Unit-2

Classical Theory / Economics is also called supply side economics (supply creates own demand)

Kenyesian Economics is also called demand side economics (effective demand)

Ricardo, Adam Smith, JB Say, T.R. Malthus, Marshall, Pigou, J.S. Mill are classical economists.

GDP includes income earned in geographical territory even foreign nationals and companies based in the territory whereas GNP excludes them and include those citizens working abroad.

Classical Theory of Income and Employment

Assumptions:

1. Perfect Competition in long run
2. Wage-Price Flexibility
3. Laissez Faire Economy (no govt. intervention) it is based on two concepts: Say's Law & Wage cut theory
4. All ~~at~~ units produced are sold
5. Homogenous labour.
6. Perfect Equilibrium

__/__/__

Says Law

Supply creates its own demand.

Whenever any product is produced, the demand of that product is also simultaneously generated through the process of payment of remuneration to the factors of production.

There can be no overproduction of goods

AD = AS

Savings = Investments

If someone saves a portion due to which savings will increase in economy so interest rates will fall and that amount will be invested

Automatic adjustment of full employment

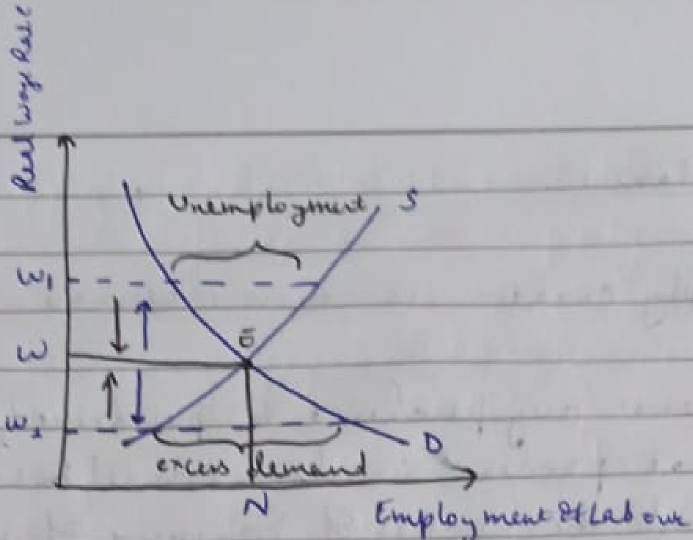
Wage-Cut Theory

Full employment always and if there is unemployment then cut wages

It was assumed money wages = real wages (wages adjusted after inflation)

If wages are cut cost of production reduces making goods cheaper increasing demand thus requiring more employees

_/_/_



If wages increase more people are willing to work as compared to demand, resulting in unemployment and due to more supply than demand wages will reduce till equilibrium but if they go further less people will work resulting in more demand of labour and wages will go up again.

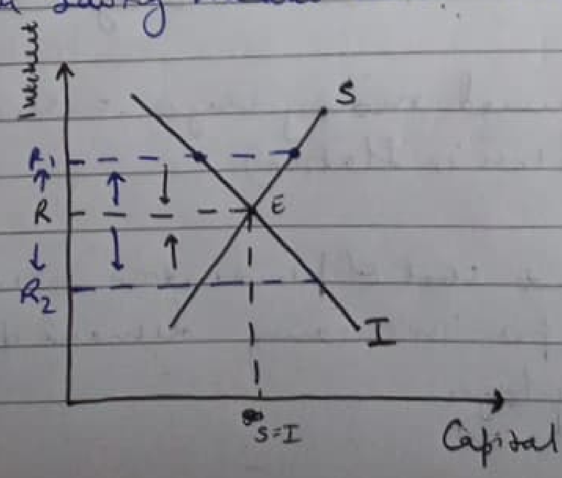
Interate Rate Flexibility Model

Saving = Investment

Whatever saved is invested, whatever not spend is saved

Full employment

· higher saving means lower interest and vice-versa



___/___/___

Quantity Theory of Money - Cambridge Version

Value of money is determind by its demand and supply

Store of value function of money

We hold some part of income as cash balance (k)

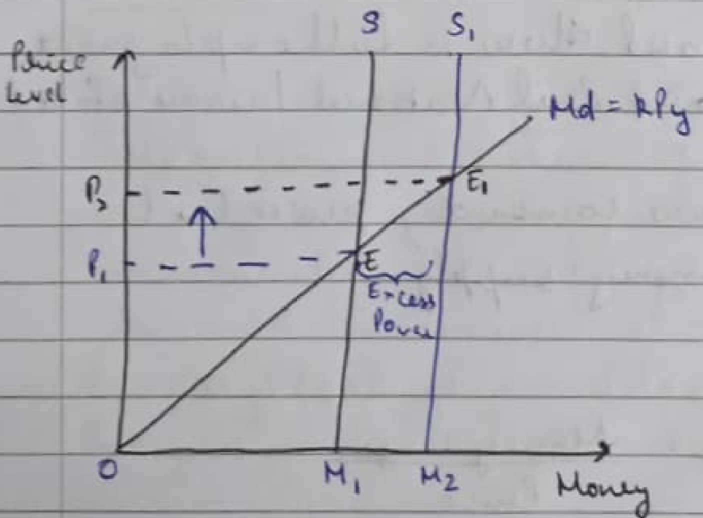
$$Md = k\,Py$$

Md = money demanded P = Price level
k = Portion of nominal income y = Real national income
Py = nominal national income M = money supply

No control on money supply
when supply is equal to demand

$$Md = M$$

$\boxed{M = k\,Py}$ Equilibrium Equation



Money supply is constant

Money supply is independent variable while price level is dependent on supply

If govt for any reason increase money supply there will be exess power with people to purchase so they will increase demand which increase price level to P_1 at new equilibrium E_1

$$M = kPy$$

~~k: velocity of money~~

If we hold more money than velocity of money circulation is less

$$k = \frac{1}{v}$$

$$M = \frac{1}{v} \times Py$$

$$P = \frac{1}{k} \cdot \frac{M}{y}$$

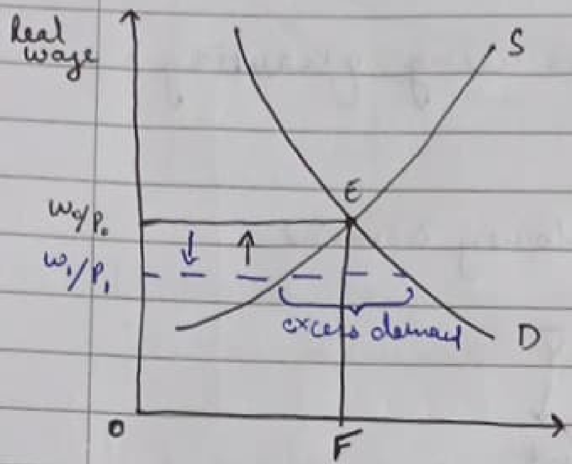
k is constant and there is full employment of resources and Real National Income is fixed

As k and y are constant, price level depend on money supply

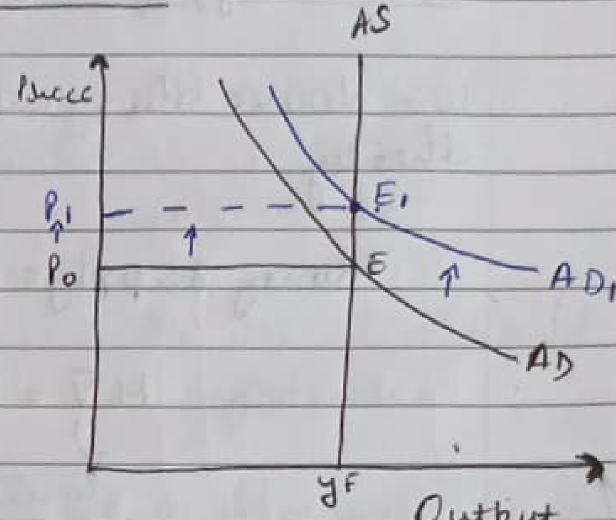
$$\text{Real Wage} = \frac{\text{Money Wage}}{\text{Price}}$$

_/_/_

Classical Full Employment Model



Labour Market Eqn



Due to increase in prices real wage goes down but at that point unequilibrium exists resulting in excess demand for labour which increases wages bringing back to original level
As long as both wages and prices increases in equal proportion real wage remains same, along with output and employment.

Criticism

Demand creates supply not other way round.
Full employment is rare phenomenon.
Self adjustment is not possible and need govt. intervention.
Saving ≠ Investment
Quantity Theory rejected and money is not neutral.
Cutting wages does not increase employment

__/__/__

Classical Aggregate Demand Curve

We derive this curve using quantity theory.

Money supply = Money Demand

$$M\bar{V} = P\bar{Y}$$

$\bar{V}$, $\bar{Y}$ → Constant

if $k = \frac{1}{4}$ & $M = 300$

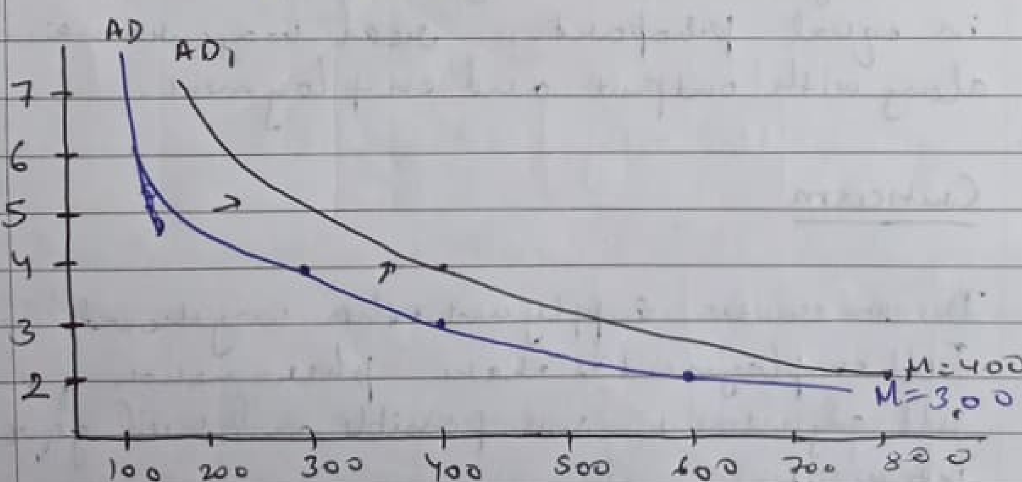
$\Rightarrow V = 4$

$$M\bar{V} = PY$$

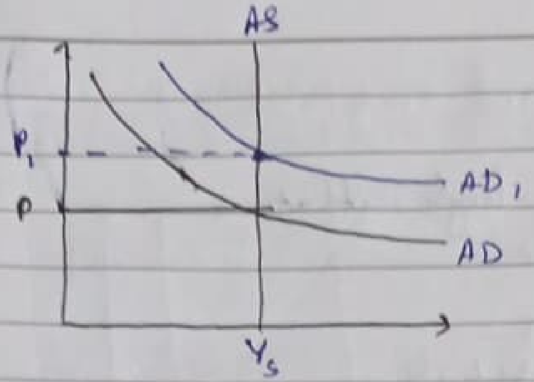
$$1200 = PY$$

if M increases to 400

so $PY = 1600$



Due to increase in money supply AD shifts



If money supply increase AD will shift and price increases and output is constant

It is implicit as it does not focus on factors of aggregate demand.

<u>Effect of Fiscal and Monetary Policy</u>

<u>Monetary Policy</u>

It is the demand side of economic policy implemented by the central bank. It is ~~too~~ required to ensure economic stability by ~~atta~~ achieving price stability and promote sustainable economic growth.

<u>Types</u>

<u>Expansionary</u>:

Implemented during recession/slowdown
lowest interest rates
unfavourable to save
promotes spending
increase money supply

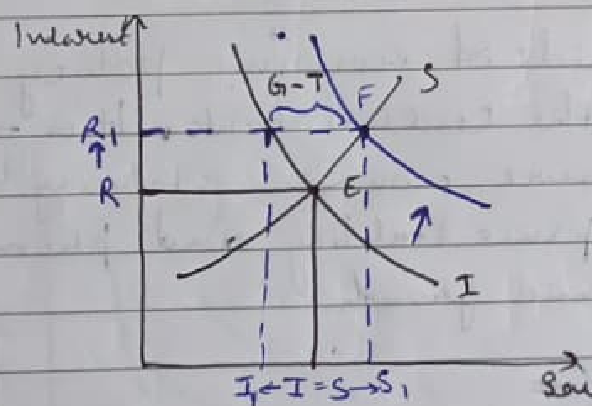
Contractionary

Implement during high inflation
Raise interest rate
curb spending
decrease money supply

Fiscal Policy

Policy related with taxes and govt. expenditure

1. Government Expenditure :
Using sources such as taxation, sell bonds and creating new money, here we will take selling bonds



Govt Exp = Tax

Now govt is spending more using bonds so
$G > T$, $G-T$ (budget deficit)
So demand for bonds will increase, so Investment curve will shift. As more borrowers than lenders interest rate will increase

Due to increasing rates people will save more and proportionate consumption will decrease and new decreased investment will be I_1

Due to increase in government spending interest rate increases resulting in crowding out i.e. ~~pri~~ decrease in private spending (consumption, investment)

As $\uparrow G = \downarrow C + \downarrow I$, $AD = G + C + I + Nx$
so AD remains unaffected and so does output, employment and prices.

If govt increases expenditure by increasing tax only ~~so~~ no affect on equilibrium

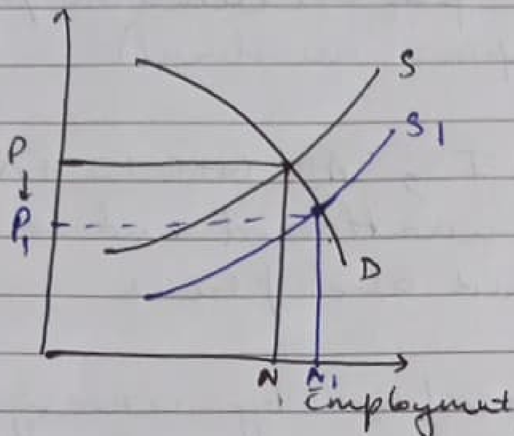
If govt. print money as per Quantity theory due to more supply only prices will increase

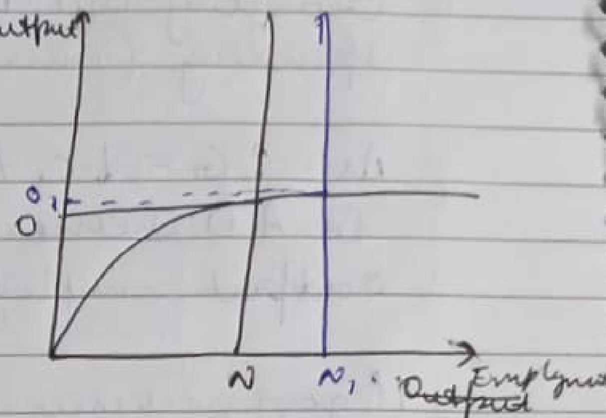
2. Tax Policy

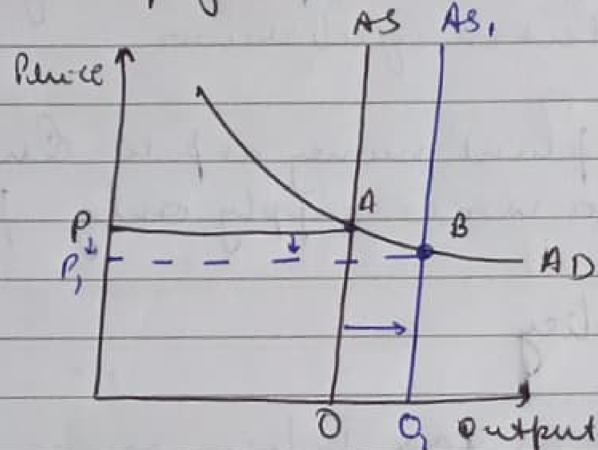
Reduction in tax policy can be two types lumpsum ~~out~~ amount reduction and tax rate reduction

In lumpsum reduction ~~it can be selling bonds~~ disposable income increase so does consumption
Loss of revenue can be recovered by selling bonds which will follow as mentioned, increase in interest and money printing in which only price increase

When tax rate is reduced consumption increases but also impact supply side that is increase in real wage which results in increased employment, increased output and prices reduce







<u>Monetary Policy</u>

It affects only supply of money and only impact price in classical theory