

# The Simple Keynesian Model: Conditions for Equilibrium Output

- A central notion in the Keynesian model is that an equilibrium level of output requires that *output be equal to aggregate demand*.
- In Keynesian model, this condition for equilibrium can be expressed as  $Y = E$
- where  $Y$  is equal to total output (GDP) and  $E$  equals aggregate demand or desired expenditures on output.

# Aggregate Demand

- Aggregate demand (  $E$  ) consists of three components:
  - Household consumption (  $C$  ),
  - Desired business investment demand (  $I$  ), and
  - Government sector's demand for goods and services (  $G$  ).

Thus, in equilibrium we have

- $Y = E = C + I + G$

# Assumptions

- We are dealing with a “closed” economy, neglecting foreign trade.
- We need not distinguish between GDP and GNP
- Depreciation is also neglected, so we do not need to distinguish between GDP and NDP.
- We also assume that GDP and national income are equivalent.
- *The aggregate price level is fixed. All variables are real variables, and all changes are changes in real terms.*

## The Model

- With national product  $Y$  also measuring national income, we can write  $Y = C + S + T$
- National income, all of which is assumed to be paid to households in return for factor services (wages, interest, rents, dividends), is either consumed ( $C$ ), paid out in taxes ( $T$ ), or saved ( $S$ ).
- In addition, from the fact that  $Y$  is national product, we can write  $Y = C + Ir + G$
- National product as consumption plus *realized* investment ( $Ir$ ) plus government spending

- *In equilibrium* therefore,

$$C + S + T = Y = C + I + G$$

- or, equivalently,  $S + T = I + G$

- In similar fashion, we can see that in equilibrium

- $C + Ir + G = Y = C + I + G$

- or, by canceling terms,  $Ir = I$

## Continued

- There are then three equivalent ways to state the condition for equilibrium in the model:
- $Y = E = C + I + G$  -----(1)
- $S + T = I + G$  -----(2)
- $Ir = I$  -----(3)

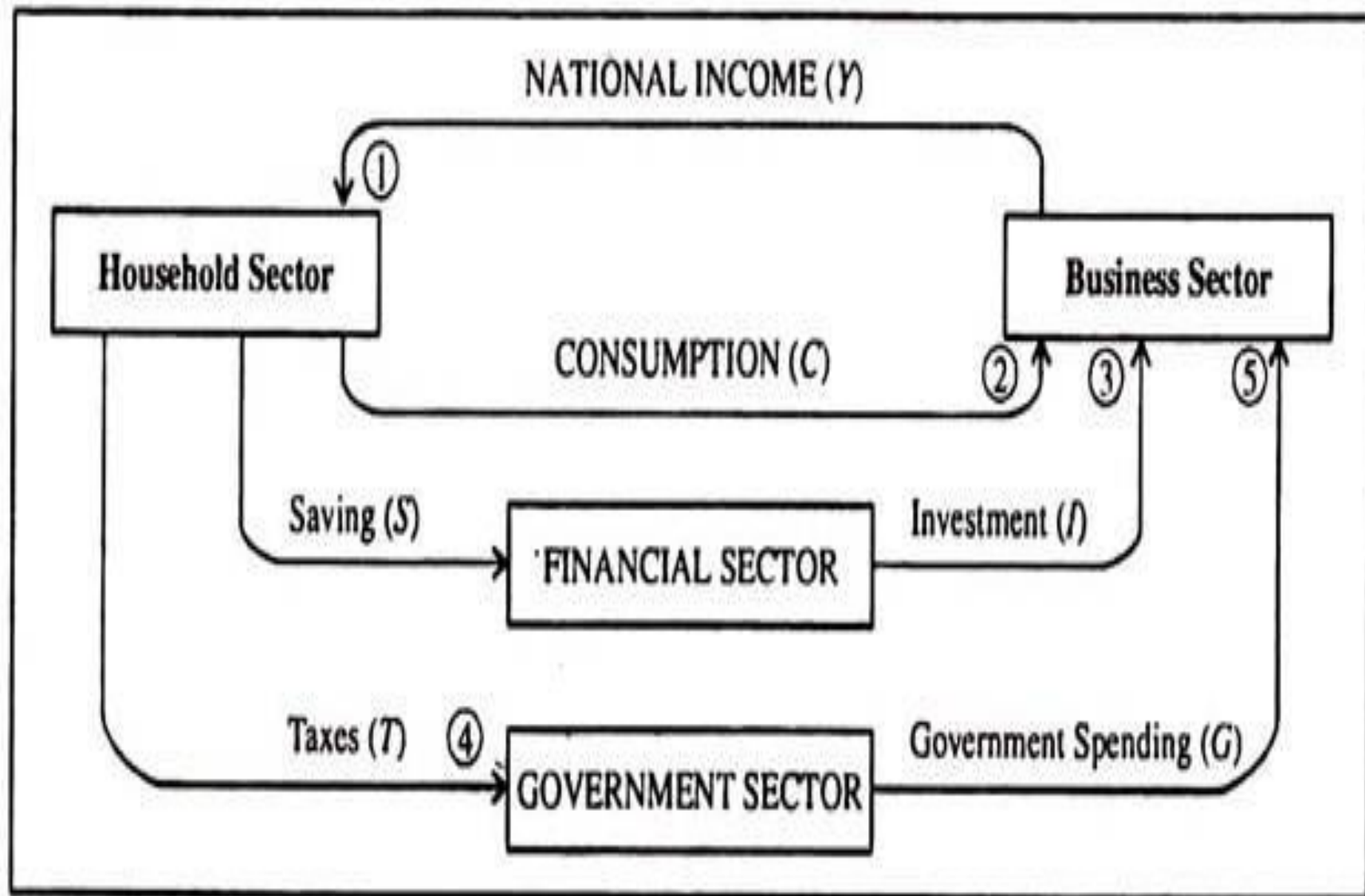


Fig. 8.1 The Circular Flow of Income and Output in a Closed Economy



# THANK YOU

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