Money

Definitions of Money

- Traditional Definition : This view is defined as currency and demand deposits, and its most important function is to act as a medium of exchange. However, there are other assets which are equally acceptable as a medium of exchange. By ignoring these assets, the traditional view does not analyse their influence in increasing their velocity.
- Friedman's Definition: He defined money as the sum of currency plus all adjusted deposits in commercial banks. This is the broader view as it includes bank deposits, non bank deposits and any other type of assets through which the monetary authority influence the level of income, prices, employment or any other macro economic variable.
- Gurley – Shaw: Money which was defined as equal to currency plus demand deposits is only one liquid asset. Thus a wider definition was formulated which was based upon liquidity which includes bonds, insurance reserves, pension funds, savings and loan shares.
- Pesek and Saving definition: According to them Money should include demand deposits as well as money issued by government. Time and Savings deposits from banks are excluded. Thus total money which includes demand deposits is termed as net wealth of society

Functions of Money

Money has three functions in the economy

2. Medium of Exchange : Money acts as a medium of exchange that it is an item that buyers give to sellers when they purchase goods and services. This transfer of money from buyer to seller allows the transaction to take place. Thus money is commonly acting as a medium of exchange.

2. Unit of Account : When we want to measure and record economic value, we use money as the unit of account.

3. Store of value : A store of value is an item that people can use to transfer purchasing power from present to the future.

Kinds of Money

- Money and Near Money: Money is a legal tender and gives possessor liquidity in hand. It performs the medium of exchange function. Near money are almost perfect substitutes for money and perform the function of medium of exchange and store of value. People prefer to keep near money assets due to the fact that the yield from them is higher than from demand deposits and that they are safer than cash.

Neutrality and Non Neutrality of Money.

- Money is neutral if it affects relative prices and leaves the interest rate unaffected. If this happens instantaneously the neutrality of money is instantaneous. If there is a time lag there is long – run neutrality.
- According to classicists money is neutral in its effect on employment, income and output. Thus, according to them main function is to determine the general price level at which goods and services are exchanged.
- In the Keynesian theory at the full employment level when any increase in the quantity of money brings about a proportionately increase in price level but output remains unchanged at that level.

Non Neutrality of Money

- Non neutrality of money was proposed by Friedman and according to them that money supply does affect interest rates at least in the short run . If there is permanent acceleration in money supply it will permanently change the real income.

Value of Money : It is a relative concept which expresses the relationship between a unit of money and the goods and services which can be purchased with it. The relationship between the value of money and price level is an inverse one.

Fisher's Quantity of money : The cash transactions approach

This theory states that the quantity of money is the main determinant of the Price level or the value of money. If there is change in the quantity of money price level also changes proportionately.

- If the quantity of money is doubled the price level will also double and the Value of money will be one half.

Fisher's theory

$PT = MV + M'V'$

P ……. Price level , M…….. Total quantity of legal tender money

V……the velocity of circulation of M, M'…… the total quantity of credit money, V'……… the velocity of circulation of M', T…total amount of goods and services exchanged for money or transactions performed by

Assumptions of the theory

- P is a passive factor which is affected by other factors.
- The proportion of M' to M remains constant.
- The theory is applicable in the long run.
- It is based on the assumption of full employment in the economy.

The Cambridge Equations: Cash Balance Approach

- Marshall, Pigou, Robertson and Keynes formulated this theory
- Cash Balance approach considers the demand for money not as a medium of exchange but as a store of value.
- The Cambridge equation shows that given the supply of money at a point of time, the value of money is determined by the demand for cash balances.
- When the demand for money increases people will reduce their expenditure on goods and services and will prefer to have larger cash holdings. This in turn will reduce the price level and raise the value of money. On the contrary increase in demand for goods and services will raise the price level and lower the value of money.

Marshall's Equation

- According to this equation the price level is affected by only that part of money which people hold in the form of cash for transaction purposes.
- It assumes that demand for real balances is proportional to the income level.
- $M = k\,PY$
- $1/\,P = kY\,/\,M$
- M – supply of money
- P – Price level
- k - fraction of real income which people wish to hold in cash and demand deposits.
- Y – Aggregate real income of the community.

Pigou's Equation

- Pigou has expressed the cash balance approach in the form of an equation.
- P = k R/M
- P … Purchasing power or value of money.
- K…. Proportion of real income which people wish to hold in cash and demand deposits.
- R….. Real income
- M ….. Number of actual units of legal tender money.

Criticism

- Neglects interest rate
- Demand for money not interest inelastic
- Neglect of goods market.
- Neglects speculative demand for money.