- Therefore, some appropriate expansion in the money supply is sufficient both to raise P in the level that reduces real wage to the full employment equilibrium level and to provide the increase in AD needed to purchase the full employment output at that price level.

Example :

|	N	Y	W	P	$MPP_L = W/P$	M	V	S_L	D_L	u.
Original eq.	200	600	4.00	1	4	150	4	200	200	0
New eq.	180	545	4.8	1.1	4.36	150	4	204	180	24
Final eq.	200	600	4.8	1.2	4.00	180	4	200	200	0

* **Classical Theory with Saving & Investment**

- The classical model fails to breakdown aggregate demand into demand for consumption goods and demand for capital goods.

- This means that it does not recognise the process of saving & investment.

- However, introduction of savings does not invalidate the classical theory.

- Goods market is in equilibrium when saving is equal to investment.

- Both saving & investment is the func's of rate of interest.

- Thus, equality of saving and ~~ins~~ investment is bring by rate of interest.

- Interest rate adjusts upward and downward ~~to~~ to correct any ~~disequilibrium~~ disequilibrium, shifts in the saving & investment func's will lead to the establishment of the new equilibrium positions.

- All the money that is saved is refrainment from the current consumption by that amount.

- Unless all that is saved is invested, the economy ~~s~~ may experience over-production ~~or recession~~, leading to recession.

- In the capital market, saving becomes equal to investment through a flexible mechanism called rate of interest.

- Saving → direct func" of rate of interest
 Investment → Inverse func" of rate of interest

- Higher is the rate of interest, higher is the saving ∵ rate of interest is a river for saving.

- Higher is the rate of interest, higher is the cost of borrowing capital, hence lower is investment

- The point of intersection of +vely sloped saving curve & -vely sloped investment curve gives the eq. rate of interest.

- A/c to classical economists, all factor prices are flexible & so interest rate is the price of capital, ∴ it is also flexible.
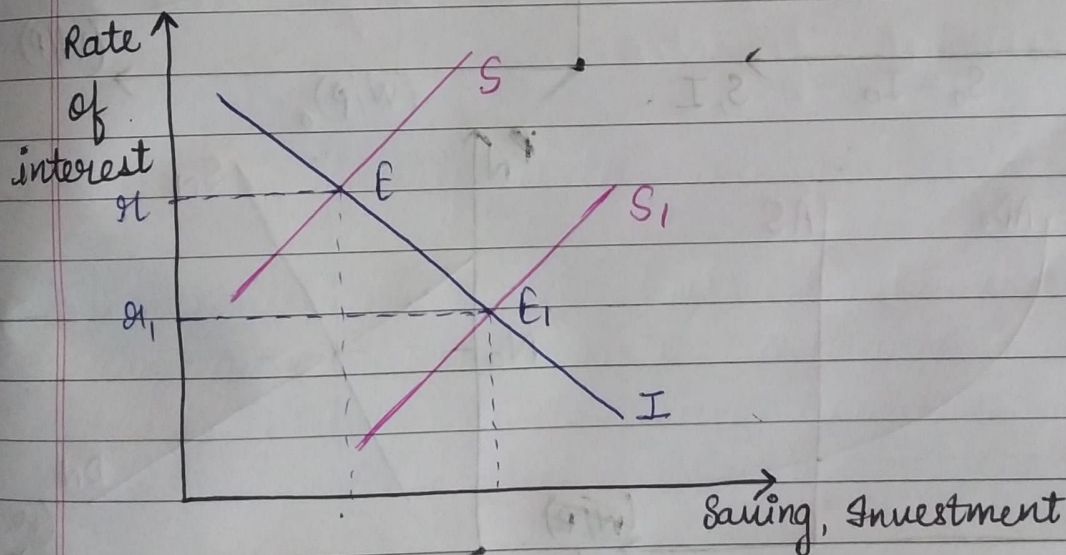
- Even if the saving or investment curve shifts, then also as long as interest rate is flexible, eq. can be achieved b/w saving & investment.

- Supply & demand of labour both are functions of real wage i.e. price of labour similarly saving & investment are func^n's of price of capital i.e. interest rate.

- ∵ ds labour market can be cleared by flexible wage rate, capital market can be cleared by flexible interest rate.
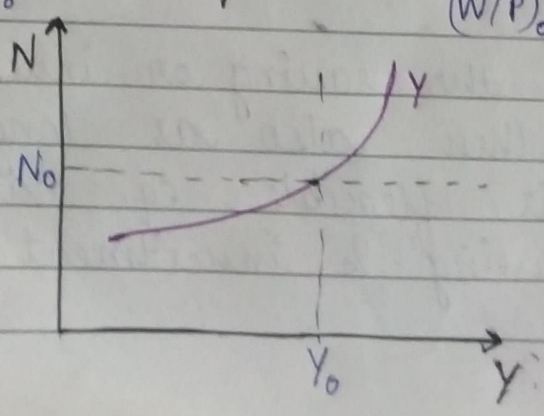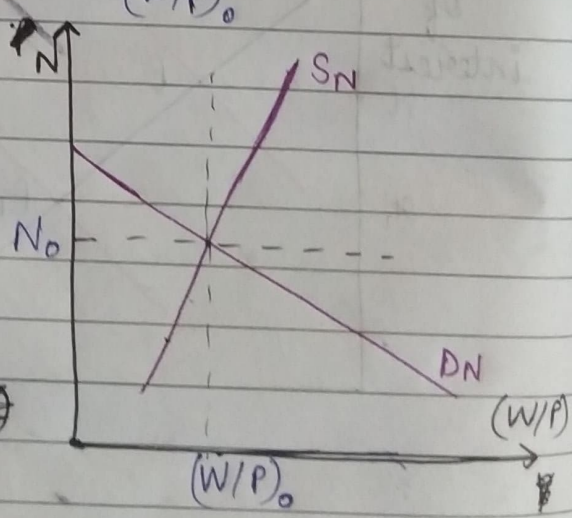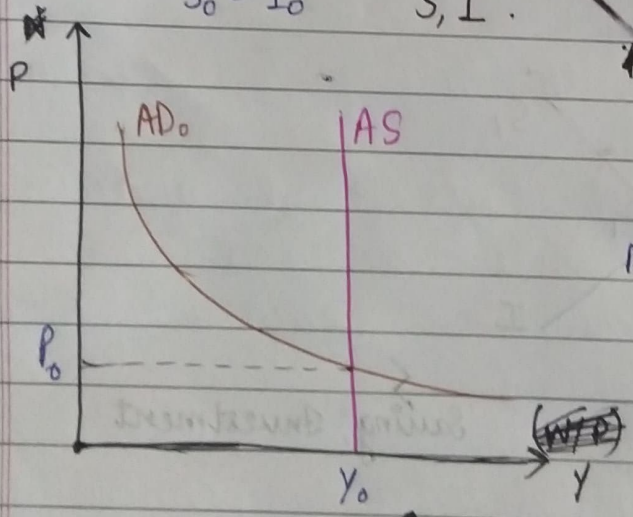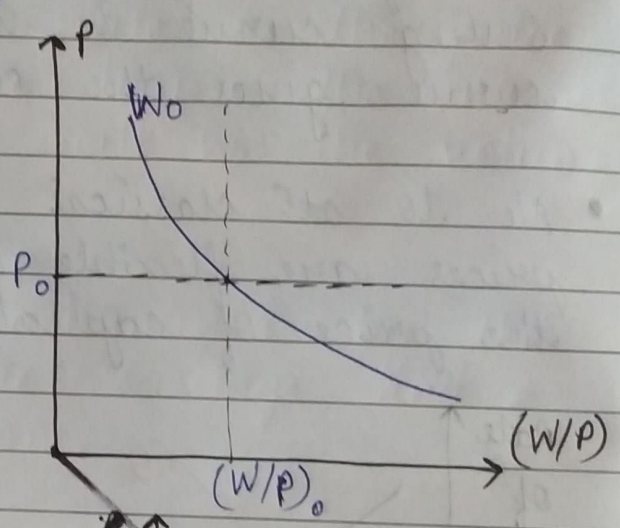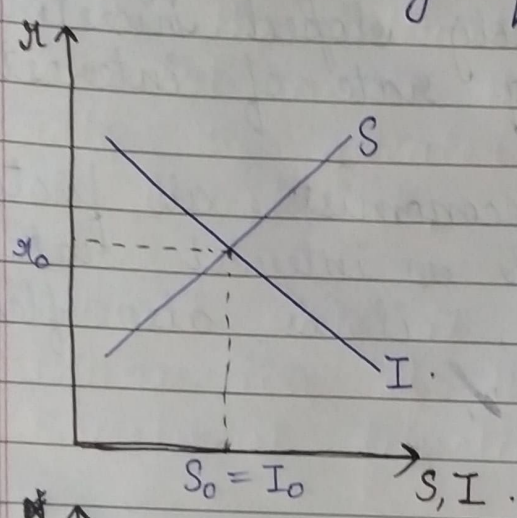
* ~~Sup~~ Summary

- The intersection of the supply and demand curve determine both the real wage and the level of employment which is the full employment level.

- With the fixed techniques of production and fixed capital stock, the output in the short run becomes a function of employment.

- The AS curve is perfectly inelastic under the assumption of flexible wage flexible. The AD curve is determined by the stock of money given the assumption that the velocity of money is stable.

- The price level is then determined by the intersection of the AS & AD curve because the AS curve is perfectly inelastic and the position of AD depends on the size of the money stock, the size of the money stock determine the price level.

- The money wage adjust to the equilibrium price level to produce the real wage required for full employment equilibrium.

- Saving is a direct function of the interest rate and investment is an inverse function of the interest rates.

- Interest rate is the measure of the reward for the saving. The higher interest rate the greater will be the volume of savings.

- With the interest rate as the price of capital goods, the lower the interest rate the greater will be the volume of investment.

- Interest rate is determined by the intersection of the savings and investment function.