

EQUILIBRIUM IN THE MONEY MARKET: A COMPARATIVE ANALYSIS OF CLASSICAL AND KEYNESIAN THEORIES

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Abstract: This article offers a detailed comparative examination of the perspectives held by classical and Keynesian schools of economic thought regarding the demand and supply of money, equilibrium within the money market, and the operational dynamics of the banking system through monetary and banking multipliers. Particular emphasis is placed on exploring the theoretical underpinnings of the classical approach, including Say's Law, the notion of money neutrality, and the role of liquidity, alongside the incorporation of IS-LM models within both frameworks. The juxtaposition of these theoretical perspectives highlights fundamental disparities in interpreting the role of money in economic systems and the mechanisms facilitating market equilibrium.

Keywords: Classical theory, Keynesianism, demand for money, supply of money, banking multiplier, monetary multiplier, IS-LM model, Say's Law, money neutrality, liquidity.

The concept of equilibrium in the money market constitutes a cornerstone of macroeconomics, fundamentally influencing the operation of the entire economic framework. A thorough understanding of the mechanisms establishing monetary equilibrium empowers governments, central banks, and the private sector to more effectively manage economic activity.

Within classical economic theory, money was initially regarded as a neutral instrument, exerting no influence on the real economic sector. This neutrality implied that fluctuations in the money supply impacted only price levels, leaving output volume and employment unaffected. This viewpoint was grounded in Say's Law, articulated in the early 19th century, which posited that the supply of goods inherently generates demand for them. Under conditions of full employment and flexible prices, Say's Law elucidated the market's natural tendency toward equilibrium, negating the need for governmental intervention.

In the classical paradigm, the demand for money was interpreted solely as a function of price levels and transaction volumes. Money was deemed essential by economic agents for facilitating exchanges, with demand directly proportional to the nominal production volume. Consequently, classical economists argued that alterations in money supply exerted only temporary effects, leaving fundamental macroeconomic parameters unaltered [1].

Within the classical model, the interest rate was determined by the equilibrium between savings and investment. Liquidity levels were considered a minor factor, predicated on the assumption of full capital mobility and the absence of barriers to utilizing money for investment [2]. The IS-LM model formalizes this approach, where the classical perspective aligns with a vertical LM curve: changes in money supply do not affect interest rates or output [3].

Given the assumption of absolute price and wage flexibility, the IS-LM model in its classical interpretation depicted a horizontal LM curve at any given output level, as adjustments in money supply were instantaneously offset by corresponding price level changes. Markets for goods and

finance consistently gravitated toward equilibrium through automatic adjustments, ruling out the possibility of persistent unemployment.

The classical framework of banking and monetary multipliers rested on the premise of full convertibility of deposits into loans. Since classical theory assumed economic agents held no excess cash reserves, the velocity of money remained high, with additional reserves rapidly channeled into lending. This resulted in an efficient banking multiplier, significantly expanding initial reserves into larger money aggregates.

In contrast, Keynesian theory, as articulated by John Maynard Keynes, challenged the postulates of money neutrality and market self-regulation. Keynes contended that, in real-world conditions, price and wage rigidity, coupled with investment decisions influenced by uncertainty, imparted a distinct nature to money demand. He identified three motives for holding money: transactional, precautionary, and speculative. The latter — demand for money as a store of value amid unstable expectations — proved particularly significant.

In the Keynesian interpretation, liquidity occupied a central role: at elevated levels of liquidity preference, economic agents preferred retaining money over investing in securities, thereby diminishing the efficacy of monetary policy. Within the Keynesian IS-LM framework, the LM curve exhibited a positive slope, with equilibrium between goods and money markets achievable only through active government intervention.

The IS-LM model in Keynesianism accommodated scenarios of underemployment and price rigidity. On the graph, the IS curve reflects equilibrium in the goods market, while the LM curve represents the money market. Keynes emphasized that monetary changes could influence real variables, rejecting the classical notion of automatic money neutrality. Shifts in money supply could notably impact investment, production, and employment.

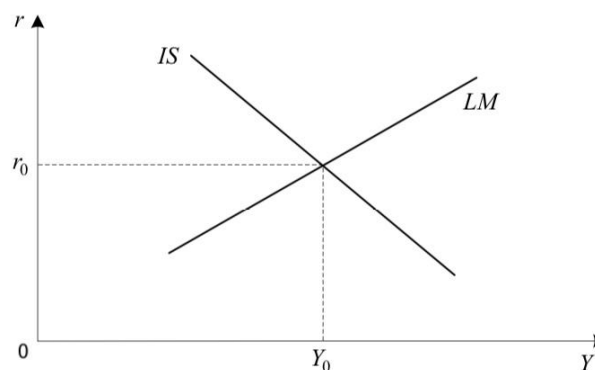


Figure 1. IS-LM Model in Keynesian Theory

The Keynesian approach to banking and monetary multipliers was more circumspect, recognizing the potential for a “liquidity trap,” wherein an increase in money supply failed to stimulate lending or expenditure. In such instances, even with high multiplier values, an expansion of the monetary base did not proportionately increase the money supply. Thus, Keynesians underscored the necessity of coordinating fiscal and monetary policies.

A comparison of the two approaches to money demand, supply, and equilibrium in the money market reveals profound differences in understanding economic dynamics. The classical school relied on self-regulating mechanisms, asserting that money merely facilitated exchange without affecting the real economy. Any excess money supply, they argued, would translate into price increases, maintaining output and employment at natural levels.

Conversely, the Keynesian perspective posited that, under conditions of price rigidity and uncertain expectations, an increase in money supply could influence the real sector, boosting aggregate demand and production. Money was viewed as an asset competing with bonds, its functions extending beyond a mere medium of exchange.

The IS-LM model in its classical form featured a vertical IS curve and a horizontal LM curve at full employment, whereas the Keynesian interpretation allowed for gradual adjustments in both

markets, with the possibility of failing to reach full employment. Thus, in the classical model, money was neutral and devoid of real impact, while in the Keynesian model, it served as an active tool for economic stabilization.

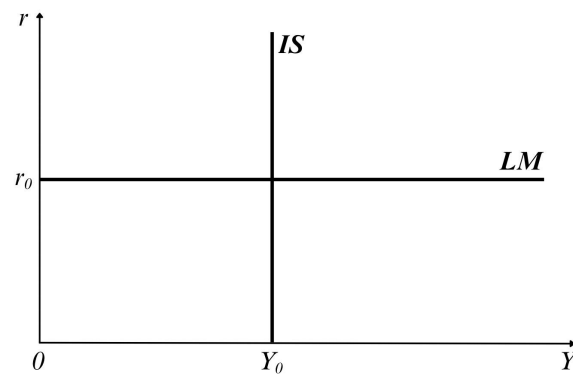


Figure 2. IS-LM Model in Classical Theory

In the context of contemporary economic realities, both frameworks retain relevance. Classical theory proves valuable for analyzing long-term trends and inflationary processes, while Keynesian theory excels in explaining short-term fluctuations and the role of active economic policy during instability. The integration of ideas from both schools today underpins many macroeconomic models, highlighting the importance of a holistic approach to studying monetary processes.

This comparative analysis demonstrates that the classical model relies on idealized assumptions of full flexibility and rationality, whereas the Keynesian theory accounts for the real instability of economic processes, psychological factors in agent behavior, and potential market inefficiencies. The classical theory applies to long-term periods where the economy can self-regulate, while the Keynesian approach better explains short-term deviations, crises, and recessionary periods.

The practical application of the classical model was evident in the non-interventionist policies of the 19th century, when states adhered to laissez-faire principles, attributing inflationary processes solely to monetary factors [4]. However, the Great Depression of the 1930s exposed the limitations of the classical model: despite declining prices, unemployment remained elevated, a phenomenon inexplicable under the neutrality of money [5].

Empirical evidence suggests that Keynesian policies of active government intervention proved more effective during widespread unemployment and stagnation. The New Deal programs under Franklin D. Roosevelt in the United States, aimed at stimulating demand and employment through public expenditure, were rooted in Keynesian principles [6]. Modern examples, such as the quantitative easing measures implemented by the U.S. Federal Reserve following the 2008 crisis, also reflect a Keynesian approach to money market regulation [7].

The primary findings of this analysis suggest that neither theory can be deemed universally applicable. Classical theory remains significant for examining long-term trends, including inflationary processes and growth factors. Meanwhile, Keynesian theory remains indispensable for understanding short-term economic dynamics, combating recessions, and addressing unemployment.

Conclusions indicate that effective management of the money market requires integrating both classical and Keynesian elements, contingent on the economic cycle's stage and prevailing macroeconomic conditions. During economic upswings, reliance on classical self-regulation principles may be appropriate, whereas crises and instability necessitate the active deployment of Keynesian policy tools [1].

Further development of models synthesizing the strengths of both theories, such as within the new Keynesian school — which acknowledges market rigidities while allowing for long-term money neutrality — is recommended. Additionally, a promising research direction involves deepening the analysis of psychological factors in agent behavior and integrating rational expectations models into Keynesian frameworks.

In conclusion, the comparison of classical and Keynesian theories of money market equilibrium underscores the necessity of a comprehensive approach to macroeconomic regulation. The article's key arguments highlight the classical model's limitations in the short term and the critical role of Keynesian ideas during instability. Future research prospects lie in developing integrated models capable of capturing the complex interrelationships among money, interest rates, employment, and economic growth in an evolving global economy.

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