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Dr. Abhay Kumar Pathak	Content of the Paper:
Deptt. of Economics,	Macro Economics
Marwari College,	Module:- 5
Darbhanga (LNMU)	

TOPIC:- EVALUATION OF THE QUANTITY THEORY OF MONEY

The Quantity Theory of Money is the oldest and has been the most influential theory purporting to explain the determination of the value of money at any one time and the variations of this value over periods of time. Both the approaches the cash transactions approach and the cash balances approach are the expression of the relationship between the quantity of money supply and the general level of prices. It becomes clear that the theory does not hold much water in explaining the forces causing changes in the values of money.

(1) It focusses on immediate rather than ultimate factors:-

Both the approaches of the quantity theory indicate some factors like the quantity of money in circulation (M), the velocity of circulation of money (V) the amount of goods bought by the money (T), fractional part of T over which people wish to hold command in the form of cash (K) and the total real income expressed in terms of any particular commodity enjoyed by the community at any given period of time (R) as direct determinants of the value of money. But actually all these variables are affected by complexity of economic factors like consumption, savings, investment, income, etc. A number of technical, institutional and psychological factors play their parts in the macroeconomic drama in a modern economy. Hence, to know the real determinants of the price level and the value of money, one has to go beyond the quantity equations.

(II) Exogeneity of Money Supply:-

In quantity equations, the quantity of money M is assumed to be an exogenous and policy-determined variables. But modern economists say that M is an endogenous variable and likely to respond to P when P, the price level, changes on account of cost-push element.

(III) Lacks Analytical Approach:-

In the transactions and cash balance approaches of quantity theory, all kinds of goods are lumped together. No analytical distinction is made between consumption goods and capital assets to examine their effect upon income, employment, output and prices.

(IV) Validity in Long-run order:-

Quantity equations are, by and large equilibrium

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equations for the money market in the long term. They are true only in the long run and not in the short run.

(V) No Real Guidance to Policy Market :-

The quantity theory of money furnishes no relevant guidance for an appropriate monetary policy to avoid trade cycles, because they lay emphasis only on secular long-run prices, while a trade cycle is relatively a short-term phenomenon.

(VI) Manipulative Approach :-

The quantity theory equations trace the result but without explaining the process involved in obtaining it. Equations pose a direct relationship between the changes in money supply and the price level. But, actually there is no direct and proportionate relationship as depicted.

(VII) Consequence Rather than Causation :-

The quantity theory of money is not a causative factor in the state of business and a determinant of value, but it is only a consequence. In fact, the value of money is a consequence of income rather than the quantity of money. If people have money income, they would spend it partly or fully. This would increase the velocity of circulation and monetary demand for goods and services and consequently, prices would rise if the supply of goods and services is scarce.

The important merit of the quantity theory, however, lies in the fact that the monetary policy has always aimed at controlling prices through management and regulation of quantum of money in circulation. The central bank adopts the bank rate policy and open market operations under the assumption that a large supply of money will cause prices to rise and bring about the revival of economic activities, and vice versa.