study materials for BA(hons) Economics

Part – 1

Paper – 2

Topic – Cash Balance Approach of Money

# Introduction

## Quantitate Theory of Money: The Cambridge Cash Balance Approach

The equation of exchange has been stated by Cambridge economists, Marshall and Pigou, in a form different from Irving Fisher. Cambridge economists explained the determination of value of money in line with the determination of value in general.

Value of a commodity is determined by demand for and supply of it and likewise, according to them, the value of money (i.e., its purchasing power) is determined by the demand for and supply of money. As studied in cash-balance approach to demand for money Cambridge economists laid stress on the store of value function of money in sharp contrast to the medium of exchange function of money emphasised by in Fisher's transactions approach to demand for money.

According to cash balance approach, the public likes to hold a proportion of nominal income in the form of money (i.e., cash balances). Let us call this proportion of nominal income that people want to hold in money as k.

**Then cash balance approach can be written as:** $M^d = kPY$ ….(1)

Y = real national income (i.e., aggregate output)

P = the price level PY = nominal national income

k = the proportion of nominal income that people want to hold in money

$M^d$ = the amount of money which public want to hold

Now, for the achievement of money-market equilibrium, demand for money must equal worth the supply of money which we denote by M. It is important to note that the supply of money M is exogenously given and is determined by the monetary policies of the central bank of a country. Thus, for equilibrium in the money market.

$M = M^d$

As $M^d = kPY$

Therefore, in equilibrium $M = kPY$ …(2)

Monetary equilibrium Cambridge cash balance approach is shown in Fig. 20.2 where demand for money is shown by a rising straight line kPY which indicates that with k and Y being held constant demand for money increases proportionately to the rise in price level. As price level rises people demand more money for transaction purposes.