Wages,Interest &Rent

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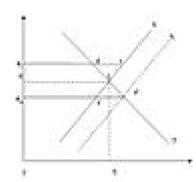
Class-M.A.Sem-II

Theory of interest



Savings and investment

In the classical theory supply and demand for capital determines the optimal interest rates. The rate of interest that is determined by the intersection of investment and saving is the price of investible resource (capital). The demand for capital is done by the entrepreneur for further investment and for the productive purpose. But the productivity of capital is dependent on the law of variable proportion. Which means as more and more of capital is employed the productivity from capital goes on decreasing. Therefore, the entrepreneur will employ only capital up to that level where the rate of interest is equal to the Marginal productivity of capital(MPK). , where MPK is the **marginal productivity of capital** and **R/P** is **real rental for capital**. It shows that demand for capital is inversely related to rate of interest.There are many other factors which affect the demand for capital. On the other hand, supply of capital is positively related to the rate of interest. As the rate of interest increases the savings increases and vice versa. Thus the entrepreneur will employ the capital where MPK is equal to **real price of capital**.[7] The optimal rate of interest rate is determined by the intersection of demand and supply curves. If the rate of interest rises above the equilibrium interest rates the demand for the investment will decline and the supply of savings will increase. As there is excess of savings than demand in the economy the market forces will bring the interest rate to the original interest rates.Now, if the interest rates fall below the optimal level then the there is excess of demand than supply in the economy and hence, the market forces will adjust the interest rates.