Quantity Theory of Money

Velocity of Circulation
How many times a dollar, euro, etc. is spent purchasing finished goods and services

All Transactions
All the goods and services sold within an economy

$$M \times V = P \times T$$

Money Supply
All the money in the economy

Price Level
The price level of all goods and services in an economy

ASSUMPTIONS OF THE THEORY:

1. P is passive factor in the equation of exchange which is affected by the other factors.
2. The proportion of M' to M remains constant.
3. V and V' are assumed to be constant and are independent of changes in M and M'.
4. T also remains constant and is independent of other factors such as M, M', V and V'.
5. It is assumed that the demand for money is proportional to the volume of transactions.
6. The supply of money is assumed as an exogenously determined constant.
7. The theory is applicable in the long run.
8. It is based on the assumption of the existence of full employment in the economy.

Suppose M = Rs. 1,000, V = 4, P = Rs. 2 and T = 2,000.

Thus $MV = PT$

$Rs.\ 1{,}000(4) = Rs.\ 2(2{,}000)$

$Rs.\ 4{,}000 = Rs.\ 4{,}000$

If M increases by 50 p.c., i.e., M rises to Rs. 1,500 then P will rise by 50 p.c. from Rs. 2 to Rs. 3.

$Rs.\ 1{,}500(4) = Rs.\ 3(2{,}000)$

$Rs.\ 6{,}000 = Rs.\ 6{,}000$

or $P = \frac{MV}{T}$

$Rs.\ 3 = \frac{1{,}500(4)}{2{,}000}$

$M \uparrow \overline{V} \rightarrow M\overline{V} \uparrow \rightarrow P \uparrow, \overline{T}$

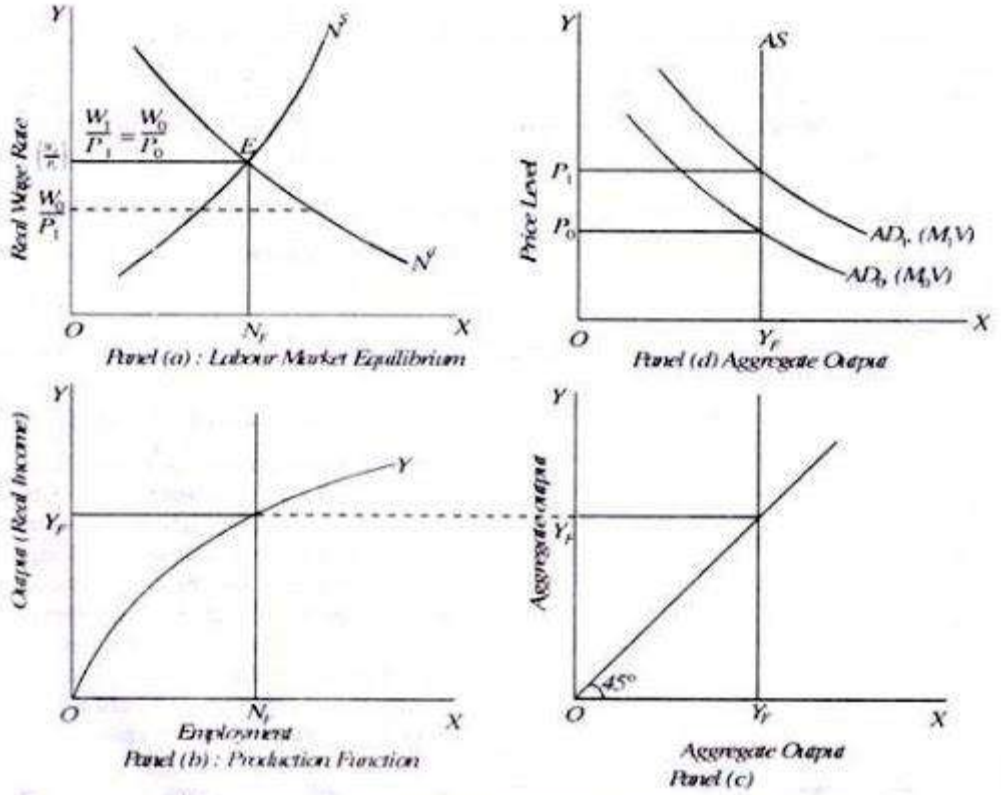

Fig. 3.7. *Determination of Income and Employemnt : Complete Classial Model*

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$\text{Rs. } 3 = \frac{1{,}500(4)}{2{,}000}$

$M \uparrow \overline{V} \rightarrow M\overline{V} \uparrow \rightarrow P \uparrow, \overline{T}$

	Classical	*Keynesian*
(1)	$Y = C + I$	$Y = C + I$
(2)	$S = Y - C = S\ (i)$	$S = Y - C = S\ (Y, i)$
(3)	$I = I\ (i)$	$I = I\ (Y, i)$
(4)	$S = I$	$S = I$
(5)	$Y = f\ (N)$ (with $f'\ (N) > O$ and $f''\ (N) < O$	$Y = f\ (N)$ (with $f'\ (N) > O$ and $f''\ (N) < O$
(6)	$D_L = f' = F(W/P)$	$D_L = f' = F\ (W/P)$
(7)	$S_L = N = N(W/P)$	$S_L = N = N\ (W/P)$ if $W \geq W_0$
(8)	$D_L = S_L$	$D_L = S_L$
(9)	$M_d = L_1 = kY$	$Md = L_1 + L_2 = KY + L_2\ (i)$
(10)	$M_d = M_s$	$M_d = M_s$

PLEASE READ THE CLASSIACAL EQUATIONS ONLY