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(Paper-2)

Theory Of Money

c. Income-Expenditure Approach:

The income-expenditure approach is given by Keynes. It is also termed as the modern theory of money. Keynes was agreed with the concept that changes in quantity of money produces changes in the price levels, as given in the quantity theory of money.

However, he did not agree with the view that determining relationship between quantity of money and price level is as easy as demonstrated by quantity theory.

According to the modern theory of money, changes in price level are brought by the changes in national income rather than quantity of money. The main reason for the change in the price level is the changes that occur in the aggregate income or expenditure. Therefore, change in quantity of money can only bring changes in the price level when it can change the aggregate expenditure with respect to the supply of output.

If there is no rise in the expenditure, then the demand for goods would not rise and consequently, the price level would not increase. In case, the expenditure rises but the supply of output is fairly elastic, then also the price level would not rise.

Therefore, the impact of change in quantity of money would depend on the following factors:

a. Effect of change in money supply on level of aggregate expenditure and volume of production

b. Type of relation between aggregate expenditure and volume of production

The amount of expenditure depends on the consumption function, investment demand schedule, liquidity preference schedule, and supply of money. An increase in the quantity of money would decrease the rate of interest. However, in case the rate of interest is very low, then the increase in quantity of money would not be able to reduce rate of interest further.

The reduced rate of interest would help in increasing the rate of investment by individuals, which would further result in increase in income. The increase in income would increase the aggregate expenditure of a nation. However, when the increased quantity of money is not able to reduce the rate of interest as it is already very low, the investment would not show any increase.

Thus, the income and aggregate expenditure would simultaneously fail to show any type of increase. In such a case, the price level would not rise even with the rise of quantity of money. However, it is also not guaranteed that if the increase in quantity of money reduces the rate of interest, then price level would rise or not.

This is because it may be possible that the proportional increase in price level is very less as compared to increase in money supply. Therefore, it is hard to determine relationship between changes in money supply and changes in price level. This is because they are indirectly related to each other and depend on aggregate expenditure and elasticity of supply of output.