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Topic- Classical and Keynesian system

Introduction to Economic Systems:

Classical vs. Keynesian

Classical and Keynesian economics represent two major schools of thought that have shaped economic theory and policy.

Classical Economics:

Originating with economists like Adam Smith, David Ricardo, and John Stuart Mill, Classical economics dominated the field until the early 20th century. It posits that free markets are self-regulating and that economies naturally achieve full employment through flexible prices and wages. The primary assumption is that the economy is inherently stable and that any deviations are short-lived. In this view, limited government intervention is necessary since markets will self-correct through the "invisible hand" of competition.

Keynesian Economics:

Keynesian economics emerged in response to the Great Depression of the 1930s, which challenged Classical assumptions. Developed by British economist John Maynard Keynes, this school of thought argues that economies are not always self-correcting and often require active government intervention to stabilise output and employment. Keynesian theory

emphasises the importance of aggregate demand—the total demand for goods and services in the economy—and argues that insufficient demand can lead to prolonged periods of high unemployment and underutilization of resources.

The fundamental difference between Classical and Keynesian economics lies in their perspectives on market self-regulation and government intervention. While Classical economists believe that economies naturally achieve equilibrium, Keynesian economists argue that active intervention is necessary to address demand deficiencies and stabilise economic fluctuations.

2. Core Principles of the Classical Economic System

1. Self-Regulating Markets :

Classical economics is built on the belief that free markets are self-regulating. According to this view, the economy naturally moves toward equilibrium, with prices, wages, and interest rates adjusting to changes in demand and supply. For example, if there is a surplus of goods, prices will fall, leading to increased demand and a reduction in supply until equilibrium is restored. This principle is rooted in Adam Smith's concept of the "invisible hand," where individual self-interest in a competitive market leads to societal benefit.

2. Say's Law:

Classical economics relies on Say's Law, which states, "supply creates its own demand." This means that production generates an equivalent level of demand in the economy. According to Say's Law, when businesses produce goods, they also pay wages to employees and profits to owners, creating the income needed to purchase the output. In other words, production is the source of economic demand, and under normal circumstances, the economy will not face a lack of demand.

3. Full Employment Assumption:

Classical economists assume that the economy operates at or near full employment. Since wages and prices are flexible, any deviation from full employment is considered temporary,

as the labour market adjusts to changes in supply and demand. If unemployment occurs, Classical theory suggests that wages will fall, making it cheaper for firms to hire workers until full employment is restored.

4. Neutrality of Money:

In Classical economics, money is considered neutral in the long run, meaning it only affects price levels rather than real variables like output and employment. Any increase in the money supply leads to inflation, as more money circulates without an increase in the quantity of goods and services. This assumption implies that monetary policy does not impact real economic activity in the long term.

3. Keynesian Critique and Core Principles

John Maynard Keynes challenged several of the foundational principles of Classical economics, introducing ideas that redefined economic theory and policy.

1. Critique of Say's Law:

Keynes argued that demand does not always equal supply, especially during economic downturns. In his view, Say's Law does not hold in a modern economy with complex financial systems and a variety of savings and spending behaviours. Keynes believed that the economy could suffer from a lack of aggregate demand, leading to prolonged unemployment and underproduction.

For example- During the Great Depression, insufficient demand meant that goods produced were not purchased, leading to widespread unemployment and economic stagnation.

2. Importance of Aggregate Demand:

Keynes introduced the concept of aggregate demand as a critical factor influencing economic output and employment. He argued that during recessions, total spending in the economy could fall short of what is needed to purchase all available goods and services. This shortfall can result in high unemployment and unused production capacity. Keynes emphasised that

only through increasing aggregate demand—via government spending, investment, and consumer spending—can the economy return to full employment.

3. Role of Government Intervention:

Keynesian theory advocates for active government intervention to stabilise the economy. During periods of economic downturn, the government should increase spending to stimulate demand and reduce unemployment. In contrast to Classical economics, which assumes that markets self-correct, Keynes argued that without intervention, economies could remain in prolonged periods of low output and high unemployment.

4. Short-Run Price and Wage Rigidity:

Unlike Classical economists, Keynesians believe that wages and prices do not always adjust quickly to changes in demand and supply. For example, wages may be "sticky" downward, meaning that they do not fall easily even when unemployment rises. This rigidity prevents the economy from self-correcting and can lead to persistent unemployment.