How Much Does Money Really Matter?

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The purpose of this comment is not to go into details of why money matters and when money matters, but rather to examine in brief how much money matters. The development of the subject in recent years has given rise to controversy and complication in understanding the issue constitutes the major problem for us. I have tried to distinguish between the ages of writers and see what of us the L.D.C.'s whether the age of classists, Keynes's & Friedman's suits in our context.

1) About the emergence of money:— World civilization has its long history. Its ups and downs are not regulated by any Creator. Actions and inter-actions have, over centuries renewed, modified, and corrected the prevailing systems or orders or thinking. Man wished and tried to live better and happier and this, in turn, initiated the process of the development of material life. Money was one of man's innovations which lessened the loss of time and efforts resulting from the barter system of exchange.

2) Historical review:— Many things were used as money during the course of its development—Stones, clays, salts, animals, metals, and a host of other things. Metallic form of money, however, was given recognition on the ground that it was durable, portable, cognizable, transferable, and so generally acceptable. But because of the scarcity of gold relatively to demand, and the relative abundance of other metals with respect to needs, the metallic form of money is becoming a matter of the past and also a matter of academic interest only day by day. The paper or credit

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or debt money, now, circulates through-out the world as a standard currency of the country concerned. A very large part of what circulates today as the medium of exchange is credit money. The principal constituents of present day money are currency and demand deposits.

3) Changing view on the role of money: Though writers before Keynes tried to analyse the role of money, they were mainly concerned with the relationship between money supply and the general level of prices. They took money as the medium of exchange only, and studied its impact upon the behaviour of the level of price, fluctuations in which were regarded as resulting in economy-wide oscillation. Except as the source of price fluctuations it was not supposed to influence the general behaviour of real economic variables such as output and employment. But Keynes and the Keynesians related money to the general behaviour of the economy on the ground that the supply of money is a determinant of total outlay.

Increased aggregate demand in the form of C+I gives us the higher level of employment and output (in the below full-employment condition). Excess of money supply over desired holding will, either, increase total spending on goods C+I and increase the price of goods and services or decrease the rate of interest which leads to higher investment. The former route was taken by the classical writers and the second was purely the Keynesian type of analysis. After Keynes there has been no debate on the close relationship between the stock of money and the behaviour of real economic variables, but the controversy relates mainly to the transmission mechanism i.e. whether money effects directly or indirectly the volume of employment and output and whether it effects them through the change in prices or change in interest, or so on. This basic divergence in thinking led to the development of other important propositions of which I shall talk in brief, as it is not possible within a small compass to deal with them in full.

4) Process of development of debate:— Economists talk of any particular economic event, usually in terms of demand and supply. The supply of money together with the demand for it determines the general behaviour of the real economy. Steady growth of money corresponding to the growth of National income or the growth of productivity proportionately together with money supply is the prerequisite for stable and healthy progress. The basic factors that determine changes in money supply are:

(a) changes in international monetary base (international reserve) components
(b) changes in the domestic monetary base components and
(c) changes in monetary multiplier.

Nominal monetary supply can be regulated by the monetary authorities but the demand for money i.e. money that people want to hold in whatever form they choose is out of their control. It is one of the basic tasks of the monetary authorities to keep close watch and vary monetary conditions, i.e. the supply side, accordingly in order to achieve and maintain the desired goal of stable and healthy progress.

Now we ask why do public demand money? To answer this question, we are required to know a little of monetary history. The capacity of money to act as a medium of exchange was the source of demand for it according to the classical writers. In this view money should not distort the natural relationship of demand and the supply of goods. Money should only be medium of exchange. No one except a miser would like to hold money in this sense. But the neoclassical writers including Marshall took a less extreme position as to whether or not money may remain idle. They realized if money is allowed to remain in idle form then that may lead to divergence between income and spending. In the Marshallian equation, \( M = Kp_0 \), where \( K \) now become the reciprocal of \( V \). Here \( K \) is the fraction of income that is held idle, and \( V \) is the usual transaction velocity in the equation \( MV = p_0 \). But the basic assumption that the money is demanded for transaction purposes as supposed in the equation of exchange remained as it was.

Keynes introduced the speculative demand for money. For him, money is not merely the medium of exchange, rather it is also the store of value. If money supply is \( M^* \) then \( M = L_t + L_s \), because total money would be absorbed in transaction balance \((L_t)\) and speculative balance \((L_s)\). But the determinants of the two are different. Since \( L_t = KY \) and \( L_s = l(r) \), where \( K \) is the fraction of income \((y)\) and \((r)\) is the rate of interest or the cost of money, we can have an equation for the total demand for money: \( L_s + L_t = KY + l(r) \). Here Keynesian precautionary demand is included in \( L_t \). This is done as precautionary demand is mostly sensitive to income changes as is transaction demand. The rate of interest will have no or negligible effect on these demands where as \( L_s \) is more volatile and according to Keynes sensitive to changes in \( r \). There has been negative correlation between \( L_s \) and \( r \). If we combine both functions into one, we write that as \( L = f(y, r) \). In formulating this function of liquidity preference or demand for money or holding of idle money Keynes supposed that people will keep their assets primarily in two forms.
(a) money and
(b) interest bearing securities.

These were for Keynes close substitutes for each other. Post Keynesian writers such as Milton Friedman, Tobin, Baumol, Meltzer, Burstein and others exercised their minds over the problem of the demand for money. Another determinant was added in the money demand function, namely, public wealth (w). Greater the publics’s wealth the higher would be demand for money that public will be inclined to hold. Counting wealth as another determinant we get the final function of the demand for money \( L = f(y, r, w) \) This way, money is viewed as one among many forms in which an individual can hold his assets. But money has a significance of its own. Other forms of wealth or assets are not controllable by government in a free society, whereas money can be controlled. Even if government can control nominal money, it cannot control the volume of money that is in public account. Each of us decides what part of it to spend and what part to keep idle according to the circumstances. The amount of money that we want to hold (demand for money) may differ from the amount the monetary authorities supply (either \( M>L \) or \( M<L \)). The excess of supply over demand would lead people to reduce money balance and to increase their stock of other assets. In consequence prices will go up and will bring about an increase in employment and output (if it is below full employment). Similarly, the excess of demand over supply of money will result in the reduction of demand for goods and that would reduce the price level, output and employment. This is the simplified version of quantity theory (modern).

The Keynesian theory propounds the view that real economic variables are affected by changes in ‘r’ the price paid for holding money. This is because the excess or shortage of ‘M’ affects ‘r’ and that in its turn influences the level of ‘I’. For Keynesians, money is only the close substitute for bonds or other short-term interest bearing assets as referred to above, But in modern ‘Monetarists’ view, money is not regarded as a close substitute for a small range of paper financial assets. Instead, It is regarded as an assets with certain characteristics, which cause it to be a substitute, not for any one small class of assets but more generally for all assets alike, real or financial. These writer, in other words, think that one may hold wealth in the form of human capital as well (though switching is not quick and returns not secured) in stead of holding a quantity of money or bonds etc.
The debate does not end here. Income-expenditure approach Keynesians adopt particular transmission mechanism to analyse the effects of growth of money on real economy, their approach is preceding via interest rate changes, on the other hand, monetarists do not accept this transmission mechanism and the liquidity preference theory and suggest instead that an increase in the stock of money directly affects expenditures, prices, and the returns on physical assets. Individuals according to them may establish portfolio equilibrium by purchasing either financial or physical assets, as mentioned above and there by directly affect the behaviour of the real economy via increased aggregate demand. The possibility of substitutability between money and other assets real and financial broadened by these later writers makes money a crucial and independent factor for changing the level of output, employment and prices. The change in the stock of money, for them, is not the outcome of the changes in the real economy but it is the changes in the stock of money that increases the expenditures, Prices and outputs. Therefore, to stabilize and to raise the level of output (growth) what is necessary is to regulate money supply first, and not the other way round.

5) The case with L. D. C.'s

We talked about the relationships between money and other variables in the context of developed countries such as U. S. A. or Great Britian. But the question whether growth of money affects the real economy through price changes or interest rate changes in a country like ours is a complicated issue which can be analysed only by examining the conditions and the working of the national economy. Since security market is underdeveloped and the economy still is nonmonetized, the use of money and commercial papers is limited only to the urban, selected hills, and the Terai areas. The excess money supply, in this situation, does not work through the change in the rate of interest as is the case with Keynesian system which presumes a well developed financial system, availability of commercial papers and willingness to lend and borrow Because of the imperfect financial market structure, nonmonetization of the economy together with the unwillingness to lend and borrow Keynesian transmission mechanism fails in our context. The increased money supply, i.e., money owned by public, therfore, does not affect the rate of interest to influence the investment, output employment in turn. Rather the money in public hand will be directed into different assets productive and unproductive and commodity holding. This results in the rise in the level of prices. But the further effects of rising price on investment, interest, output and employment is negligible. Since agriculture is less responsive to the changes in prices, the secondary effects is not in operation. The initial rise in price does not lead to higher production.
Similarly, rising prices and interest rate may have very weak correlation even if they may be positively related as supposed by monetarists.

Therefore, we might have portfolio adjustment and transmission mechanism similar to those of the monetarists but the resemblance does not go very far.

Further, the control over nominal money does not stop our inflationary and deflationary situations completely. If the supply rigidity of goods is one and basic cause of rising price level besides money supply, bottlenecks are to be overcome, and structural and institutional defects are to be removed side by side. Because, as we know from above, both the factors money supply and structural deficiencies are responsible for the present inflationary situation in our context. If in some respects we are closer to the 'monetarists world, while in others we are closer to the structuralists’ world. We are perhaps to strike a balance between the two policy actions.

References:-