

The background is a dark teal color with various financial symbols and numbers scattered across it. Symbols include the dollar sign (\$), the yen sign (¥), the euro sign (€), and the pound sign (£). Numbers are in various sizes and colors (teal, light green, yellow). There are also arrows pointing up and down, suggesting market movements. The overall theme is finance and economics.

# Classical Theory of the Rate of Interest

# Introduction

Economists like Ricardo, J. S. Mill, Marshall and Pigou developed the, classical theory of interest which is also known as the capital theory of interest or the saving-investment theory of interest or the real theory of interest.



# Continued

According to this theory, interest is a real phenomenon and the rate of interest is determined exclusively by the real factors, i.e., the supply of and demand for capital under perfect competition.

The supply of capital is governed by thrift (i.e. saving) or time preference and the demand for capital is influenced by the productivity of capital.



# Assumptions of Classical Theory of Interest

- Perfect competition exists in the factor market
  - (a) The equilibrium rate of interest is determined by the competitive forces of demand and supply in the capital market
  - (b) Interest rate is flexible, i.e., it freely moves to whatever level the demand and supply forces dictate.
- The theory assumes full employment of resources.

# Continued

- when all resources are fully employed, higher rate of interest is paid to induce people to save or abstain from consumption or postpone consumption
- Income level is assumed to be constant
- Demand and supply schedules of capital are independent and do not influence each other
- Money is neutral and serves only as a medium of exchange and not as a store of value



# Supply of Capital

The supply of capital depends upon savings which, in turn, depend upon a number of psychological, economic and institutional factors broadly classified as –

- (a) the will to save,
- (b) the power to save, and
- (c) the facilities to save



# Demand for Capital

The demand for capital or investment demand depends on:

- the productivity of capital, i.e., returns on investment, and
- the rate of interest, i. e., the cost of investment.



# Continued

The producer will continue his investment of capital as long as the productivity of capital is more than the rate of interest and will stop further investment when the productivity of capital equals the rate of interest.

Thus, the demand for capital is inversely related to the rate of interest





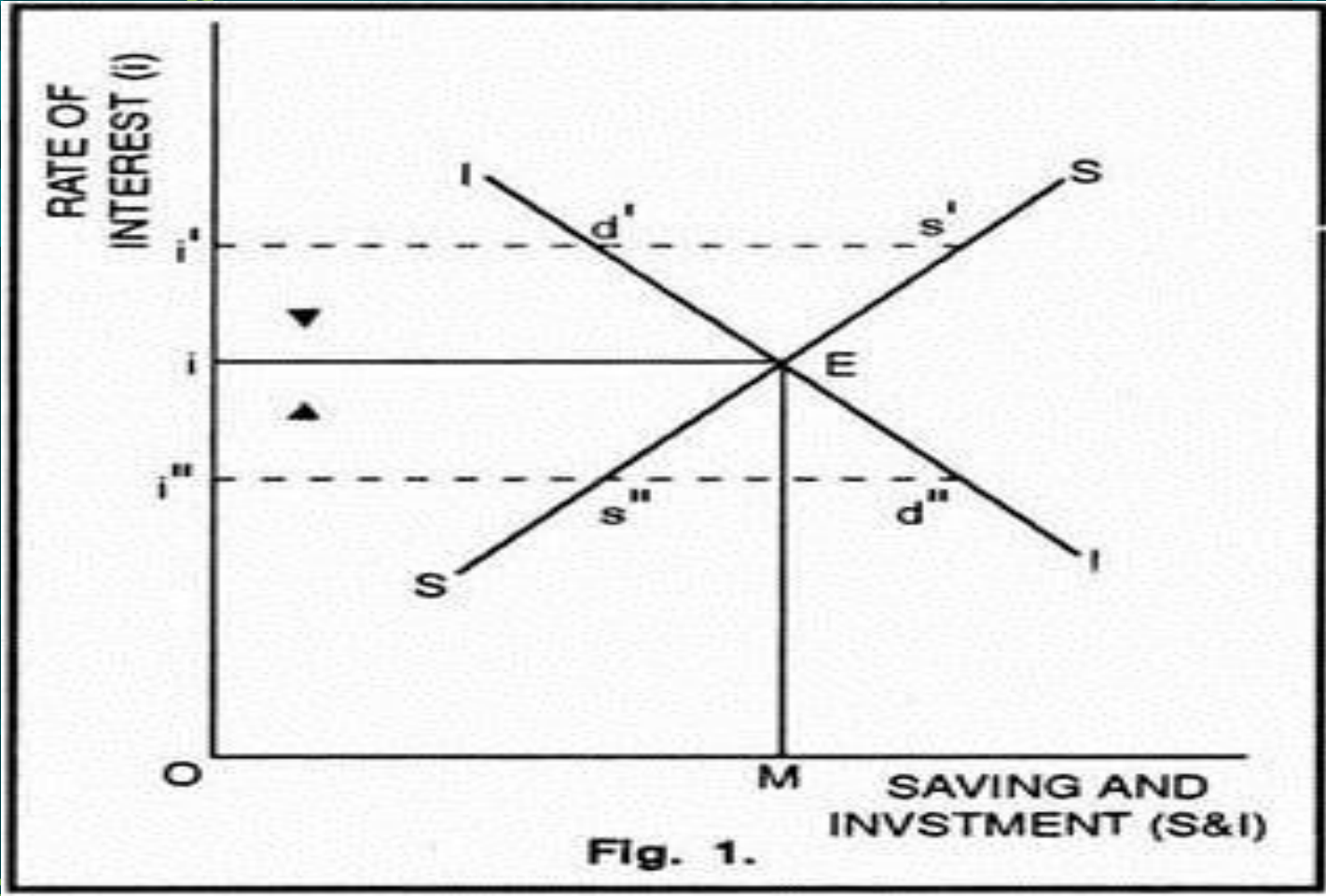


Fig. 1.

SAVING AND INVESTMENT (S&I)

# Equilibrium

The determination of equilibrium rate of interest of the following three conditions:

(i) The supply of capital or saving is an increasing function of the rate of interest:

$$S = f(i); dS/di > 0$$

(ii) The demand for capital or investment is a decreasing function of the rate of interest:

$$I = f(i); dI/di < 0$$

(iii) The supply of capital equals the demand for capital:

$$S = I$$



# Thanks!

Any questions?

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