

Transactions and Cash Balances Approaches (Comparison)

Here is a comparison between transactions and cash balance approaches.

It may be clearly understood that there is no doubt about the superiority of cash balances version over the transactions version of the quantity theory of money.

The difference between the two versions is not as fundamental as might appear at first sight.

A closer examination of the two approaches will show that they are more or less similar as both the versions show that the price level depends upon the quantity of money. Both the approaches can be easily compared.

$P = MV/T$ (Fisher) or M/KT (Roberson)

These equations make use of the same symbols implying more or less the same thing. The two equations show that V and K tend to be the opposite of each other. The higher the fraction of the real income that people hold in money, the lower will be the velocity of money and vice versa. V and K are reciprocals $V = 1/K$ or $K = 1/V$. It means that when people want to hold more (higher the K), the velocity of circulation of money will be less (lower the V). If, therefore, we want to enquire into the causes of the fluctuations in the velocity of money, we should turn to the causes which determine changes in the factor K .

In fact, the two versions can be reconciled by substituting $1/V$ for K and $1/K$ for V in the two equations. The new term K , represents the ratio of cash balances desired relative to the national income, thus emphasizing the role of money as a store of value. The Cambridge cash- balances equation stresses the role of money as an asset, whereas the transactions approach stresses the use

of money as a circulating medium. We can demonstrate the similarity between the two versions with the help of the Fig. 28.2.

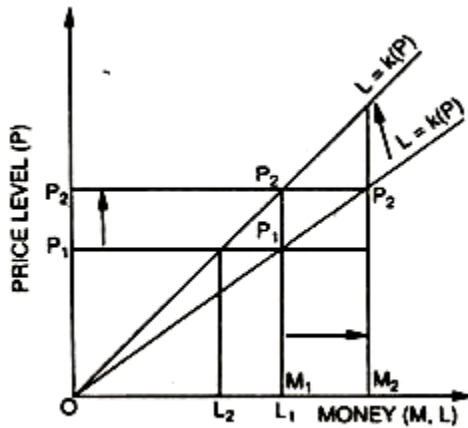


Fig. 28.2

In the figure as the quantity of money increases from M_1 to M_2 , there is a direct effect on the price level which rises from P_1 to P_2 . This is what quantity theory transactions approach tells us. But the mechanism through which cash balances approach operates is different. The equation $L = k(P)$ shows that the demand for cash balances is related to price level. With changes in the demand for cash balances (L) there are proportionate and corresponding changes in price level (P). with a reduction in the demand for cash balances, from L_1 to L_2 , price level (P) rises from P_1 to P_2 . This is because the reduced demand for cash balances (L_1, L_2) releases the same amount of money for exchange, which raises prices.