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The Static Models of Income Determination

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Our aim is to examine how the monetary system affects the achieved level of income and employment. To do this we will first set out the details of two pure models of income determination, the Keynesian and the Classical models, and then both compare and synthesize these models.

In many ways the syntheisis is not needed, for the Keynesian model can be presented as a general theory in which the classical results are special cases of the general system. However the Keynesian system has become identified with some simple special cases rather than with the more general formulation of the problem of income determination. Even though the general case is closer to the ~~original~~ spirit of the Keynesi~~an approa~~ch, in the polemics surrounding policy formulation those using the Keynesian approach have tended to emphasize certain special cases.

The basic differences between the Keynesian and the Classical system centers around the nature of the labor market equilibrium. One result in the classical system is that the labor market always tends towards a full employment equilibrium, whereas in the Keynesian system the labor market may not tend toward full employment: it may achieve a position such that none of the endogenous changes brought about by an excess supply (or demand) for labor will tend to bring the system into full employment equilibrium.

The Classical Model

Income determination in the classical model is dominated by the equilibrium in the labor market. The demand and supply of labor determine the quantity of labor used and the real wage rate. Once the quantity of labor employed is determined, output is determined by the production function. Savings and investment relations, as functions of the interest rate, determine both the interest rate and the split of real income between savings and consumption. The quantity of money and its velocity(which may depend upon the interest rate), given the level of output, determine the price level.

The following observations can be made as a result of the above quick sketch of the Classical system:

1. The various markets: labor, saving and investment and price level determining markets are all solved independently of each other. At most the equilibrium results in one market are fed into the relations stating behavior in the successive markets; thus full employment output is a parameter in the saving and investment relations. The question whether the level of output which equilibrates saving and investment at same interest rate is compatible with the level of output determined by supply and demand in the labor market does not arise. Such a question would arise only in a general or mutually interdependent system, whereas the classical model tends to be stated as a sectored model in which the solutions for the different markets is achieved in isolation