

The lower panel of the diagram shows the relation between total output and the quantity of the variable factor (labour). It shows the short-run production function which is expressed as $Q = f(K, L)$, where Q is output, K is the fixed quantity of capital and L is the variable factor labour. Total output Q_0 is produced with the employment of L_0 units of labour. According to classical economists this equilibrium level of employment is the 'full employment' level. So the existence of unemployed workers was a logical impossibility. Any unemployment which existed at the equilibrium wage rate (W_0) was due to frictions or restrictive practices in the economy in nature.

The classical economists believed that aggregate demand would always be sufficient to absorb the full capacity output Q_0 . In other words, they denied the possibility of under spending or overproduction. This belief has its root in Say's Law.

(a) Say's Law: According to Say's Law supply creates its own demand, i.e., the very act of producing goods and services generates an amount of income equal to the value of the goods produced. Say's Law can be easily understood under barter system where people produced (supply) goods to demand other equivalent goods. So, demand must be the same as supply. Say's Law is equally applicable in a modern economy. The circular flow of income model suggests this sort of relationship. For instance, the income created from producing goods would be just sufficient to demand the goods produced.

(b) Saving-Investment Equality: There is a serious omission in Say's Law. If the recipients of income in this simple model save a portion of their income, consumption expenditure will fall short of total output and supply would no longer create its own demand. Consequently there would be unsold goods, falling prices, reduction of production, unemployment and falling incomes.

However, the classical economists ruled out this possibility because they believed that whatever is saved by households will be invested by firms. That is, investment would occur to fill any consumption gap caused by savings leakage. Thus, Say's Law will hold and the level of national income and employment will remain unaffected.

(c) Saving-Investment Equality in the Money Market: The classical economists also argued that capitalism contained a very special market – the money market – which would ensure saving investment equality and thus would guarantee full employment. According to them the rate of interest was determined by the demand for and supply of capital. The demand for capital is investment and its supply is saving. The equilibrium rate of interest is determined by the saving-investment equality. Any imbalance between saving and investment would be corrected by the rate of interest. If saving exceeds investment, the rate of interest will fall. This will stimulate investment and the process will continue until the equality is restored. The converse is also true.

(d) Price Flexibility: The classical economists further believed that even if the rate of interest fails to equate saving and investment, any resulting decline in total spending would be neutralized by proportionate decline in the price level. That is, Rs 100 will buy two shirts at Rs 50, but Rs 50 will also buy two shirts if the price falls to Rs 25. Therefore, if households saves more than firms would invest, the resulting fall in spending would not lead to decline in real output, real income and the level of employment provided product prices also fall in the same proportion.

(e) Wage Flexibility: The classical economists also believed that a decline in product demand would lead to a fall in the demand for labour resulting in unemployment. However, the wage rate would also fall and competition among unemployed workers would force them to accept lower wages rather than remain unemployed. The process will continue until the wage rate falls enough to clear the labour market. So a new lower equilibrium wage rate will be established. Thus, involuntary unemployment was logical impossibility in the classical model.

M4 (Broad money) is a wider definition of what constitutes money. M4 includes deposits saved with banks and building societies and also money created by lending in the form of loans and overdrafts.

$M4 = M0$ plus sight (current accounts) and time deposits (savings accounts).

When a bank or another lender grants a loan to a customer, bank liabilities and assets rise by the same amount and so does the money supply. Again M4 is a useful background indicator to the strength of demand for credit. The Bank takes M4 growth into account when assessing overall monetary conditions, but it is not used as an intermediate target of monetary policy. Its main value is as a signpost of the strength of demand which can then filter through the economy and eventually affect inflationary pressure.

Cambridge Approach of money

While Fisher was developing his quantity theory approach to the demand for money, a group of classical economists in Cambridge, England, which included Alfred Marshall and A. C. Pigou, were studying the same topic. Although their analysis led them to an equation identical to Fisher's money demand equation ($M_d = k \times PY$), their approach differed significantly. Instead of studying the demand for money by looking solely at the level of transactions and the institutions that affect the way people conduct transactions as the Banking Republic key determinants, the Cambridge economists asked how much money individuals would want to hold given a set of circumstances. In the Cambridge model, then, individuals are allowed some freedom in their decision to hold money and are not completely bound by institutional constraints such as whether they can use credit cards to make purchases. Accordingly, the Cambridge approach did not rule out the effects of interest rates on the demand for money.

The classical Cambridge economists recognized that two properties of money motivate people to want to hold it: its utility as a medium of exchange and as a store of wealth.

Because it is a medium of exchange, people can use money to carry out transactions. The Cambridge economists agreed with Fisher that the demand for money would be related to (but not determined solely by) the level of transactions and that there would be a transactions component of money demand proportional to nominal income.

That money also functions as a store of wealth led the Cambridge economists to suggest that the level of people's wealth also affects the demand for money. As wealth grows, an individual needs to store it by holding a larger quantity of assets — one of which is money. Because the Cambridge economists believed that wealth in nominal terms is proportional to nominal income, they also believed that the wealth component of money demand is proportional to nominal income.