Quantity Theory of Money

Prepared by
Bubu Sensowa
Assistant Professor, Dept. of Economics
Hatichong College, Nagaon, Assam

Quantity Theory of Money attempts to explain the value of money or the general price level. According to the theory, the value of money varies inversely with the quantity of money and the price level varies directly with the quantity of money. If, for example, the quantity of money is doubled, the price level will also be doubled and the value of money halved and vice-versa.

Quantity Theory of money

- Fisher's Transaction Approach
- The Cambridge Cash Balance Approach

Fisher’s Transaction Approach

Other things remaining unchanged, as the quantity of money in circulation increases, the price level also increases in direct proportion and the value of decreases and vice versa.

The equation of Exchange

$MV=PT$ or $P=MV/T$

Where M is the quantity of Money, volume of money in circulation

V is the velocity of circulation of money

P is the Price Level

T is the total goods and services transacted

Like other commodities, the value of money or Price Level is also determined by the demand and supply of Money.

Supply of Money= Demand for Money

$$MV = PT$$

$$P = MV/T$$

Fisher further extended the equation

$$MV + M'V' = PT$$

$$P = MV + M'V'/T$$

Where M' is demand(bank) deposit

V' is the velocity of circulation of demand(bank) deposit

According to Fisher P depends on

1. the quantity of Money, volume of money in circulation(M)
2. the velocity of circulation of money(V)
3. the Price Level(P)
4. the total goods and services transacted (T)
5. The demand(bank) deposit (M')
6. the velocity of circulation of demand(bank) deposit.(V')

The transaction approach maintains that other things remain unchanged, i.e., **if V, M', V' and T remain unchanged, there exist a direct and proportional relationship between M and P.**

Assumptions of the Quantity Theory

- V is constant and is not influenced by the change in M
- T is also remain constant and is not affected by change in M
- V is constant and is not influenced by the change in M
- M is a Medium of Exchange
- P is a passive factor.
- The theory is based on long period
- Constant relation between M and M’

Criticisms of the quantity Theory

1. **V cannot remain constant as assumed by Fisher. It increases with the increase in money supply**

2. **When M increases, V' also increases**

3. **Actually, P is not passive as assumed by Fisher. Rising Prices increases profits and thus promote business and trade.**

4. According to Fisher M changes P but actually, P occurs independently and this later on influences money supply

5. If there is an increase in T, it will definitely increase V.

Criticisms of the quantity Theory

6. **During prosperity growing T may lead to an increase in M**

7. M and T are not Independent

8. Unrealistic assumption of long period.

9. Unrealistic assumption of full employment.

10. It is a static theory as it assumes the values of V,V',M' and T remain constant

11. MV=PT is a mere truism and proves nothing.

12. MV=PT is technically inconsistent. M is a stock concept but V is a flow concept

Criticisms of the quantity Theory

13.It fails to explain trade cycle.

14. It ignores the other determinants of prices such as income,expenditure, investment, saving, consumption, population etc.

15. It fails to integrate Monetary theory with price theory.

16. The theory considers money only as a medium of exchange only . It neglects the store of value function of money.

17. It is an one sided theory as it considers supply of money determines the value of money and assumes the demand for money remain constant only .

18. Keynes critised the theory on the ground that there is no direct and proportionate relation between M and P

Merits of the quantity Theory

1.It provides an important clue to the fluctuations in prices.

2. Till 1930's, it was used by the Economists and policy makers to explain the changes in P.

3. It is the basis of Monetary Policy.

Thank you