FOR BBA

1. Subject Name : Macroeconomics
2. Semester/Year : Fourth (Sem- IV)
3. Name of the Teacher : Dr. Sudip Ghosh
4. Name of the topic : Money - Demand for Money & Supply of Money

Demand for Money

Classical economists considered money as simply a means of payment or medium of exchange. On the other hand, J.M. Keynes laid stress on the store of value function of money.

As essential point to be noted about people's demand for money is that what people want is not nominal money holdings but real money balances (This is also referred to as simply real balances). This means that people are interested in the purchasing power of their money holdings, that is, the value of money balances in terms

Aug 2010

of goods and services which they could buy. If with the doubling of price level, nominal money holdings are also doubled, their real money balances would remain the same. If people are merely concerned with nominal money holdings irrespective of the price level, they are said to suffer from money illusion.

In his theory of demand for money, Fisher and other classical economists laid stress on the medium of exchange function of money, that is, money as a means of buying goods and services. In any given period, the value of all goods, services or assets sold must equal to the number

of transactions T made multiplied by the average price of these transactions. Thus the total value of transactions made is equal to PT. On the other hand, because value paid is identically equal to the value of money flow used for buying goods, services and assets, the value of money flow is equal to the nominal quantity of money supply M multiplied by the average number of times the quantity of money in circulation is used or exchanged is used or exchanged for transaction purposes. The average number of times a unit of money is used for transactions of goods, services

and assets is called transactions velocity of circulation and is denoted by V. Symbolically, Fisher's equation of exchange is written as under:

$$MV = PT \quad \cdots\cdots (1)$$

where M = the quantity of money in circulation

V = transactions velocity of money in circulation

P = Average price

T = the total number of transactions

The above equation (1) is an identity, that is true by definition. However, by taking some assumptions about the variables V and T, Fisher transformed the above identity into a theory of demand for money.

According to Fisher, the nominal quantity of money M is fixed by the Central Bank of a country (note that Reserve Bank of India is the Central Bank of India) and is therefore treated as an exogenous variable which is assumed to be a given quantity in a particular period of time. The most important assumption which makes Fisher's equation of exchange as a theory of demand for money is that velocity of circulation (V) remains constant and is independent of M, P and T. This is because he thought that velocity of circulation of money (V) is determined by institutional and technological

factors involved in the transaction process. Since these institutional and technological factors do not vary much in the short run, the transactions velocity of circulation of money (V) was assumed to be constant.

As we know that for money market to be in equilibrium, nominal quantity of money supply must be equal to the nominal quantity of money demand. In other words, for money market to be in equilibrium

$$M_s = M_d$$

where M_s is fixed by the Central Bank of a country.

With the above assumptions, Fisher's equation of exchange in (1) above can be rewritten as

$$Md = PT/V$$

or, $$Md = \frac{1}{V} PT$$

Thus, according to Fisher's transactions approach, demand for money depends on the following three factors:

(1) the number of transactions (T)

(2) the average price of transactions (P)

(3) the transaction velocity of circulation of money

Other theories of Demand for Money

1) The Cambridge Cash Balance Theory of Demand for Money : $M_d = kPY$

where Y = real national income,

P = average price level of currently produced goods and services

PY = nominal income

k = proportion of nominal income (PY) that people want to hold as cash balances

2) Keynes' theory of Demand for Money:

Liquidity preference (the demand for money to hold or the desire of the public to hold cash)

Liquidity preference of a particular

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individual depends upon several

considerations. The desire for liquidity arises because of three motives: (i) the transactions motive, (ii) the precautionary motive, and (iii) the speculative motive.

(3) Tobin's Portfolio Approach to Demand for Money

(4) Baumol's Inventory Approach to Transactions Demand for Money

(5) Friedman's Theory of Demand for Money

Supply of Money

Money supply plays a crucial role in the determination of price level and interest rate. In economic analysis it is generally presumed that money supply is determined by the policy of Central Bank of a country and the Government. It is important to note that besides Central Bank and Government, the public and commercial banks also play an important role.

Importance of Money Supply

1) Growth of money supply is an important factor not only for acceleration of the process of economic develop-

ment but also for the achievement

of price stability in the economy.

(2) It is now regarded as a legitimate instrument of economic growth. Kept within the proper limits, it can accelerate economic growth but exceeding of the limits will retard it.

(3) Management of money supply is essential in the interest of steady economic growth.

Concept of Money Supply

By money supply, we mean the total stock of monetary media of exchange available to a society for use in connection with the economic activity of the country. According to the standard concept of money supply, it is composed of the following two elements:

1) Currency with the public: In order to arrive at the total currency with the public in India, we add the following items:

(a) Currency notes in circulation issued by the RBI

(b) the number of rupee notes and coins in circulation

(c) small coins in circulation

2) Demand deposits with the public (bank money or deposite money):

~~Demand~~ Deposits with the banks are broadly divided into two types:

(1) demand deposits: deposits in the banks are those deposits which can be withdrawn by drawing cheques on them

(2) time deposits: an interest-bearing bank deposit with a specified period of maturity - a money deposit at a banking institution that can be withdrawn for a specific term or period of time. When the term is over, it can be either withdrawn or

Reserve Bank of India classifies factors determining money supply into the following categories:

(a) Government borrowing from the banking system

(b) Borrowing of the private or commercial sector from the banking system

(c) Changes in net foreign assets held by the RBI caused by changes in BOP position, and

(d) Government's currency liabilities to the public