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BA Economics Honours | Semester 3 | Calicut University

Evolution of Economic Theories

Course Code: ECO3CJ202 • Module 4

Module IV: Crises of Market Economies – Inflation, Unemployment and Growth

The macroeconomic crises of the twentieth century—from the mass unemployment of the Great Depression to the stagflation of the 1970s—fundamentally transformed economic theory. Economists abandoned classical laissez-faire doctrines, creating modern macroeconomics to analyze the simultaneous interactions of inflation, unemployment, and long-run economic growth.

Unit 13: The Keynesian Revolution

The Great Depression (1929–1933) demolished the classical doctrine of Say's Law ("supply creates its own demand"). In 1936, **John Maynard Keynes** published *The General Theory of Employment, Interest and Money*, inaugurating modern macroeconomics:

- **The Principle of Effective Demand:** Aggregate employment is determined not by flexible wages in the labor market, but by **Effective Demand**—the point of intersection between Aggregate Demand ($AD = C + I + G + NX$) and Aggregate Supply (AS).
- **Sticky Nominal Wages and Prices:** Due to trade union contracts and institutional resistance, nominal wages are rigid downward. Cutting nominal wages during a depression merely reduces workers' purchasing power, depressing aggregate demand further.
- **Underemployment Equilibrium:** A capitalist economy can settle into a chronic, stable equilibrium with high persistent unemployment. Full employment is not automatic; it requires deliberate, compensatory government fiscal policy (deficit spending on public infrastructure) to restore aggregate demand.
- **Liquidity Preference:** Interest rates are not determined by saving and investment (loanable funds), but by the supply and demand for money, driven by three motives: transactions, precautionary, and **speculative** motives. In severe depressions, the economy enters a **Liquidity Trap**, rendering monetary policy completely impotent.

Unit 14: The Phillips Curve Controversy

In 1958, A.W. Phillips documented an empirical inverse relationship between unemployment and the rate of change of nominal wages in the UK (1861–1957). In 1960, Paul Samuelson and Robert Solow recast this into a stable policy trade-off between **Inflation and Unemployment**, suggesting policymakers could choose lower unemployment at the cost of modest inflation.

In 1968, **Milton Friedman** and **Edmund Phelps** shattered the Phillips Curve consensus by introducing inflation expectations:

> **Expectations-Augmented Phillips Curve**
>
> $$pi = pi^{e} - \beta(u - u_{n})$$
>
> Where: π = Actual inflation rate, π^{e} = Expected inflation rate, β = Parameter reflecting wage responsiveness, u = Actual unemployment rate, and u_{n} = Natural rate of unemployment (NAIRU).

They demonstrated that the short-run trade-off exists only because workers are temporarily fooled by unanticipated inflation. In the long run, workers revise their inflation expectations upward ($pi^e = pi$), shifting the short-run Phillips curve outward. The **Long-Run Phillips Curve is strictly vertical at the Natural Rate of Unemployment (u_n)**. The catastrophic **Stagflation** of the 1970s (simultaneous double-digit inflation and high unemployment triggered by OPEC oil shocks) provided empirical proof of the Friedman-Phelps hypothesis.

Unit 15: Theories of Long-Run Economic Growth

Long-run macroeconomic analysis explores how economies expand their productive capacity over generations:

- **Classical Growth Theory (Smith and Ricardo):** Growth is propelled by capital accumulation and division of labor. However, Ricardo warned that diminishing agricultural returns and population growth would eventually drive food prices and wages up, depressing industrial profits and culminating in a **Stationary State** where net investment ceases.
- **The Harrod-Domar Growth Model (1939/1946):** Combined Keynesian multiplier analysis with the accelerator principle. The warranted growth rate (G_w) required to keep capital fully utilized depends on the national saving rate (s) and the capital-output ratio (v):

  Harrod-Domar Formula

  $$g = \frac{s}{v}$$

  Where: g = Equilibrium rate of economic growth (ΔY/Y), s = Net national savings ratio (S/Y), and v = Incremental capital-output ratio (K/Y). Principle: Growth expands with higher savings and greater capital efficiency.

  Because saving propensity, capital-output ratio, and labor force growth (n) are determined independently, full-employment growth is inherently unstable (the "knife-edge" problem).
- **The Solow Neoclassical Growth Model (1956):** Nobel laureate Robert Solow resolved Harrod-Domar's knife-edge instability by introducing smooth neoclassical factor substitutability between labor and capital ($Y = F(K, L)$). Solow demonstrated that economies naturally converge to a balanced **Steady State** where capital per worker is constant (k^*). In the long run, capital deepening cannot sustain permanent increases in per capita income growth due to diminishing returns to capital; **long-run sustained growth in per capita income is driven exclusively by exogenous technological progress** (A).

Macroeconomic Growth Model	Key Assumptions	Determinant of Steady-State Growth	Policy Implication
Classical Model (Ricardo)	Fixed land supply; diminishing agricultural returns.	Zero long-run growth (Stationary State).	Free agricultural trade (repeal Corn Laws) to delay stagnation.
Harrod-Domar Model	Fixed factor proportions (L-shaped isoquants).	$g = s/v$ (Knife-edge instability).	State planning to mobilize domestic savings and manage capital ratio.

Macroeconomic Growth Model	Key Assumptions	Determinant of Steady-State Growth	Policy Implication
Solow Neoclassical Model	Smooth factor substitution; diminishing returns to capital.	Exogenous technological progress ($g = x$).	Invest in scientific R&D, education, and technology transfer.

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.

Analytical Dimension	Orthodox / Classical Perspective	Heterodox / Institutional Framework	Empirical Policy Manifestations in India
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 (Solow neoclassical growth model).	Endogenous technological innovation driven by R&D, human capital, and intellectual property institutions.	National Innovation Foundation, Startup India, and public digital 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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Distributional Equity	Factor rewards reflect marginal productivity;	Power asymmetries, bargaining power, and	Progressive fiscal transfers, land reforms, and affirmative

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	distribution is secondary to allocative efficiency.	historical wealth accumulation shape distribution.	human capital investments.
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