Mohamed Khaider University, Biskra

Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: Commercial Sciences
Level: Second year Bachelor

Lecture 06: Demand for Money

The demand for money arises from its function as a medium of exchange and as a store of value. Hence individuals, households and firms wish to hold money partly in cash and partly in the form of fixed asset.

Learning Objectives

By the end of this lecture, you should be able to:

- Explain the motives for holding demand

- Describe the Quantity Theory of Money

- Understand

1- Demand for Money

In monetary economics, demand for money refers to the desired holding of financial assets in the form of money, that is, bank deposits or cash rather investments. This means total amount of money balances that people want hold for certain purposes

2- The Quantity Theory of Money

The classical theory of money is based on two major assumptions: (i) First is the Say's law of market which states that supply creates its own demand, that is, the sum of values of goods produced is the equal to the sum of values of goods consumed. (ii) Second is the assumption of full employment.

A- Fisher's Quantity Theory of Money

The Irving Fisher's Quantity Theory of Money (QTM) hypothesis states that any change in the quantity of money produces an exactly direct and proportionate change in the price level and the value of money decreases and vice versa. In other words, money is demanded for transaction purposes. Fisher's equation is represented as:

$MV = PT$…………………(1)

M; stock of money

V; the velocity of circulation of money – the number of times a unit of money changes hand-

P; the general price level or index of prices

Equation (1) explains the total stock of money used for transactions as equal to the value of goods sold in the economy. If both *V* and *T* are constant, then changes in *M* must cause changes in *P* to preserve the equality between *MV* and *PT*. It exists a direct and proportional relation between *M* and *P*.

3- Keynes' Liquidity Preference Approach

Keynes in his General Theory used a new term 'liquidity preference' for the demand for money. He highlighted three motives for the demand for money namely; transactionary, precautionary and speculative motives.

A-The Transactions Demand for Money: As a medium of exchange, money is held for the regular payment for goods and services. This means that money is held in cash for immediate transactions of business and personal exchanges. Transactions demand for money depends upon the level of income, business turnover, interest rate and period between receipts and disbursement of income. Transactions demand for income is directly related to income and is expressed as:

L1 = KY

Where ***L1*** is the transactions demand for money, ***K*** is the proportion of income kept for transactions purpose and ***Y*** is income.

B-The Precautionary Demand for Money: This is the provisions to cater for emergencies and contingencies or to provide for unexpected expedition. Individuals reserve cash for unexpected needs such as illnesses, accidents and other unforeseen circumstances. Businesses also keep cash in reserve to take care of unfavorable conditions or to gain from unexpected deals. According to Keynes, the precautionary demand for money is a function of income level.

D-The Speculative Demand for Money: Money held for speculative purposes is a liquid store of value for investment in an interest-bearing securities or bonds. Speculative demand for money is inversely related to interest rate. The higher the rate of interest, the lower money will be demanded for speculative purposes and vice versa