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BA Economics Honours | Semester 3 | Calicut University

Evolution of Economic Theories

Course Code: ECO3CJ202 • Module 3

Module III: Crises of Market Economies – Money and Business Cycles

Capitalist market economies do not expand along smooth, unbroken equilibrium trajectories; their historical reality is characterized by recurrent macroeconomic convulsions: commercial crises, financial panics, bank collapses, and cyclical fluctuations in real output. Economists have devoted intense analytical inquiry to understanding the nature of money, credit creation, and the systemic causes of business cycles.

Unit 9: The Nature and Evolution of Money

Money evolved historically from primitive commodity money (cowrie shells, cattle, grain) to metallic specie (gold and silver coinage) and eventually to paper fiat currency and digital banking credits. In early monetary theory, economists debated whether money was a purely neutral "veil" that facilitated physical exchange without affecting real variables (the classical dichotomy), or an active engine capable of disrupting real economic coordination.

The Peel's Bank Act of 1844: Currency School versus Banking School

In mid-nineteenth-century Britain, a monumental debate erupted over the regulation of the Bank of England's note issuance:

- **The Currency School (Lord Overstone, Robert Torrens):** Argued that paper banknote issuance must be rigidly backed 100% by gold reserves (beyond a fixed fiduciary limit), behaving exactly as a pure metallic currency would. They asserted that excessive unbacked bank note issuance was the primary cause of price inflation and commercial crises. Their view was enshrined in Sir Robert Peel's Bank Charter Act of 1844, which separated the Bank of England into distinct Issue and Banking Departments.
- **The Banking School (Thomas Tooke, John Fullarton):** Argued that banknote issuance should be elastic and responsive to the needs of commerce. Under their celebrated *Law of Reflux*, commercial banks could not over-issue convertible paper banknotes; any surplus currency issued beyond commercial transaction requirements would automatically reflux back to the issuing bank for debt repayment or gold redemption.

Unit 10: The Classical Quantity Theory of Money

The classical paradigm anchored price level determination in the Quantity Theory of Money:

- **Fisher's Transactions Approach:** Formalized by Irving Fisher in 1911 through the Equation of Exchange:

  $$M \cdot V = P \cdot T$$

  Where M is nominal money stock, V is transaction velocity, P is the average price level, and T is the physical volume of transactions. Assuming velocity V is institutionally fixed and transaction volume T is determined by full-employment output, changes in money supply cause strictly proportional changes in the price level ($DeltaMproptoDeltaP$). Money is completely neutral in the long run.
- **The Cambridge Cash-Balance Approach:** Formulated by Alfred Marshall, A.C. Pigou, and John Maynard Keynes (pre-1936), focusing on money demand rather than velocity:

$$M^d = k \cdot P \cdot Y$$

Where k is the fraction of annual nominal income that economic agents choose to hold as liquid cash balances ($k = 1/V$). The Cambridge approach humanized monetary theory, linking money demand to subjective liquidity choices.

Unit 11: Karl Marx's Critique of Capitalist Crises

In *Das Kapital* (1867), **Karl Marx** rejected classical harmonies and Say's Law, arguing that capitalism is inherently prone to recurrent structural crises. Marx deconstructed the internal contradictions of capitalist accumulation:

1. **Surplus Value (s):** Capitalists extract surplus value from the working class by paying labor only the value of its labor power (subsistence wage v), while appropriating the surplus labor time.
2. **Rising Organic Composition of Capital (c/v):** Competitive pressure compels capitalists to continuously invest in labor-saving machinery (constant capital c) relative to living labor (variable capital v).
3. **Tendency of the Rate of Profit to Fall:** Because living labor is the sole source of surplus value, as c/v rises, the general rate of profit ($r = \frac{s}{c+v} = \frac{s/v}{c/v+1}$) inevitably tends to decline. Capitalists counter this by intensifying worker exploitation, leading to crises of *under-consumption* and *over-production* that culminate in systemic capitalist collapse.

Unit 12: Theories of the Business Cycle

Non-Marxist theorists formulated alternative models of cyclical economic fluctuations:

- **R.G. Hawtrey's Purely Monetary Theory:** The business cycle is a purely monetary phenomenon. When commercial banks lower interest rates and expand credit, merchants borrow to expand inventories, stimulating production and employment. Eventually, gold drains force banks to restrict credit, triggering distress inventory liquidations, falling prices, and economic depression.
- **Joseph Schumpeter's Innovation Theory:** Business cycles are driven by discontinuous "swarms" of technological and organizational **Innovations** introduced by visionary entrepreneurs (steam engines, railroads, electricity, automobiles). The commercial boom is driven by creative destruction; once innovations are standardized and absorbed, credit deflation ensues, generating the cyclical downswing.
- **Friedrich Hayek's Austrian Over-Investment Theory:** When central banks artificially suppress market interest rates below the "natural rate of interest" (Wicksellian framework), they induce entrepreneurs to over-invest in long-term, capital-intensive production processes (malinvestment). When bank credit reaches its limit, interest rates surge, revealing that real consumer savings are insufficient to complete these long projects, forcing painful economic liquidations.

Advanced Theoretical Formulations and Empirical Frameworks (Analytical Division 1)

The theoretical structures established in this module carry far-reaching implications for empirical economic research, institutional policymaking, and dynamic market equilibrium. In contemporary economic analysis, economists employ sophisticated econometric models, institutional diagnostic frameworks, and comparative

historical evaluations to rigorously assess the validity of core assumptions and their real-world outcomes across developing and advanced economies.

Empirical Methodology, Identification Strategies, and Econometric Estimation

Empirical validation of economic models necessitates the rigorous treatment of endogeneity, omitted variable bias, and measurement error. Whether analyzing consumer behavior, firm cost structures, fiscal multipliers, or monetary transmission mechanisms, applied researchers utilize instrumental variables (IV), difference-in-differences (DiD), synthetic control methods, and regression discontinuity designs (RDD) to isolate causal relationships from mere statistical correlation.

Consider the structural estimation of policy impacts across decentralized economic agents. When evaluating macroeconomic interventions or microeconomic regulatory changes, parameters estimated from observational datasets must account for expectations formation and structural parameter stability in accordance with the Lucas Critique. Consequently, contemporary applied economics bridges micro-foundations with aggregate macroeconomic phenomena through dynamic stochastic general equilibrium (DSGE) modeling and micro-econometric panel estimations.

Comparative Institutional Analysis, Market Failures, and Policy Governance

Economic outcomes are fundamentally mediated by institutional architectures, legal property rights regimes, and regulatory governance. In emerging market economies such as India, market imperfections—including asymmetric information, transaction costs, infrastructural bottlenecks, and credit constraints—often necessitate nuanced policy interventions that differ substantially from textbook laissez-faire predictions.

Analytical Dimension	Orthodox / Classical Perspective	Heterodox / Institutional Framework	Empirical Policy Manifestations in India
Market Efficiency	Markets clear instantaneously; price mechanism allocates resources optimally without systemic friction.	Markets are prone to structural failures, information asymmetry, and coordination coordination failures.	Targeted regulatory oversight, public investment in infrastructure, and social safety nets.
Behavioral Motivation	Hyper-rational agents maximizing expected utility with complete cognitive computational capacity.	Bounded rationality, behavioral heuristics, loss aversion, and institutional anchoring effects.	Choice architecture, behavioral nudges (NITI Aayog initiatives), and consumer financial protection mandates.
State Intervention	State role restricted to core public goods, contract enforcement, and national defense (minimalist state).	State acts as developmental catalyst, risk-absorber of last resort, and promoter of equitable distribution.	Strategic industrial policy (PLI schemes), counter-cyclical fiscal intervention, and universal public services.
Distributional Equity	Factor rewards reflect marginal productivity; distribution is secondary to allocative efficiency.	Power asymmetries, bargaining power, and historical wealth accumulation shape distribution.	Progressive fiscal transfers, land reforms, and affirmative human capital investments.
Technological Progress	Exogenous technological shocks arriving randomly	Endogenous technological innovation driven by R&D, human capital, and	National Innovation Foundation, Startup India, and public digital

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	(Solow neoclassical growth model).	intellectual property institutions.	infrastructure (India Stack / UPI).

Comprehensive Empirical Analysis: The Kerala Model and Sub-National Development

In the context of the Indian economy and sub-national development paradigms, the Kerala Model of Development provides a seminal empirical case study illustrating the complex trade-offs between social development and economic growth. Characterized by high physical quality of life indicators—including near-universal adult literacy, high life expectancy, and low infant mortality rates comparable to advanced Western economies—achieved despite historically modest per capita state domestic product, Kerala demonstrates the transformative power of public social expenditure, agrarian land reforms, and decentralized local governance (Panchayati Raj institutions).

However, contemporary economic analysis also highlights structural challenges confronting this development paradigm: high educated unemployment, fiscal constraints stemming from escalating public debt servicing and pension obligations, and heavy reliance on external remittance inflows from migrant workers in the Persian Gulf. Sustaining this high-welfare equilibrium necessitates transitioning toward a knowledge-driven economy, incentivizing high-tech manufacturing, and mobilizing sustainable sub-national fiscal resources.

Policy Synthesis and Analytical Evaluation

Policy formulation in dynamic economic environments must therefore synthesize foundational deductive reasoning with robust inductive empirical inquiry. Economists must continuously evaluate the balance between market incentives and regulatory governance, ensuring that institutional frameworks promote both productive efficiency and distributive social justice.

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