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TOPIC :- REFORMULATION OF 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. The Quantity Theory of Money is the crux of the classical monetary thoughts which proclaim the idea of a unique functional relationship between money and prices. In short, the quantity theory implies that the quantity of money brings about a directly proportionate change in the price level and hence an inversely proportionate change in the value of money. Therefore, it emphasises a functional relationship between the quantity of money and the value of money. The quantity theory has two refined approaches namely as the cash transactions approach and the cash balance approach.

The traditional quantity theory of money and quantity equations do not show how a change in the quantity of money reacts upon the price level. Keynes tackled this aspect of the problem in his 'General Theory' by a restatement of the quantity theory. In this connection, he tried to integrate the theory of money with the theory of employment. To Keynes, the effect of changes in quantity of money on the price level should be visualised through the interrelated effect on the wage rate, income, investment, employment etc. Thus, an increase in the quantity of money will have no effect whatsoever on prices, so long as there is any unemployment, and that employment will increase in exact proportion to any increase in effective demand brought about by the increase in the quantity of money, while, as soon as full employment is reached, wage rate and price will increase in exact proportion to the increase in effective demand. Hence, Keynes enunciated the quantity theory of money as "so long as there is unemployment, employment will change in the same proportion as the quantity of money."

To elucidate this point, Keynes first considers the effect of changes in the quantity of money on the quantum of effective demand; the increase in effective demand is supposed to be spent partly in increasing the quantity of employment and partly in raising the level of prices. Hence, Keynes noticed a condition where prices rise gradually as employment increases, instead of prices rising in proportion to the quantity of money, which is true in a condition of full employment, as assumed by the classical theorists.

Prof. Keynes stressed that there is no direct link between money supply and price level, but there is series of casual links between the two. Changes in the quantity of money first affect the rate of interest, which in turn, affects the investment function and the level of effective demand and consequently the volume of employment and output. If money supply increases with a given demand for money the rate of interest will fall. Given the marginal efficiency of capital, a fall in interest rate will induce an increase in investment. With an increase in investment expenditure, the level of effective demand will go up. Increased investment leads to an increase in the level of employment, output and income. There is a multiplier effect involved in the process of income propagation, based on the phenomenon of marginal propensity to consume and consequent changes in the flow of consumption expenditure.

Factors for the effects of a change in quantity of money on the price-level :-

Following are the factors which affect for the effects of a change in quantity of money on the price-level:-

(i) Effect of changes in money supply on the level of aggregate demand or spending.

(ii) Relation between aggregate spending and the volume of production.

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