The Level of Output and Aggregate Demand: the Keynesian Explanation

Study guide

From the point of view of overall government control of the economy, this is the most important chapter in the book, for it highlights the factors determining the level of economic activity.

The essential point you must grasp is that there is a circular flow of income. Payments by firms to households comprise the incomes of households. Income is spent on the goods and services produced by firms, and this expenditure forms the receipts of firms. From these receipts, firms pay for the factors of production provided by households. And so the circle continues.

‘Withdrawals’ from the circular flow occur through saving, taxation and spending on imports (the production of firms outside the UK). But these withdrawals can be compensated for by ‘injections’ into the circular flow — by government spending, investment spending and spending on UK exports by foreigners (that is, on goods produced by UK firms).

If total injections, $I + G + X$ (exports) exceed total withdrawals, $S + T + M$ (imports), the level of factor payments (income) will expand. If total injections are less than total withdrawals, the level of factor payments will contract. Equilibrium will exist (that is, there will be no change in the level of factor payments) when total injections and total withdrawals are equal.

Note that $I$ does not have to equal $S$, or $G$ equal $T$, and so on. The level of $Y$ is maintained if the total of $I + G + X$ equals the total of $S + T + M$. Differences between $G$ and $T$ are shown in the budget as a deficit or surplus, and differences in $X$ and $M$ in the balance of current payments as an adverse or a favourable balance.

The above can be shown diagrammatically, as follows:

This is your basic diagram. You can use it to explain the impact of any change in the withdrawals or injections on the level of activity. Suppose, for instance, that there is unemployment and that the government moves from...
a balanced budget to a budget deficit, other variables remaining unchanged. What has happened is that $G$ has increased relative to $T$, which will have an expansionary effect. This is the first approach.

The rest of the chapter is really a development of the above theme. It fills in the details to the following questions:

What determines the level of consumption spending? How does consumption spending change as income changes? What factors determine investment spending? What impact do changes in one variable have on the other variables? By how much does income expand when total injections exceed total withdrawals? What effect does a change in income have on exports and imports? How can it be used to suggest what policies the government should follow to adjust AD?

Changes in the level of income and of government policy can always be explained in terms of the circular flow diagram. An alternative method is to use the 45° diagram (Fig 30.9). This has more precision, because it expresses diagrammatically the exact relationship of consumption, investment and government spending to the level of income (though, to simplify, investment and government spending are usually assumed to be autonomous). It can thus show directly the equilibrium level of income which will result, and the inflationary or deflationary gap. If you use this diagram, be sure that you understand it thoroughly; otherwise stick to the circular flow diagram.

Questions

I. The link between spending and production

1. Define ‘aggregate demand’ for a closed economy.
2. Draw a diagram to show the relationship between AD and employment.
3. How does (a) an increase, (b) a decrease in AD actually affect firms in (i) the short period, (ii) the long period?

II. Reasons for changes in Aggregate Demand

4. Assuming a closed economy with no government activity, how could (a) an increase, (b) a decrease in AD come about?
5. If a person saves part of his money income and buries the money in a hole in the ground, what effect will it have on the size of AD?
6. Give another example of how saving can lead to a fall in AD.
7. When does an increase in spending not lead to an increase in employment?

III. Consumption spending and saving

8. Define ‘consumption’.
10. Name two kinds of saving other than by persons.
11. Give three examples of contractual saving by individuals.
12. A man has an income of £20 000 which is disposed of as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housekeeping, clothes, cigarettes, golf, holidays, etc.</td>
<td>15 000</td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>600</td>
</tr>
<tr>
<td>Mortgage repayments on house</td>
<td>2000</td>
</tr>
<tr>
<td>Regular purchase of stocks and shares through a unit trust</td>
<td>1000</td>
</tr>
<tr>
<td>Superannuation deductions from pay</td>
<td>900</td>
</tr>
<tr>
<td>Addition to deposit account at bank</td>
<td>500</td>
</tr>
</tbody>
</table>

What is his (a) consumption, (b) saving?

13. Suggest three ways in which the government could reduce spending (consumption) by individuals.