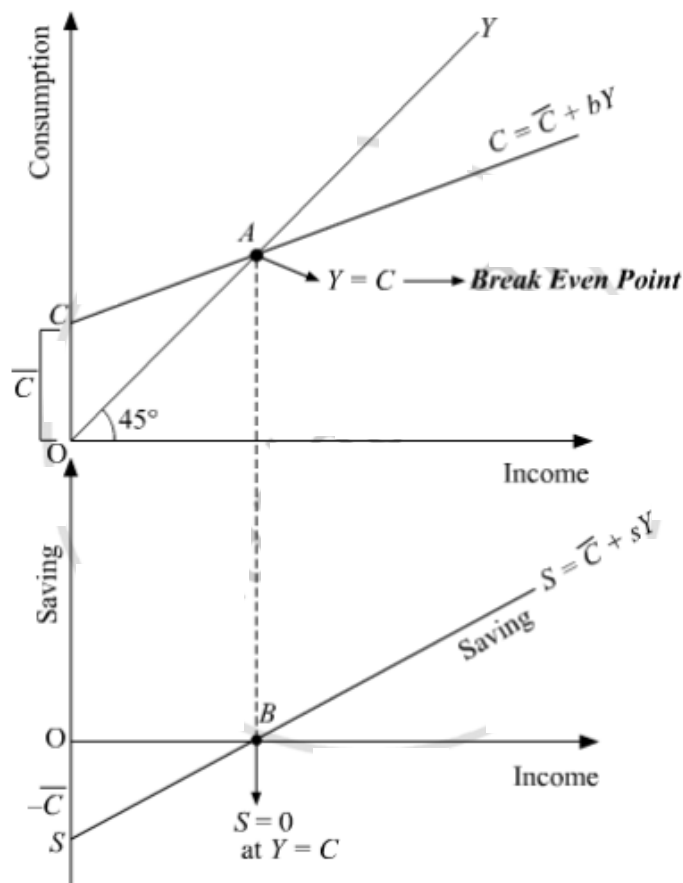
Question: 27

Write Short note on:

Break-even Point

Solution

Breakeven point is a point where consumption exactly equals income and correspondingly, savings are zero. Graphically, it is represented by the intersection of the income line or the 45 degrees line and the consumption curve. Algebraically, breakeven is achieved when $Y = C$



Question: 28

Write Short note on:

Average Propensity to Consume

Solution

Average Propensity to Consume (APC) expresses the propensity to consume in aggregate terms. It shows the ratio of consumption expenditure to the level of income. Algebraically,

$$APC = C/Y$$

Question: 29

Write Short note on:

Marginal Propensity to Consume

Solution

Marginal propensity to consume expresses the propensity to consume in proportionate terms. It refers to the ratio of change in the consumption expenditure to the change in the disposable income. Algebraically, $MPC = \Delta C / \Delta Y$.

Question: 30

Answer the following question:

What are the determinants of Aggregate Demand (AD)?

Solution

Aggregate demand implies the total demand of final goods and services by all the people in an economy. Aggregate demand is the summation of consumption expenditure (C), investment expenditure (I), government expenditure (G), and net earnings from foreign transactions (X - M) (Where, X is exports and M is imports).

Algebraically,

$$AD = C + I + G + (X - M)$$

i. Consumption expenditure (C): Consumption expenditure refers to the total expenditure incurred by all the households in an economy on different types of final goods and services in order to satisfy their wants. Consumption expenditure can be further divided in two categories as - Autonomous consumption expenditure and Induced consumption expenditure. Autonomous consumption expenditure is independent of the levels of disposable income whereas, induced consumption expenditure varies directly with the level of disposable income.

ii. Investment expenditure (I): Private investment expenditure refers to the planned (ex-ante) total expenditure incurred by all the private investors on creation of capital goods such as expenditure incurred on new machinery, tools, buildings, raw materials etc. Broadly, investment can be categorised into two types- Autonomous investment expenditure and Induced investment expenditure. The autonomous investment expenditure is independent of the rates of interest and levels of income whereas, the induced investment expenditure varies inversely with the rate of interest and directly with the levels of income.

iii. Government expenditure (G): Government expenditure refers to the total planned expenditure incurred by the government on consumption and investment purposes to enhance the welfare of the society and to achieve higher economic growth rates. The government expenditure comprises of both investment expenditure as well as consumption expenditure.

iv. Net exports (X - M): Net exports of a country refers to the difference between the demand for domestically produced goods and services by the rest of the world (exports) and the demand for goods and services produced abroad by the residents of that country.

Question: 31

Answer the following question:

What are the determinants of Aggregate Supply (AS)?

Solution

Aggregate supply indicates the total amount of goods and services produced within an economy at a given the general (or overall) price level during an accounting period.

$$AS = f(\bar{N}, \bar{L}, \bar{K}, \bar{T})$$

where,

AS = Aggregate supply

N = Natural resources

L = Labour

K = Stock of capital

T = State of technology

Natural resources: Natural resources include the gifts of nature such as fertile land, weather conditions, adequate rainfall, flora and fauna, perennial rivers etc. The abundant availability of all these factors act in favour of production. The aggregate supply of a country bestowed with these natural resources will be higher and vice-versa.

Labour: Availability of skilled and motivated labour is another determinant of supply. The supply in an economy with abundance of skilled labour will be high and vice-versa.

Capital: Capital is essential in the production process. Capital helps in acquiring raw materials, equipments, plant and machinery, buildings etc. which are essential for increasing the production. Greater the stock of capital, greater would be the level of output and production.

State of technology: The state of technology in an economy decides the level of supply. Advanced technology helps in improving the production efficiency in a a country. With better and advanced technology production can be increased while reducing the cost of production. This in turn positively affects the supply. Thus, the availability of modern and advanced technology helps in increasing the supply.

Question: 32

Answer the following question:

State J. M. Keynes' Psychological Law of Consumption.

Solution

According to Keynes' psychological law of consumption, although with the increase in the income, the consumption expenditure increases, however, this increase in the consumption is less than the increase in the income. In other words, the rate of increase of consumption is lesser than the rate of increase in income. This is because the consumers do not spend the whole of the increase in their income on consumption. Rather, a part of the increase in the

income is saved. Thus, the proportionate increase in the consumption is less than the proportionate increase in the income.

Question: 33

Answer the following question:
What is autonomous consumption?

Solution

Autonomous consumption is the consumption that is independent of income. In other words, expenditure on such consumption is undertaken irrespective of the level of income. It includes consumption of such items as food, clothing, shelter, etc. Such an expenditure cannot fall to zero. This part of consumption expenditure is symbolically denoted by $\bar{C}$. The bar over C represents the constant consumption expenditure. It remains constant irrespective of the level of income.

Question: 34

Answer the following question:
State the subjective factors determining consumption function?

Solution

Consumption function is affected by many subjective factors or the psychological factors. Such factors vary from person to person and are based on a person's personal decisions. According to Keynes, there are eight subjective motives which prevent an individual from current consumption.

i. Motive of precaution: People save money for the future in order to meet unexpected expenditure.

ii. Motive of foresightedness: People cut down their spending in order to meet future requirements for money. For examples, requirements for higher education, marriage, buying a house etc.

iii. Motive of improvement: Individuals cut down their expenditure to improve their standard of living.

iv. Motive of independence: As per this motive, people save more in order to depict more power and independence.

v. Motive of pride: Another motive that prevents people from spending is the wish to maintain the same economic stability in the future. Providing some wealth to their future generations or making donations gives them a feeling of pride.

vi. Motive of enterprise: People prevent current consumption and save for the purpose of investing. Under this motive, people save to invest in a profitable enterprise.

vii. Motive of calculation: Under this motive, people save to invest in shares and debentures in order to increase their income.

viii. Motive of avarice: Some people have a habit of abstaining from expenditure and consumption.

Question: 35

State with reason whether you agree or disagree with the following statement.

Aggregate demand depends only on the consumption expenditure.

Solution

The above statement is incorrect. Apart from consumption expenditure, the aggregate demand also depends on the investment, government expenditure and net exports. It consists of the following components.

Demand by households - Private consumption expenditure (C)

Demand by firms - Private investment expenditure (I)

Demand by government - Government expenditure (G)

Demand by foreign sector- Net exports (X – M)

Where, X is exports and M is imports.

Thus,

$$AD = C + I + G + (X - M)$$

Question: 36

State with reason whether you agree or disagree with the following statement.

Aggregate supply is influenced by the state of technology only.

Solution

The above statement is incorrect. Besides, the state of technology, the aggregate supply is affected by various other factors as well, namely, natural resources, labour force and stock of capital. The aggregate supply function can be represented as follows.

$$AS = f(\bar{N}, \bar{L}, \bar{K}, \bar{T})$$

Where,

AS = Aggregate supply

N = Natural resources

L = Labour

K = Stock of capital

T= State of technology

Question: 37

State with reason whether you agree or disagree with the following statement.

Positive net earnings from foreign transactions add to aggregate demand.

Solution

Positive income from foreign transactions implies that the income of the people increases. Aggregate demand is a direct function of the net positive income earnings from foreign transactions. As such income increases the aggregate demand also increases.

Question: 38

State with reason whether you agree or disagree with the following statement.

At break-even point, consumption (C) is equal to income (Y).

Solution

Breakeven point is a point where consumption exactly equals income and correspondingly, savings are zero. Graphically, it is determined at the intersection of the income line or the 45 degrees line and the curve. Algebraically, breakeven is achieved when $Y = C$

Question: 39

State with reason whether you agree or disagree with the following statement.

Savings are negative before break-even point.

Solution

The above statement is correct. Breakeven point is achieved where consumption exactly equals income and correspondingly, savings are zero. Below this point consumption exceeds income. In such a situation consumption is financed by drawing from past savings, that is the savings are negative.

Question: 40

Answer in detail.

Explain the determinants of aggregate demand.

Solution

Aggregate demand is the summation of consumption expenditure (C), investment expenditure (I), government expenditure (G) and net earnings from foreign transactions (X – M).

where, X is exports and M is imports

$$AD = C + I + G + (X - M)$$

i. Consumption expenditure (C): Consumption expenditure refers to the

total expenditure incurred by all the households in an economy on different types of final goods and services in order to satisfy their wants. There are two types of consumption expenditure - Autonomous consumption expenditure and Induced consumption expenditure. Autonomous consumption expenditure is independent of the levels of disposable income whereas, induced consumption expenditure depends on the levels of disposable income.

ii. Investment expenditure (I): Private investment expenditure refers to the planned (ex-ante) total expenditure incurred by all the private investors on creation of capital goods such as expenditure incurred on new machinery, tools, buildings, raw materials etc. Broadly, investment can be categorised into two types- Autonomous investment expenditure and Induced investment expenditure. The autonomous investment expenditure is independent of the rates of interest and levels of income whereas, the induced investment expenditure depends varies inversely with the rates of interest and directly with the levels of income.

iii. Government expenditure (G): Government expenditure refers to the total planned expenditure incurred by the government on consumption and investment purposes to enhance the welfare of the society and to achieve higher economic growth rates. The government expenditure comprises of both investment expenditure as well as consumption expenditure.

iv. Net exports (X – M): Net exports of a country refers to the difference between the demand for domestically produced goods and services by the rest of the world (exports) and the demand for goods and services produced abroad by the residents of that country.

Question: 41

Answer in detail.

What is Aggregate Supply? Explain the determinants of Aggregate Supply.

Solution

Aggregate supply indicates the total amount of goods and services produced within an economy at a given the general (or overall) price level during an accounting period. The aggregate supply function is represented as follows.

$$AS = f(\bar{N}, \bar{L}, \bar{K}, \bar{T})$$

where,

AS = Aggregate supply

N = Natural resources

L = Labour

K = Stock of capital

T = State of technology

i. Natural resources: Natural resources include the gifts of nature like fertile land, weather conditions, adequate rainfall, flora and fauna, perennial rivers

etc. All these factors act in favour of production. The aggregate supply of a country bestowed with these natural resources will be higher than the one with lower availability of natural resources.

ii. Labour: Availability of skilled and motivated labour is another determinant of supply. Highly skilled, efficient and productive labour force is better able to contribute to the production process. In this regard availability of skilled labour has a positive affect on the aggregate supply.

iii. Capital: Capital is essential in the production process. Capital helps in acquiring raw materials, equipments, plant and machinery, buildings etc which are essential for increasing the production and productivity. However, the accumulation of capital in an economy depends on the level of saving and investment. The greater the level of saving and investment, greater is the capital accumulation, thereby, greater is the impact on aggregate supply.

iv. State of technology: The state of technology greatly affects the level of production and supply in the economy. Modern and advanced technology helps in increasing the productivity and production, while lowering the cost of production. While on one hand, it helps in better utilisation of the existing resources, on the other hand, it helps in exploring new and better resources. In this manner availability of modern and advanced technology has a positive impact on the aggregate supply.

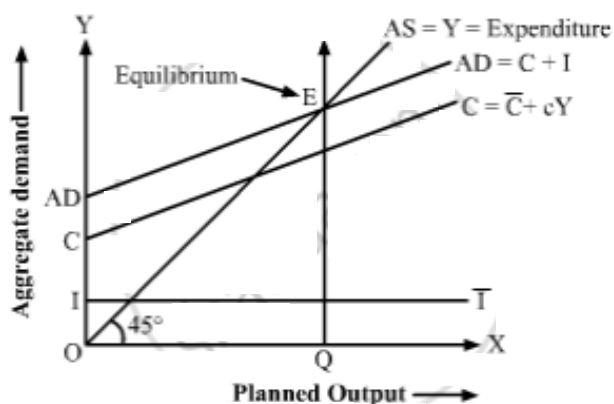
Question: 42

Answer in detail.

Explain the equilibrium between Aggregate Demand and Aggregate Supply.

Solution

The equilibrium level of income is determined at that point, where Aggregate Demand (AD) is equal to Aggregate Supply (AS). Here, AD refers to the planned/desired level of expenditure in the economy during an accounting year. Similarly, AS refers to the planned/desired level of output in an economy during an accounting year.



In the diagram, the consumption curve is depicted by C and the investment curve is depicted by the horizontal straight line parallel to the output/income axis. Summing up the investment curve and consumption curve, we get the aggregate demand curve represented by $AD = C + I$. The aggregate supply curve is represented by the 45° line. Throughout this line, the planned expenditure is equal to the planned output. That is, $AS = Y = \text{expenditure}$. The implication of the 45° line is that, in case of any disequilibrium, AS will be adjusted in a way to equate AD in order to restore equilibrium back. In other words, in case of any inequality between AD and AS, equilibrium output will be determined by AD.

The point E is the equilibrium point, where the planned level of expenditure (AD) is equal to the planned level of output (AS). In other words, this suggests that there is no undesired inventory accumulation. The equilibrium level of output is OQ, which is also known as the 'effective demand'.

Question: 43

Answer in detail.

What are the objective factors influencing consumption function?

Solution

Objective or Institutional Factors: Psychological factors are external to an individual's behavior. They are also called exogenous factors.

i. Change in income: Income plays an important role in determining the consumption expenditure. Higher income means more consumption and vice versa.

ii. Change in rate of interest: Change in interest rate influences the consumption pattern. An increase in interest will result in fall in consumption expenditure and vice versa.

iii. Change in capital value: In case of capital gain to an individual, consumption will increase and in case of capital loss, consumption will fall.

iv. Fiscal policy: Changes in the fiscal policy of the government influences the consumption pattern. For example, an increase in interest rate will result in fall in consumption and vice versa.

v. Future expectations: If it is expected that in the future income will increase, the consumption will increase and vice versa.

vi. Demographic factors: Demographic factors such as size of population, age group etc. also influence the consumption pattern. For instance, if the population has a greater proportion of children, the demand for baby products would be more.

Question: 44

Answer in detail.

Give an idea about the subjective factors determining consumption function.

Solution

Subjective or Psychological Factors: These are internal factors and depend on personal decision. According to Keynes, there are eight subjective motives which prevent an individual from current consumption.

i. Motive of precaution: People save money for the future in order to meet unexpected expenditure.

ii. Motive of foresightedness: People cut down their spending in order to meet future requirements for money. For examples, requirements for higher education, marriage, buying a house etc.

iii. Motive of improvement: Individuals cut down their expenditure to improve their standard of living.

iv. Motive of independence: As per this motive, man saves more in order to depict more power and independence.

v. Motive of pride: Another motive that prevents people from spending is wanting to maintain the same economic stability in the future. Providing some wealth to their future generations or making donations gives them a feeling of pride.

vi. Motive of enterprise: People prevent current consumption and save for the purpose of investing. Under this motive, people save to invest in a profitable enterprise.

vii. Motive of calculation: Under this motive, people save to invest in shares and debentures in order to increase their income.

viii. Motive of avarice: Some people have a habit unnecessarily abstaining from consumption.