Indian Institute of Technology Bombay
Department of Humanities & Social Sciences

Dr. Surajit Bhattacharyya

Summary on the Collapse of the Classical Economics

The classical economics prevailed until the Great Depression and it had prevailed because it was never put to test by big changes in economic conditions over time. However, the Great Depression proved that the very basic postulates of the classical economics were wrong. Look at the two basic postulates of the classical economics.

One of the fundamental postulates of the classical economics is that if there is perfect competition in both the product and labor markets, then (i) the economy is always in equilibrium, and if some external forces create disequilibrium, market forces of demand and supply bring it back soon to the equilibrium, and (ii) there is always full employment, and unemployment, if any, is voluntary, that is, those who are unwilling to work at the prevailing wage rate would remain unemployed.

The second basic postulate of the classical economics is the Say's law. It says, "*supply creates its own demand*" and therefore, there is no deficiency of demand. It implies that the aggregate demand is always equal to aggregate supply, except for a short period of disturbance.

It is ironical that if market conditions were ever close to the classical perception of perfect competition, it was between the First World War and the Great Depression. Yet, the Great Depression took place! The industrial economies suffered a long-run disequilibrium and a prolonged state of involuntary unemployment. The intensity and duration of economic calamity brought about by the depression was unprecedented. In the U.S, output had fallen by 30% and unemployment had risen to over 25% In the UK, the rate of unemployment was lower (10%) but it had persisted over the 1930s. Most other industrialized nations also had experienced an unprecedented fall in their GNP and rise in unemployment. This experience invalidated the classical Say's law. There was supply of labor willing to work at prevailing wage rate but there was no matching demand for labor. There was supply of capital but there was no sufficient demand for capital. Until the beginning of recovery, there was supply of goods and services, but demand lagged far behind. This was a clear case of *failure* of the Say's law. The classical theory had no answer to these predicaments of the 1930s. This marked the collapse of the classical economics and Keynes' attack on the classical macroeconomic thoughts.