MACROECONOMICS

Classical general equilibrium theory:

2. The goods market
3. The money market

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The goods market is in equilibrium when saving S equals investment I. At that point of time, total demand equals total supply and the economy is in a state of full employment. According to the classicists, what is not spent is automatically invested.

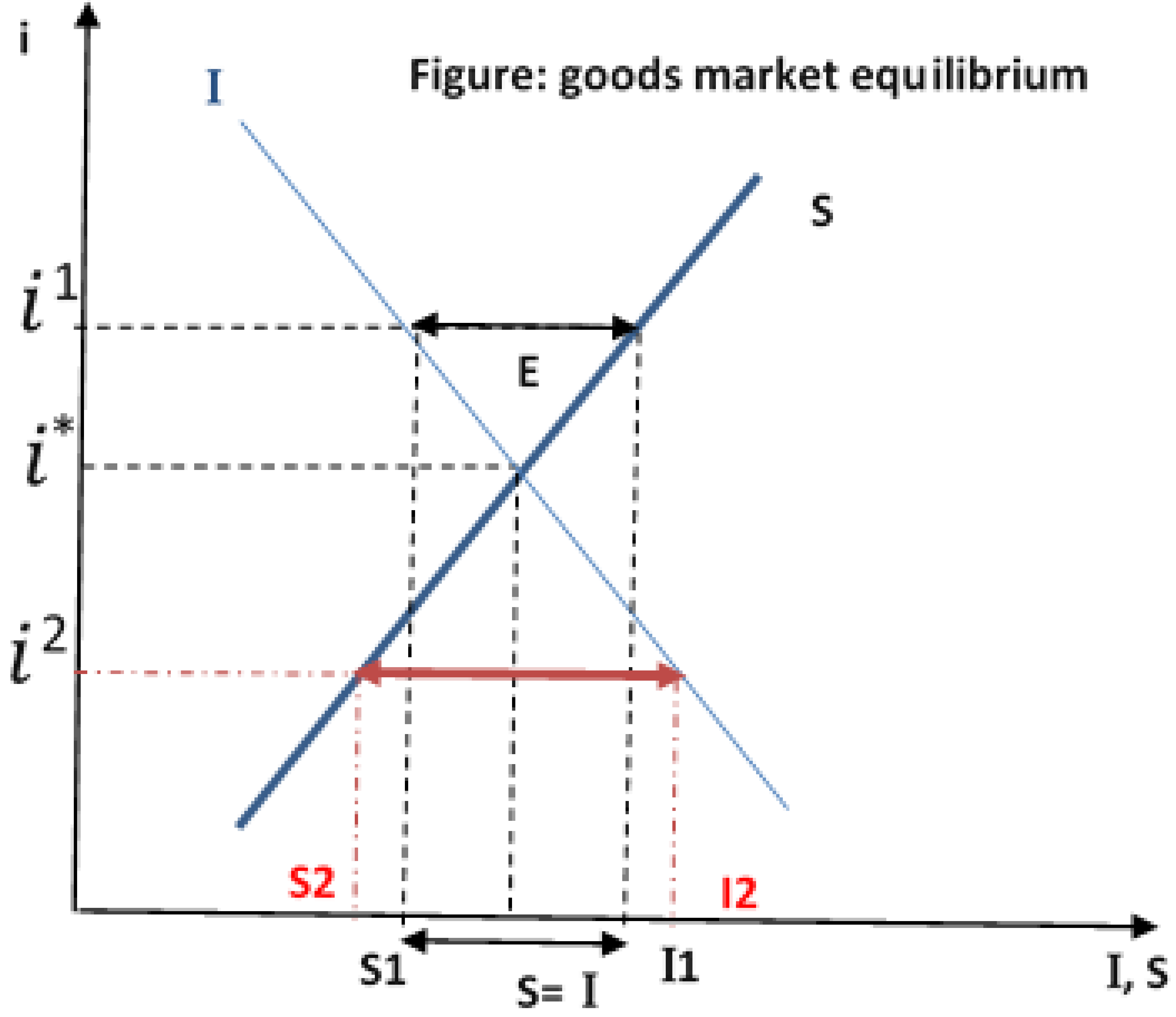
both saving and investment are the functions of the interest rate :

$$S=f(i)$$

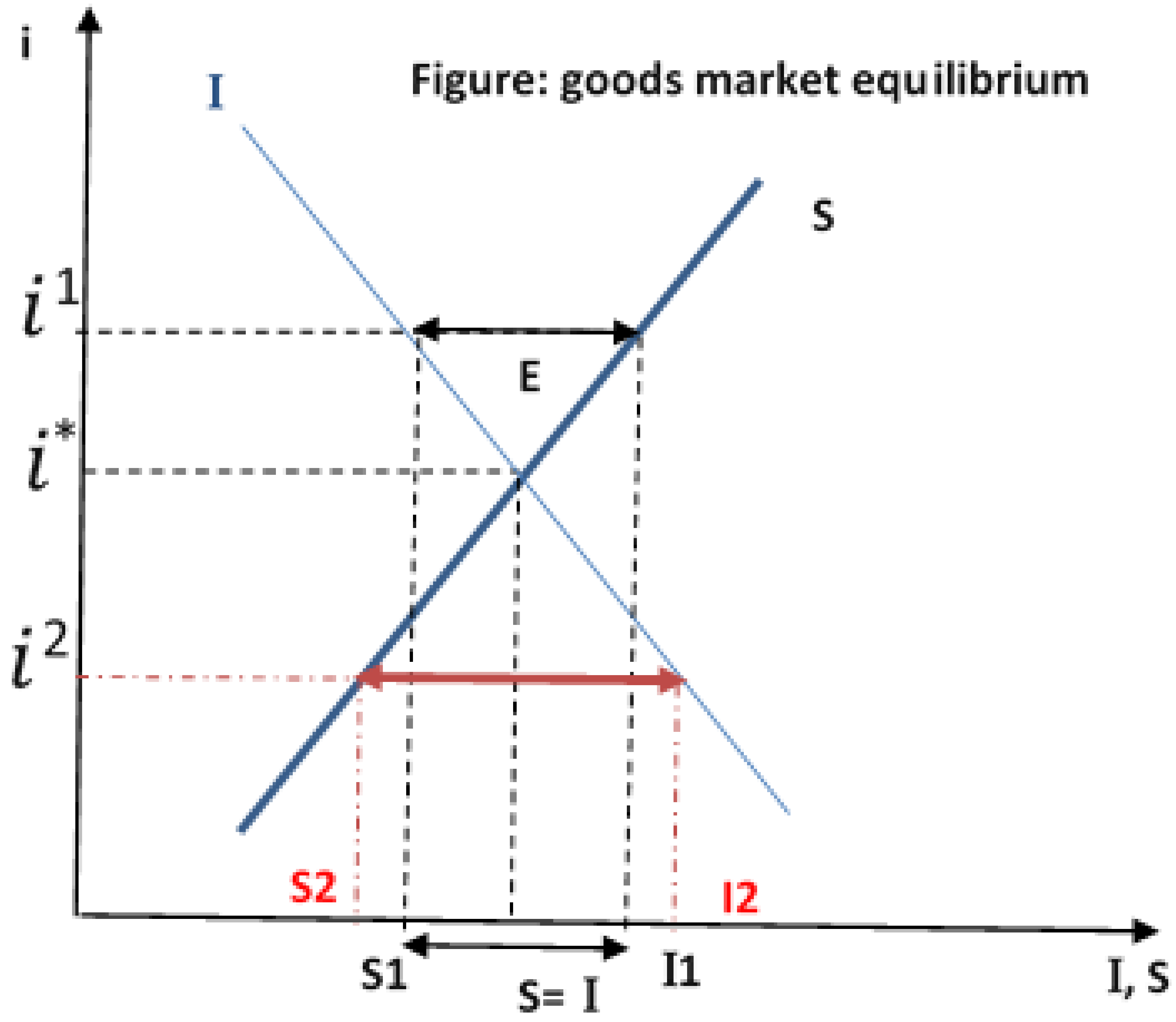
$$I=f(i)$$

$$S=I$$

saving is regarded as an increasing function of the interest rate, and investment as a decreasing function of the rate of interest.



If at any given period, investment exceeds saving : (I > S) the rate of interest will rise. Saving will increase and investment will decline till the two are equal at the full employment level.



Money Market Equilibrium:

$$MV = PT$$

The money market equilibrium in the classical theory is based on the Quantity Theory of Money, named: Fisher's equation

M = supply of money, V= velocity of circulation of M, P = Price level, and T = volume of transaction or total output.

$MV = PT$

Assuming V and T to be constant, a change in the supply of money (M) causes a proportional change in the price level (P).

Thus the price level is a function of the money supply: $P = f(M)$. The relation between quantity of money.

The aggregate demand and the aggregate supply:

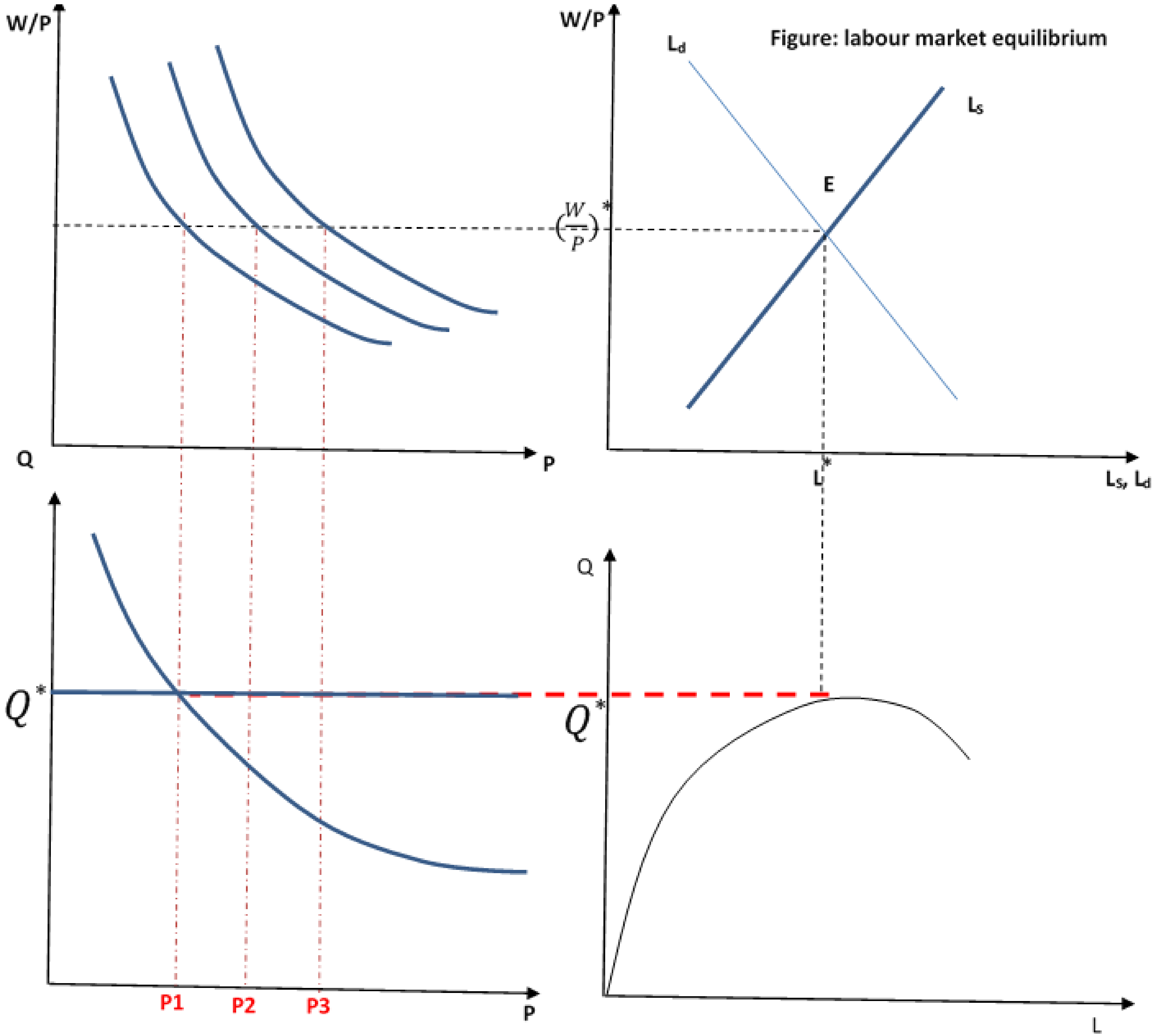


Figure: general equilibrium