- Until the Great Depression of the 1930s, most economists, using Adam Smith as a reference, had believed that a market system would ensure full employment of the productive resources except for short-term fluctuations.

- They (Classical economist) claim that if there is disequilibrium (deviations from the equilibrium point), the economy will correct itself. That is a reduction in output and employment of the economy would lead to a reduction in prices and this will increase in consumer spending. On the other hand, the reduction in employment will force to lower wages and this will decrease unemployment. The interest will decline and this will expand investment, therefore, in the long run the economy will go back to its original equilibrium.

- B.J. Say, one of the classical economists, says that supply creates its own demand. That means the equilibrium real output or income will be determined by supply side, and not by demand side.

**The assumptions of the Classical Model:**

- Pure competition exists: that means individual buyers and seller cannot control the price market and the market forces will determine the price.

- People are motivated by self-interest: that means business individuals maximize profits and households maximize their satisfaction.

- Flexible wages and prices do exist in the market. That is market force of supply and demand will determine wages and prices.

- The assumption of that actual prices = expected prices. That is people cannot be fooled by money illusion. Price changes are fully anticipated by both workers and producers. Therefore, they react changes in relative prices not money prices.

The Classical economists argued also that investors would invest all savings. That is desired savings equal desired investment. Desired saving is positively related to the interest rate and is a supply of savings curve. Desired investment is inversely related to the interest rate and is a demand for investment curve. The intersection of both desired savings and investment curves will determine the equilibrium point. On the other hand, in the classical model, wages are determined by the supply and demand of labor. The demand for labor is downward sloping because at higher wages firms will demand fewer workers to work for them. The supply of labor is upward sloping because when wages are higher, more workers are willing to work. If there’s excess supply of labor then wages will fall and those workers who are willing to accept at lower wages will be employed.

- Classical price level and output determination: In the classical model, long-term involuntary unemployment is impossible. Remember Say’s law says those flexible prices, interest rates and wages would assure full employment. The aggregate supply curve is vertical at the full employment level of output. In this model equilibrium level of real output or GDP is completely determined by supply side. Shifts of the aggregate demand curve will only change the price level (see figure 11-1).

- The great depression and Keynes: the great depression of the 1930s, GDP fell by 40% and employment rate increased to 25%. The classical idea, which was the economy will correct its self, could not work during depression. John Maynard Keynes provided an alternative to classical theory, which helped explain periods of recession.

- All income is not always spent contrary to Say’s law.
- Producers may respond to unsold inventories by reducing output rather than cutting prices.

- A recession or depression could follow this decline in employment and incomes.

- Keynes introduced short-run aggregate supply curve, which is horizontal. In Keynesian aggregate supply curve, the level of output is determined by aggregate demand because the price level is fixed (see figure 11-2). Therefore, the modern aggregate expenditure model is based on Keynesian economics. It is based on the idea that saving and investment decisions may not be coordinated enough and wages and prices are not very flexible downward.

- Internal market forces can therefore cause depressions without any external events (wars, droughts, tax increases or interest increases), which classical are claiming. However, Classical economists did not deny the existence of depressions and high unemployment but the sources of those crises lie outside the economic system. That is the effects of external shocks such as wars, tax increases, poor growing seasons, and changing tastes can reduce output and employment. This downturn in the economy was viewed as a short-term phenomenon that could be corrected by natural market forces (changes in prices, wages, and interest rates). Therefore, the economy would adjust to its equilibrium in the long run and no need for any government intervention.