Classical Economics

Chapter 11

Part I: The Classical Economic System

- **The centerpiece of classical economics is Say's law**
  - **Say's law states, "*Supply creates its own demand*"**
  - **This means that somehow, what we produce – supply – all gets sold**

Why Does Anybody Work?

- **People work because they want money to buy things**
  - **People who produce things are paid. They spend this money on what other people produce**
  - **As long as everyone spends everything that he or she earns, the economy is OK**
    - **But, the economy begins to have problems when people save part of their incomes**
  - **People do save, and saving is crucial to economic growth**
    - **Without saving, we could not have investment – the production of plant, equipment, and inventory**

Consumer Goods and Investment Goods

- **Think of production as consisting of two products: consumer goods and invest-ment goods (for now, we're ignoring government goods)**
- **The money spent on consumer goods is designated by the letter C**
- **The money spent on investment goods is designated by the letter I**

Consumer Goods and Investment Goods

If we think of GDP as *total spending*, then

GDP would be C + I

If we think of GDP as *income received*, then

GDP would be C + S

Consumer Goods and Investment Goods

If we think of GDP as *total spending*, then

GDP would be C + I

If we think of GDP as *income received*, then

GDP would be C + S

GDP = C + I

GDP = C + S

Consumer Goods and Investment Goods

GDP = C + I

GDP = C + S

And since things equal to the same thing are equal to each other, we have

C + I = C + S

Consumer Goods and Investment Goods

GDP = C + I

GDP = C + S

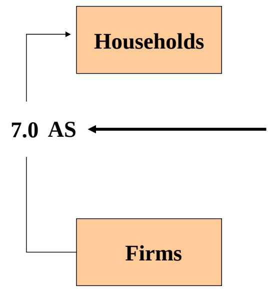
Things equal to the same thing are equal to each other

$\cancel{C} + I = \cancel{C} + S$

Next, we can subtract the same thing from both sides of the equation. In this case we subtract C

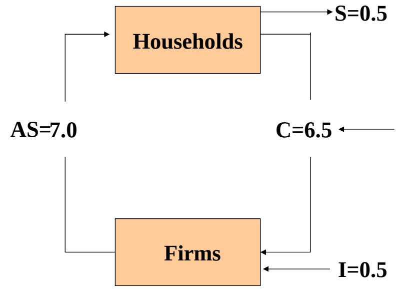
I = S

Say’s Law Revisited



The economy produces a supply of consumer goods and investment goods (Aggregate Supply = AS)

Say’s Law Revisited

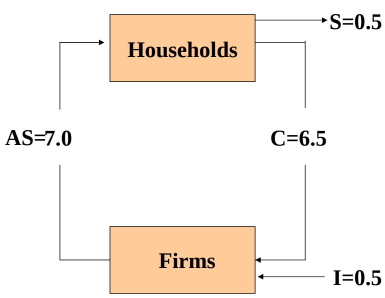


They save the rest

The people who produce these goods (Households) spend part of their incomes on consumer goods

Their savings are borrowed by investors who spend this money on investment goods

Say’s Law Revisited



GDP = C + I
GDP = 6.5 + 0.5
GDP = 7.0

I = S

GDP = 7.0 = Aggregate Demand (AD)

We can see that Say’s law holds up, at least in accordance with classical analysis. Supply does create its own demand. Everything produced is sold. (AS = GDP=AD)

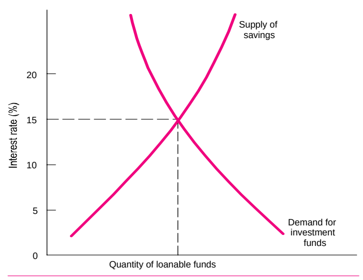
Supply and Demand Revisited

The curves cross at a price of $7.30 and a quantity of 6

Supply and Demand Revisited

The demand and supply curves cross at an interest rate of 15 percent

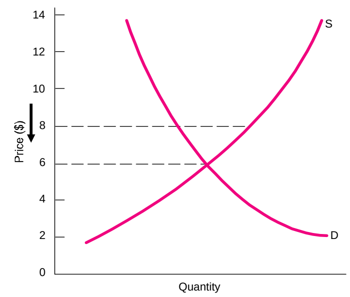
The Loanable Funds Market



Supply and Demand Revisited

If the quantity supplied is greater than the quantity demanded at a certain price (in this case $8), the price will fall to the equilibrium level ($6), at which quantity demanded is equal to quantity supplied.

Market for Hypothetical Product



Supply and Demand Revisited

If the wage rate is set too high ($9 an hour),the quantity of labor supplied exceeds the quantity of labor demanded. The wage rate falls to the equilibrium level of $7; at that wage rate, the quantity of labor demanded equals the quantity supplied

Hypothetical Labor Market

The Classical Equilibrium: Aggregate Demand Equals Aggregate Supply

- On the micro level, when quantity demanded equals quantity supplied, we're at equilibrium
- On the macro level, when aggregate demand equals aggregate supply, we're at equilibrium
- The classical economist believed our economy was either at, or tending toward , full employment
- *So at classical equilibrium* – the GDP at which aggregate demand was equal to aggregate supply – *we were at full employment*