Demand for Money

Classical

Keynesian

Demand for Money- Learning Objectives

- Meaning of Demand for Money
- Key Terms
- Approaches to Demand for Money
- Determinants of demand for money

Meaning of Demand for Money

Money is the set of assets in an economy that people regularly use to buy goods and services from other people.

People choose to hold money because of its function as a medium of exchange and store of value. If people desire to hold money ,there is a demand for money.

Key Terminology

- Liquidity : It is the ease with which an asset can be converted into the economy's medium of exchange.
- Velocity: Velocity of money refers to the speed at which the money changes hands, travelling around the economy.
- Nominal money : It is the quantity of money measured in rupees.
- Real money: this is equal to nominal money divided by price level

Classical Approach

Classical economists concentrated on money as a medium of exchange and confined their attention to ***transaction*** demand for money.

The Classical money demand function (Cambridge version) can be expressed as

$$M^d = kPY$$

Money demand (M^d) was proportional to nominal income(money income) the price level P, times real income , Y

Classical Approach

The proportion of income held in the form of money (k) was assumed to be relatively stable as long as we were considering equilibrium positions.

Fisherian version of the classical theory can be expressed as: **MV= PT**

This can be further rewritten as

$$M_d = 1/V * PT$$

Classical Approach

According to Fisher's transaction approach , demand for money depends on

I. The number of transactions (T)
II. The average price of transactions (P)
III. The transaction velocity of circulation of money.

Classical Approach

Influences like rate of interest, wealth , expectations regarding future prices have not been included into the classical approach to Demand for money.

Keynesian Approach

Keynesian approach to demand for money incorporates the two important functions of money- medium of exchange and store of value.

Keyenes analyses the motives for holding cash under three heads:

1. The transactions motive- to meet day to day business and personal requirements.

Keynesian Approach

2. The precautionary motive- to meet future requirements and unforeseen contingencies.
3. The speculative motive- to take advantage of the market movements.

Keynes holds that the transaction and precautionary motives are relatively interest inelastic ,but are highly income elastic.

Keynesian Approach

For transaction and precautionary motive the amount of money held is a function of the level of income (Y). It can be expressed as:

$$M_1 = L_1(Y)$$

The speculative demand for money is a function of the rate of interest.

$$M_2 = L_2(r)$$

Where r stands for the rate of interest, L_2 for demand function for speculative motive.

Kyenesian Approach

The Keynesian money demand function can be expressed as $M^d = L(Y,r)$

The fact that in Keynesian view money demand was a function of the interest rate as well as income is important in explaining the differences in policy conclusions between the Classical and Keynesian models.

Determinants of Demand for Money

Money demand has several determinants including interest rates and the average level of prices in the economy, real GDP and financial innovations.