Study materials for BA (hons) economics

Part – 1

Paper – 2

Topic – Transaction Approach of Money

Introduction

Quantitative Theory of Money: - Fishers' Transaction Approach

The general level of prices is determined, that is, why at sometimes the general level of prices rises and sometimes it declines. Sometime back it was believed by the economists that the quantity of money in the economy is the prime cause of fluctuations in the price level.

The theory that increases in the quantity of money leads to the rise in the general price was effectively put forward by Irving Fisher.' They believed that the greater the quantity of money, the higher the level of prices and vice versa.

Therefore, the theory which linked prices with the quantity of money came to be known as quantity theory of money. In the following analysis we shall first critically examine the quantity theory of money and then explain the modem view about the relationship between money and prices and also the determination of general level of prices.

The quantity theory of money seeks to explain the value of money in terms of changes in its quantity. Stated in its simplest form, the quantity theory of money says that the level of prices varies directly with quantity of money. "Double the quantity of money, and other things being equal, prices will be twice as high as before, and the value of money one-half. Halve the quantity of money and, other things being equal, prices will be one-half of what they were before and the value of money double."

The theory can also be stated in these words: The price level rises proportionately with a given increase in the quantity of money. Conversely, the

price level falls proportionately with a given decrease in the quantity of money, other things remaining the same.

There are several forces that determine the value of money and the general price level.

The general price level in a community is influenced by the following factors:

(a) The volume of trade or transactions

(b) The quantity of money;

(c) Velocity of circulation of money.

Fisher's Equation of Exchange:

An American economist, Irving Fisher, expressed the relationship between the quantity of money and the price level in the form of an equation, which is called 'the equation of exchange'.

This is:

$PT = MV$

Or $P = MV/T$

Where P stands for the average price level:

T stands for total amount of transactions (or total trade or amount of goods and services, raw materials, old goods etc.)

M stands for the quantity of money; and

V stands for the transactions velocity of circulation of money.

The equation or is an accounting identity and true by definition. This is, because MV which represents money spent on transactions must be equal to Pr which represents money received from transactions.