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(Paper-2)

Theory Of Money

b. Cash Balances Approach/Cambridge Equation:

Cash balances approach is the modification of quantity velocity approach and is widely accepted in Europe. This approach is based on national income approach and considers the concept of liquidity. According to cash balances approach, the value of money depends on the demand and supply of cash balances for a given period of time. The demand for money is not only dependent on the quantity of goods and services that would be exchanged, but also on the time period at which the transaction takes place.

For example, an individual would not purchase food grains for the whole year at once, but he/she would purchase on monthly basis. Therefore, he/she is required to hold enough cash with him/her to buy food grains and other products from month after month.

Thus, if in an economy individuals are habitual for holding money for overcoming their expenditure for a longer period of time, then the demand for money would be more. In such a case, only a small part of income is held by individuals and rest of the amount is invested.

This is because holding a large amount of cash as idle cash would be a loss or danger for the individual On the other hand, cash balances held by individuals should also not be very low, so that contingencies cannot be overcome.

According to Marshall, "A man fixes the appropriate fraction (of his income) after balancing one against another the advantages of a further ready command and the disadvantages of putting more of his resources into a form in which they yield him no direct income or other benefit."

Therefore, an individual should hold a particular amount of cash with him/her to fulfill his/her needs as well as overcome uncertainties. Let us express the fraction of income that should be held by individuals ask.

Now, the equation usually used is as follows:
M = kpR

Where, M = quantity of money

R = real national income (total of final goods and services that are directly consumed)

P = average price-level of real national income (average of price of clothes, food, shelter, and services)

pR represents the monetary national income. Now, a proportion of the monetary national income is held in liquid form by individuals in an economy. In addition, it also expresses the desire of individuals in an economy to have liquid cash that is termed as liquidity for buying.

If the circulation of money takes place only once, the amount of money required would be equal to the monetary national income. However, if circulation of money takes place twice, then only half pR is required for buying national product.