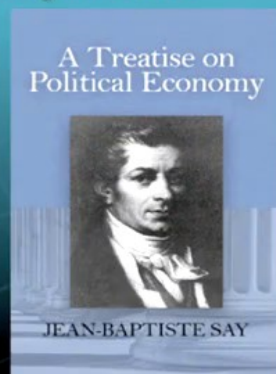
LECTURE TWO - PART TWO

The Two Pillars of Classical Economics

- Why did Keynesian economics triumph?
  - The two major pillars of Classical Economics crumbled under the weight of Keynes' argument
- Say's Law: Supply Creates Its Own Demand
- The Quantity Theory of Money: $PQ = MV$

Say's Law Says…

- Formulated in the 1800s by French businessman Jean Baptiste Say and popularized by David Ricardo.
- "Supply creates its own demand."
- What does this really mean?



How Say's Law Works

- When people work to produce goods and services, they earn income for doing so.
- Say's Law states the total income must equal the value of the goods and services.
- If the workers spend this income, it must be enough to pay for all the goods and services they produce.
- Therefore, supply creates its own demand, i.e. aggregate demand must equal aggregate supply!!!!

Thomas Malthus' Critique

- Suppose income earners don't spend all their money and instead save some of it?
- Thomas Malthus raised this possibility in his criticism of Say's Law.
- If people don't spend all of their money, there would be a glut of goods and people would be out of work.

The "Dismal Science"

- The Malthusian doctrine says population will grow faster than the production of food which will lead to mass starvation.
- Malthus' dark vision earned the economics profession its label as the "dismal science."

Thomas Malthus
The Original Dr. Doom

Say and Ricardo Respond to Malthus

- If people save some of their money, all of these savings will still be invested in the economy.
- Therefore aggregate demand, which equals consumption plus investment, will always equal aggregate supply.

Say's Law and the Circular Flow Diagram

Aggregate Supply(AS)= Employee compensation, rents, interest, & profits

Aggregate Demand (AD) = Consumption+ Investment

Unemployment Would Go Away

- Say acknowledged unemployment could exist.
- However, if wages, prices, and interest rates are allowed to adjust, unemployment goes away on its own.

The Quantity Theory of Money

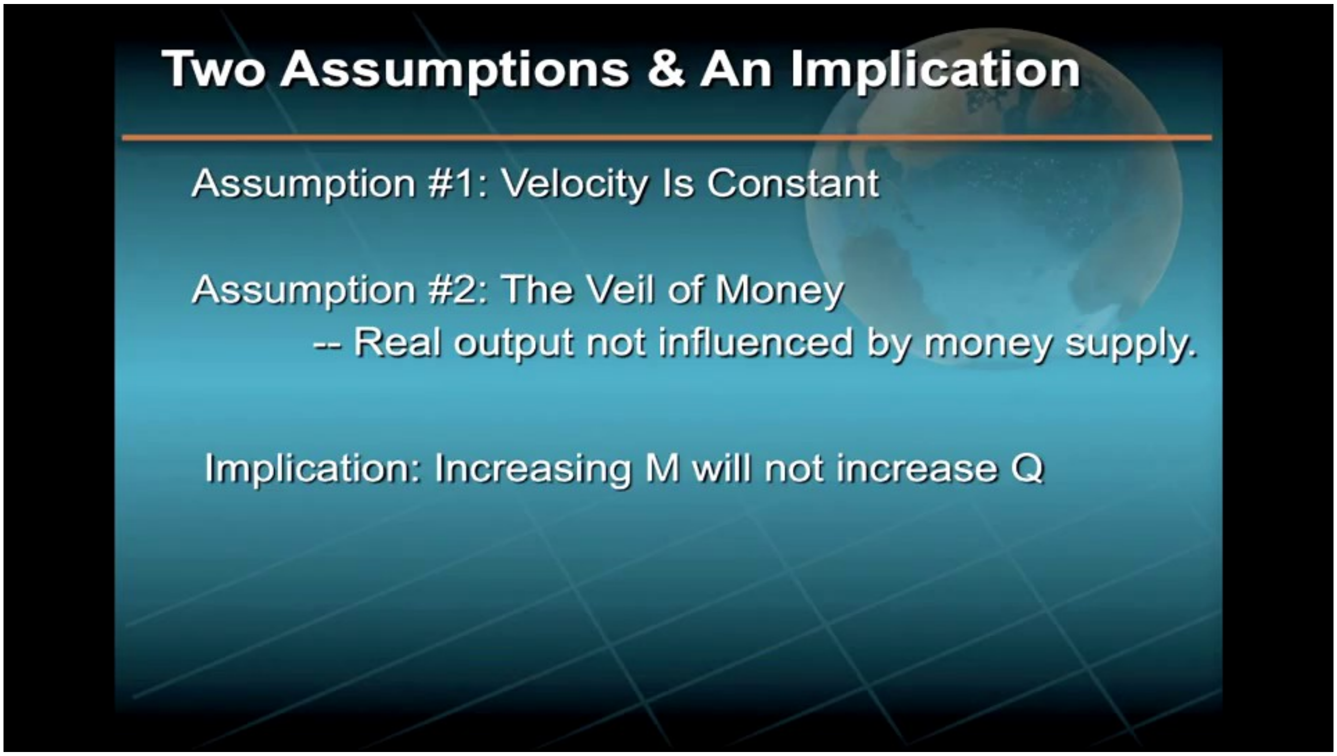
- Classical economists supported their Say's Law analysis with the quantity theory of money.
- The quantity theory of money determines the price level while Say's Law analysis determines real output.

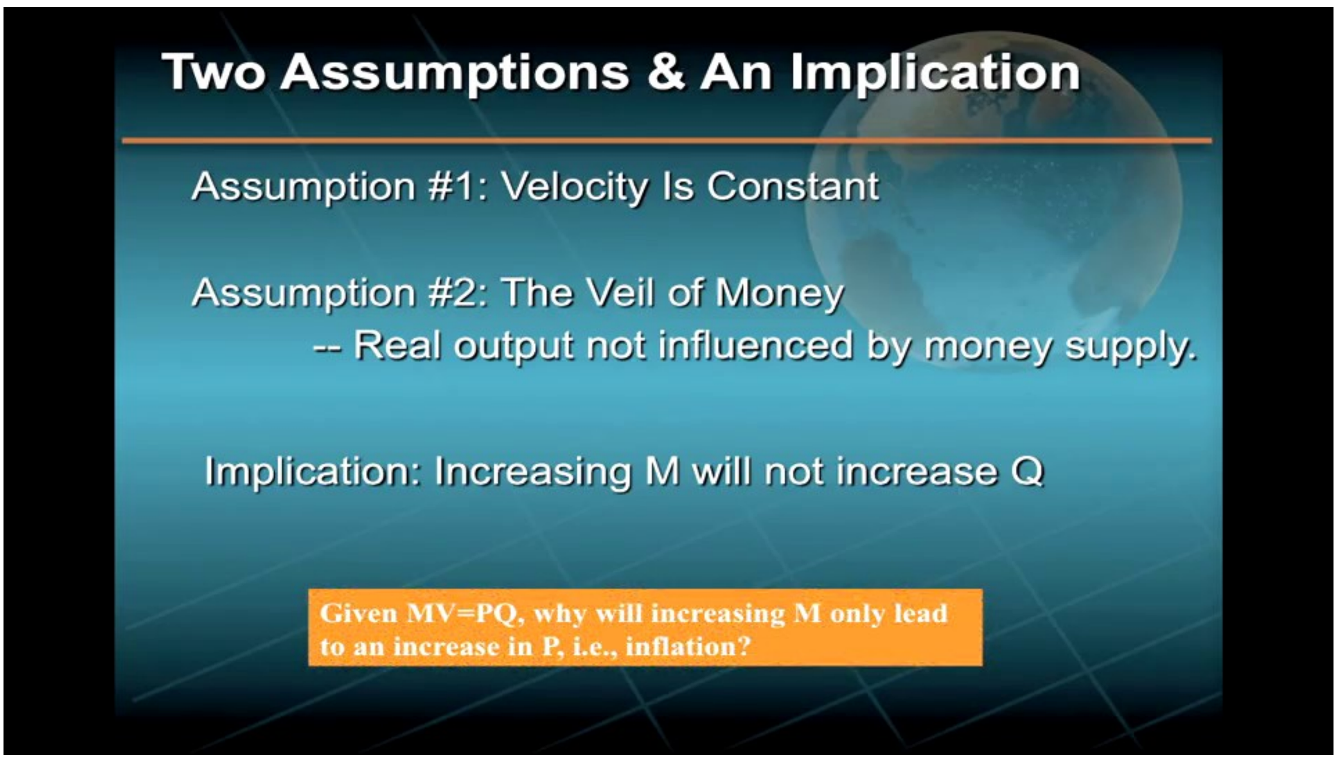
The Equation Of Exchange

- M * V = P * Q
- M = *money supply*
- V = *velocity* of money or the amount of income generated each year by a dollar of money
- P = *general price level* as measured by an index such as the consumer price index.
- Q = *quantity of real output* sold.
- P * Q = “nominal” inflation-adjusted output as measured by GDP.

M * V = P * Q

- Quantity theory of money says price level varies in response to changes in quantity of money.
- Changes in the price level are caused by changes in the money supply.
- If M up 20%, P up 20%.
- If M down by 5%, P down by 5%.


Two Assumptions & An Implication
Assumption #1: Velocity Is Constant
Assumption #2: The Veil of Money
-- Real output not influenced by money supply.
Implication: Increasing M will not increase Q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Implication: Increasing M will not increase Q
Given MV=PQ, why will increasing M only lead to an increase in P, i.e., inflation?

MV = PQ

- If V is constant on the left side, and
- If Q on the right side is unaffected by M…
- The only thing that can change if M changes, is P!