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(Paper-2)

Transactions and Cash Balances Approaches (Comparison)

There are, however, some notable differences between the two versions. Firstly, the two approaches give different interpretations to the demand for money. In the transactions approach money goes round and has wings, it is needed to exchange goods and services. In the cash-balance approach money is flat and remains idle, it is used as a store of value. Secondly, the stress in the transactions theory is on the velocity of money (V), while in the cash-balance theory, the stress is on idle balances kept as a part of national income (K). Further, the cash-transactions equation gives attention to money as a flow, while the cash-balances equation gives attention to money as a stock. Moreover, Fisher's equation explains the value of money over a period of time, while the Cambridge equation explains the value of money at a particular moment of time.

Pointing out the difference between Marshallian version of the cash balances, equation and Fisher's equation of cash transactions equation, Prof. Hansen remarks, "The Marshallian version of the quantity theory, M = kY = represents a fundamentally new approach to the problem of money and prices. It is not true, as is often alleged, that the cash balances equation is merely the quantity theory in new algebraic dress……. To assert this is to miss entirely the significance of the k in the Marshallian equation………. The difference can be stated as—in terms of the Marshallian approach, sudden and rapid shifts in the desire of the public to hold money may profoundly affect prices even though the monetary authority successfully maintains a high stability in the money supply. The desire of the public to hold cash balance—liquidity preference—enters as a powerful factor. Drastic and sudden shifts in the desire to hold money, reflected in a change in k, may produce large and quickly moving changes in the level of income and prices. Shifts in public psychology in expectations, must be taken account of not less than changes in money supply. In the Marshallian analysis a shift in k may start an upward or downward movement. It is k, and not M, that holds the stage."

Advocates of the Cambridge equation did not consider themselves to be in any fundamental disagreement with Fisher—their primary concern was the price level and for the most part they accepted the basic conclusions that the value of money varied inversely with its quantity. At the same time, they considered their approach superior to that of the transactions version. In their approach major attention was given to the role of the demand for money.

It was this emphasis on the subjective nature of the demand for money which provided the psychological insight lacking in the transactions approach and which rendered the cash balance approach, in Pigou's words, "A more effective engine of analysis." Moreover, by specifying more precisely the constituents of the demand function, the Cambridge approach also indicated the conditions which would give rise to unstable fluctuations in demand.