Module 4
Macroeconomics

(Lectures 27, 28, 29, 30, 31 & 32)

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Module 4

Lecture 27

Topics

4.1 Classical Macroeconomics

4.1.1 Fundamental Characteristics

4.1.2 Model

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4.1 Classical Macroeconomics

4.1.1 Fundamental Characteristics

- Classical macroeconomics is an extension of the classical economics as developed by Smith and Ricardo which developed into marginalist principle and neo classical economics.

- In this section, we would only talk about the short term macroeconomics and not about growth economics.

- The fundamental characteristics of classical macro is the reliance on market and non reliance on monetary variable to solve the problem of unemployment.

- In this model involuntary unemployment does not exist.

- In this model deficit spending only increases general price level without affecting the unemployment level.

- **Moral of the story:** laissez faire without government intervention is the best way to run an economy.

4.1.2 Model

- The production function is given by $Y = f(L)$ where Y is the output and L is labor.

- From this equation one can derive the labor demand function by equating $\frac{w}{P} = f'$. Solution to this equation determines employment level.

- Money market is given by the quantity theory of money $\overline{M} = kpY$where $\overline{M}$ is the supply of money in the economy, k denotes the reciprocal of income velocity of money, and p is the general price level. Y in this model denotes the full employment national income level.

- Note that, national income is determined by labor employment which is completely determined my supply and demand of labor in the market.

- Supply of labor is determined by the labor leisure choice of utility maximizing individuals.

- Demand for labor on the other hand is dependent on technology of production.

- Hence, national income is completely determined by technology and preference none of which can be affected by fiscal and monetary policies.

- Expansionary monetary policy in this model can only cause inflation in this model.

4.1.3 Implications

- The model described above cannot be attributed to some specific economists. This is rather a summary representation of the body of work done by classical economists.

- The earlier version of these models lacked micro foundation while the later versions (viz. Real Business Cycle theory) have rigorous micro foundation.

- But the essence of the model remains the same. Unemployment in this model is determined by deep fundamentals such as technology and preference.

- There government policy designed to cure unemployment is not only ineffective but also moves the economy off the path of efficiency.

- Moreover, unemployment in this model is voluntary and therefore, there is no ethical ground for government intervention.

- Hence, the two basic principles that classical macroeconomists uphold are efficiency of market and government's inability to cure recession by means of fiscal or monetary policies.

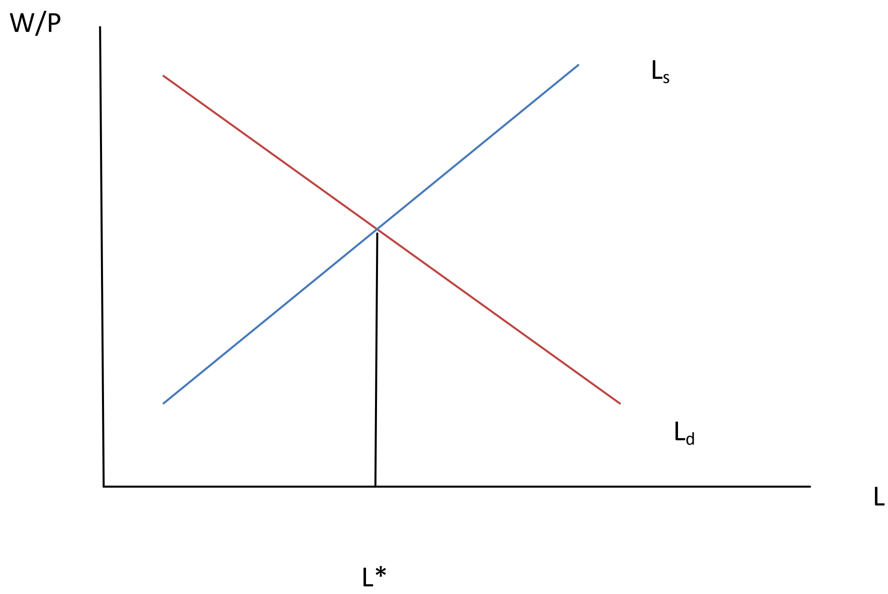

Fig 1: Labor Market

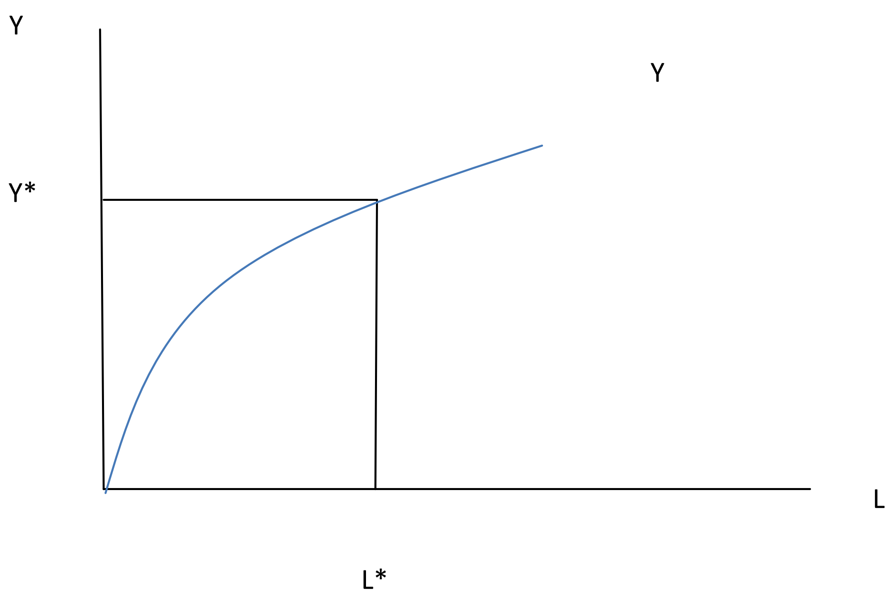

Fig 2: output level

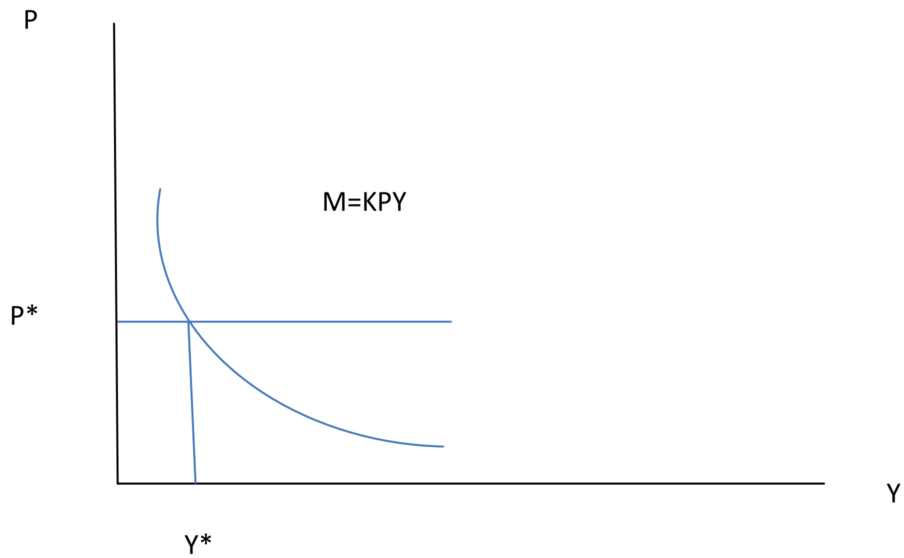

Fig 3: Money market: quantity theory of money