Subject – History of Economic Thought - II
Notes Unit 1 Part B

By -

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Keynes Theory of Money

According to Keynes' construction of this so-called classical theory, if aggregate demand in the economy fell, the resulting weakness in production and jobs would precipitate a decline in prices and wages. A lower level of inflation and wages would induce employers to make capital investments and employ more people, stimulating employment and restoring economic growth. Keynes believed, however, that the depth and persistence of the Great Depression severely tested this hypothesis.

He then presented a reformulated quantity theory of money which brought about a transition from a monetary theory of prices to a monetary theory of output. In doing this, Keynes made an attempt to integrate monetary theory with value theory and also linked the theory of interest into monetary theory. But "it is through the theory of output that value theory and monetary theory is brought into just a position with each other."

Keynes does not agree with the older quantity theorists that there is a direct and proportional relationship between quantity of money and prices. According to him, the effect of a change in the quantity of money on prices is indirect and non-proportional.

Keynes complains "that economics has been divided into two compartments with no doors or windows between the theory of value and the theory of money and prices." This dichotomy between the relative price level (as determined by demand and supply of goods) and the absolute price level (as determined by demand and supply of money) arises from the failure of the

classical monetary economists to integrate value theory with monetary theory. Consequently, changes in the money supply affect only the absolute price level but exercise no influence on the relative price level.

Further, Keynes criticises the classical theory of static equilibrium in which money is regarded as neutral and does not influence the economy's real equilibrium relating to relative prices. According to him, the problems of the real world are related to the theory of shifting equilibrium whereas money enters as a "link between the present and future".

Keynes's Reformulated Quantity Theory of Money:

The Keynesian reformulated quantity theory of money is based on the following:

Assumptions:

1. All factors of production are in perfectly elastic supply so long as there is any unemployment.

2. All unemployed factors are homogeneous, perfectly divisible and interchangeable.

3. There are constant returns to scale so that prices do not rise or fall as output increases.

4. Effective demand and quantity of money change in the same proportion so long as there are any unemployed resources.

Given these assumptions, the Keynesian chain of causation between changes in the quantity of money and in prices is an indirect one through the rate of interest. So when the quantity of money is increased, its first impact is on the rate of interest which tends to fall. Given the marginal efficiency of capita], a fall in the rate of interest will increase the volume of investment.

The increased investment will raise effective demand through the multiplier effect thereby increasing income, output and employment. Since the supply curve of factors of production is perfectly elastic in a situation of unemployment, wage and non-wage factors are available at constant rate of remuneration. There being constant returns to scale, prices do not rise with the increase in output so long as there is any unemployment.

Under the circumstances, output and employment will increase in the same proportion as effective demand, and the effective demand will increase in the same proportion as the quantity of money. But "once full employment is reached, output ceases to respond at all to changes in the supply of money and so in effective demand. The elasticity of supply of output in response to changes in the supply, which was infinite as long as there was unemployment falls to zero. The entire effect of changes in the supply of money is exerted on prices, which rise in exact proportion with the increase in effective demand."

Thus so long as there is unemployment, output will change in the same proportion as the quantity of money, and there will be no change in prices; and when there is full employment, prices will change in the same proportion as the quantity of money. Therefore, the reformulated quantity theory of money stresses the point that with increase in the quantity of money prices rise only when the level of full employment is reached, and not before this.

This reformulated quantity theory of money is illustrated in Figure 67.1 (A) and (B) where OTC is the output curve relating to the quantity of money and PRC is the price curve relating to the quantity of money. Panel A of the figure shows that as the quantity of money increases from O to M, the level of output also rises along the OT portion of the OTC curve.

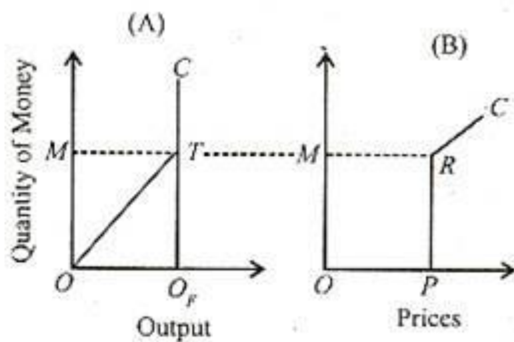

Fig. 67.1

As the quantity of money reaches OM level, full employment output OQF is being produced. But after point T the output curve becomes vertical because any further increase in the quantity of money cannot raise output beyond the full employment level OQ_F.

Panel B of the figure shows the relationship between quantity of money and prices. So long as there is unemployment, prices remain constant whatever the increase in the quantity of money. Prices start rising only after the full employment level is reached.

In the figure, the price level OP remains constant at the OM quantity of money corresponding to the full employment level of output OQ_1. But an increase in the quantity of money above OM raises prices in the same proportion as the quantity of money. This is shown by the RC portion of the price curve PRC.

Keynes himself pointed out that the real world is so complicated that the simplifying assumptions, upon which the reformulated quantity theory of money is based, will not hold. According to him, the following possible complications would qualify the statement that so long as there is unemployment, employment will change in the same proportion as the quantity of money, and when there is full employment, prices will change in the same proportion as the quantity of money."

(1) "Effective demand will not change in exact proportion to the quantity of money.

(2) Since resources are homogenous, there will be diminishing, and not constant returns as employment gradually increases.

(3) Since resources are not interchangeable, some commodities will reach a condition of inelastic supply while there are still unemployed resources available for the production of other commodities.

(4) The wage-unit will tend to rise, before full employment has been reached.

(5) The remunerations of factors entering into marginal cost will not all change in the same proportion."

Criticisms of Keynes Theory of Money and Prices:

Keynes' views on money and prices have been criticised by the monetarists on the following grounds.

1. Direct Relation:

Keynes mistakenly took prices as fixed so that the effect of money appears in his analysis in terms of quantity of goods traded rather than their average prices. That is why Keynes adopted an indirect mechanism through bond prices, interest rates and investment of the effects of monetary changes on economic activity. But the actual effects of monetary changes are direct rather than indirect.

2. Stable Demand for Money:

Keynes assumed that monetary changes were largely absorbed by changes in the demand for money. But Friedman has shown on the basis of his empirical studies that the demand for money is highly stable.

3. Nature of Money:

Keynes failed to understand the true nature of money. He believed that money could be exchanged for bonds only. In fact, money can be exchanged for many different types of assets like bonds, securities, physical assets, human wealth, etc.

4. Effect of Money:

Since Keynes wrote for a depression period, this led him to conclude that money had little effect on income. According to Friedman, it was the contraction of money that precipitated the depression. It was, therefore, wrong on the part of Keynes to argue that money had little effect on income. Money does affect national income.

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