Mona
Assistant professor (Guest Faculty)
Department of Economics
Maharaja College
Veer Kunwar Singh University, Ara
B.A Economics

Cambridge Cash Balance Approach

Introduction

The cash balance approach was formulated by Cambridge Economists Marshall, Pigou, Robertson and Keynes. Like value theory, they regarded the determination of value of money in terms of demand and supply. Cambridge cash balance approach focuses on the money demand instead of supply of money.

According to Robertson, Money is only one of the many economic things. It's Value,. Therefore,is primarily determined by exactly nomic things.Its value, therefore,is primarily determined by exactly the same two factors as determine the value of any other thing; namely, The conditions of demand for it and availability of quantity of money.

The supply of money is an exogenous factor that is determined by the central bank of the country whereas The demand for money is the demand to hold cash balance for transaction and precautionary motives.
Cash balance approach considers the demand for money not as a medium of exchange but as a store of value. When demand for money increases , people will reduce their expenditure on goods and services in order to have larger cash holding.Reduced demand for goods and services will bring down the price level and raises the value of money.On the contrary, fall in the demand for money will raise the price level and lower the value of money.

Cambridge Analysis:

Cambridge approach paid more attention on Demand for money rather than the supply oriented classical version.They argued that a certain portion of the money supply will not be used for transportation,instead,it will be held for the convenience and security of having cash on hand. The portion of cash is commonly represented as k, a portion of nominal income(the product of price and real income i.e; PY)
The Cambridge Economists also thought wealth would play a role,but wealth is often omitted from the equation for simplicity. The Cambridge equation is this:

$$Md= k.P.Y$$

Assuming that the economy is at equilibrium (Md=Ms),Y is exogenous,and k is fixed in the short run,the Cambridge equation is equivalent to the equation of exchange of Fisher with velocity equal to the inverse of k(i.e; v = 1/k)

Equation of Exchange:

$$MV = PY$$

Now putting v=1/k in the Fisher's equation of exchange.we will get;

$$M.1/k= P.Y$$

$$\text{or} \quad P= M/kY$$

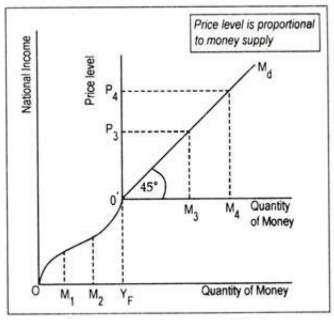

Fig. 4.1: Quantity of Money and Price Level

Explanation of the diagram:

This diagram is interesting in the sense that it first establishes the relationship between money supply and national output or national income below the full employment stage(YF).

Now the relationship between Ms and Price level can be established assuming O as the origin.Before the attainment of full employment (YF),an increase in money supply(Om1 to OM2 and to OYF) causes national income to rise more rapidly than the price level.

By utilising its resources efficiently and fully,an economy can increase its output level by increasing the volume of investment consequent upon an increase in Ms.
Since there is a limit to output expansion due to full employment,an increase in Ms from (M3to M4) will cause price level to rise from (P3 to P4) proportionally(shown in the upper panel)
For stability in Price level money supply should grow in proportion to increase in output.

Criticisms:

- **This theory is incomplete because it ignored the speculative demand for money which is considered one of the most important determinants for money holding.**
- **Another defect of the Cambridge equation" lies in its applying to the total deposits considerations which are primarily relevant only to the income deposits". And the importance attached to k is misleading when it " is extended beyond the income deposits"**

- **Cash balance approach does not tell about changes in the price level due to changes in the proportions in which deposits are held for income, business and savings purposes.**
- **The Cambridge equation like the transaction equation assumes k and Y as constant. This is unrealistic because it is not essential that the cash balances(k) and the income of the people (Y) should remain constant even during Short period.**
- **According to Patinkin, Cambridge Analysis laid an undue concentration on the money market a corresponding neglect of commodity markets, and a resulting "dehumanising of the analysis of the effects of monetary changes"**
- **This theory ignored The Real balance Effect. The real balance Effect shows that a change in the absolute price level does influence the demand and supply of goods. The weakness of Cash balance approach is in ignoring this.**

***