Causes of disequilibrium in the economy

\n[toc title="Table of Contents"]\n

\n \t

\n[/toc]\n \n

Economists usually define general disequilibrium as the state in which contrasting market forces of supply and demand fail to reach a balance and there exist an intrinsic inclination for change. The main indicator of market disequilibrium is the continuation of shortages either in the demand or supply side of the economy. There are two main models that hold divergent views concerning disequilibrium namely the classical and Keynesian models[1].

Causes of disequilibrium

Generally, the major causes for disequilibrium in the markets if the deficiencies created either in the aggregate demand or aggregate supply side of the economy. This means that in such circumstances the market does not clear. Main causes of disequilibrium are understood in the light of the economic model s followed by scholars. For instance, the Keynesian theory's causes differ from that of classical economists. For instance, following Keynesians' view, disequilibrium arises when there are disparities between leakages and injections where as classical economists argue that if such cases arise, price always adjust to bring the economy back to equilibrium.[2]

In the above diagram, equilibrium occurs at point P2-Q2 where AD2= AS. At that point, the economy is at full employment. Below this point the economy is in disequilibrium whereby it is operating below full employment.

Keynesian theory's view s about disequilibrium

Keynesian theory is the widely used model that explains the general equilibrium using the IS-LM model. Keynesian model construe that markets may not be self-adjusting therefore the markets would not lead to full employment equilibrium if the economy is left to self-regulate. Keynes used the income-expenditure theory to explain the concept of disequilibrium and full employments. He came up with a detailed analysis of the functions of money, functions of interest rates as well as the aspect of relative prices. Keynesian theory postulates that equilibrium usually occurs below the full employment level. Keynes argued that constant equilibrium cannot prevail due to the existence of involuntary unemployment.[3]

In the commodity markets, Keynesians clearly outlines the major disparities that usually reinforce a state of disequilibrium. They compare the aggregate expenditure which includes household consumption, investment function as well as government spending with the effective demand. They postulate that when the economy operates below the intersection of the two, it means there is an imbalance/disequilibrium.[4]

Keynesians denied the supply side of the classical economists. Keynes stated that firms should be given the supply schedule so that they can demand smaller amounts than the existing national demand schedule. Keynes explained the causes of disparities in supply and demand separately. According to him, supply creates income. He postulated that what people produce is the one which is bought therefore supply's value at all times equals the income value. The income is spent by the earners in consumption of more goods. Keynesian economists advocate an increase in government spending when the economy is below full employment in order to stimulate the economy.[5]

Classical economists

Classical economists holds the notion that markets are self regulatory which is opposite of Keynesian views. They construe that whenever disequilibrium state occurs between the leakages and the injections, prices usually adjusts to re-establish the general equilibrium. They held assumption that there prices are flexible savings are equal to investments as well as embracing the say's law which states that supply creates its own demand. Explaining the aspect of disequilibrium through say's law, classical theorists construe that aggregate production in the economy have to create sufficient income that to buy all units of income, failure to which disequilibrium occur.[6]

Classical economists held the notion that commodity markets always experience full employment because of the existence of flexible prices. This means that when the prices shoot up supply is higher than the demand but the situation is temporally since the prices goes down such that demand and supply could be equated to ensure equilibrium. In the capital market, classical economists saw no need for government intervention whenever disequilibrium occurred unlike in Keynesian's economy. They construe that if there disparity occurs between savings and investment there should be no intervention since the situation will self-adjust. They postulated that if savings surpass investments, the rates of interest declines and the state of equilibrium is re-established. When the savings falls below the level of investments interest rates shoots up to enhance equilibrium.[7]

Importance of the theories to the policy makers

Following Keynes view concerning unemployment policy makers is given an insight and therefore they focus on unemployment aspect because they understand clearly underlying it. They are also able to understand how their economies perform and the required adjustments. Keynesians analysis helps economies to understand the connection between savings and investments. Keynes had postulated that the amount people do save depends on how they want to invest. Since the two components are tied together. This aspect is very important in enhancing the national income equilibrium. Many policy makers use Keynes policies that he advocated to try and eliminate inflation in order to attain full employment. These include keeping the interests low to stimulate economy as advocated by Keynes.[8]

Weaknesses

Classical economics assumption that supply creates its own demand does not take effect in the current world. The reason behind this is the fact that many economies are motivated by demand; this means that their production is majorly grounded on the existing demand in the economy. Another thing that renders say’s law ineffective is that not all income earned is diverted to consumption by the individuals. Therefore, the total amount saved transform into the omitted prospective demand which is the major cause of disequilibrium. In reality, when supply goes below the level of demand, what happens there after is that producers lessen their production, wages decline thus disposable income declines, some workers are laid off, and consumption diminishes thus reducing demand.[9]Classical economics on the other hand argues that all savings are usually diverted to investments thus the interest rates changes to ensure equilibrium is ensured. Applicability of their view therefore cannot withhold. Not all savings are diverted to investments as classical economists construe. On the other hand, Keynesians are not always effective in sustaining stable economy. The advocacy that government should spend even when under deficit puts the economy in a state of high unemployment as well as elevating inflation.[10]

Conclusion

The concept of disequilibrium can not be ignored by in any economy. Various economic models have come up with different argument concerning its existence as well as coming up with strategies that tries to bring a country in the state of equilibrium thus ensuring there is full employment. These models have made tremendous contributions in the economy. However, several weaknesses prevail.