1. Discuss Keynes’s Theory of money and prices. Is it the correct explanation of changes in price level?

Ans: The traditional quantity theory of money and the quantity equations do not show how a change in the quantity of money reacts upon the price level. Keynes tries to tackle this aspect of the problem in his General Theory by a restatement of the quantity theory. In doing so, he tried to integrate the theory of money with the theory of employment. To Keynes, the effect of changes in the quantity of money on the price level (in turn, the value of money) should be visualised through the inter-related effect on the wage rate, income, investment, employment, etc.

Thus, an increase in the quantity of money will have no affect whatsoever on prices, so long as there is any unemployment, and that employment will increase in exact proportion to any increase in effective demand brought about by the increase in the quantity of money.

While, as soon as full employment is reached, wage rate and price will increase in exact proportion to the increase in effective demand. Hence, Keynes enunciated the quantity theory of money as follows: “So long as there is unemployment, employment will change in the same proportion as the quantity of money.”

To elucidate this point, Keynes first considers the effect of changes in the quantity of money on the quantum of effective demand; the increase in effective demand is supposed to be spent partly in increasing the quantity of employment and partly in raising the level of prices. Thus, Keynes conceived a condition where prices rise gradually as employment increases, instead of prices rising in proportion to the quantity of money, which is true in a condition of full employment, as assumed by the classical theorists.

Keynes stressed that there is no direct link between money supply and price level, but there is a series of causal links between the two. Changes in the quantity of money first affect the rate of interest, which in turn, affects the investment function and the level of effective demand and consequently the volume of employment and output.

Say, if money supply increases with a given demand for money, the rate of interest will fall. Given the marginal efficiency of capital, a fall in interest rate will induce an increase in investment. With an increase in investment expenditure the level of effective demand will go up. Increased investment leads to an increase in the level of employment, output and income. There is a multiplier effect involved in the process of income propagation, based on the phenomenon of marginal propensity to consume and consequent changes in the flow of consumption expenditure. So long as there is enough of unemployed labour and capital resources, an increase in the quantity of money would, in this way, lead to increase in real income or output (that is, T in terms of Fisher’s equation of exchange) rather than price level. In short, the general level of prices will not rise as output increases on account of increase in money supply, so long as there are efficient unemployed resources of every type available.

But, as output increases, a series of bottlenecks will be successively reached, where the supply of particular commodities ceases to be elastic and their prices tend to rise sharply.

After a full employment stage is reached, an increase in the quantity of money spends itself entirely in raising the price level because, an increase in effective level caused by the increased quantity of money would not be to increase the volume of employment and output. Hence, its full effect will be on raising the level of prices. Thus, every increase in the quantity of money is associated with an exactly proportionate increase in the price level and vice versa under full employment condition.

Keynes further stressed that Fisher’s quantity theory of money, in terms of the equation of exchange (MV = PT), holds well only in a state of full employment.

Keynes’ restatement of the quantity theory marks a great improvement over the Fisherian version, in the sense that he views the role of money in the causal process via consumption, investment, liquidity preference, and the rate of interest.

By formulating the quantity theory of money, he maintains that there is an extreme complexity of the relationship between prices and the quantity of money, in contrast to the simple immediate relationship exposed in the quantity equations given by Fisher and by the Cambridge economists.

Keynes holds the old fallacy that prices are determined directly by the quantity of money. He shows that prices are determined directly by the quantity of money and are influenced indirectly through the effect of changes in the quantity of money upon the rate of interest, which is one of the three strategic variables determining the level of output and employment. (The original efficiency of capital and the propensity to consume are the other two variables).

Keynes, in short, viewed that changes in P do not affect M directly but they do so indirectly through a host of strategic factors, such as the rate of interest, level of investment, employment, income and output.

According to Keynes, the quantity theory of money would be valid if the elasticity of money prices is unity.

However, no such direct relationship could exist between the quantity of money and the price level, except in a full-employment phenomenon.

So long as there is unemployment, employment will change in the same proportion as the quantity of money; when there is full employment, prices will change in the same proportion as the quantity of money. That means, so long as there is any unemployment, a sufficient increase in M can always bring about full employment; a further increase in M will be reflected in the rise of P. This is illustrated. M rises from zero to OM, real output rises up to OF, at full employment level of the given resources. A further rise in M leads to a proportionate rise in P as depicted by FP the price curve. Though a price rise is considered a post-full-employment phenomenon, during the transition period, however, before full employment is reached, with an increase in M, P may rise, though not proportionately due to the following reasons: (i) increased bargaining power of workers leading to a rise in wages and a high cost of production; (ii) operation of the law of diminishing returns, causing increasing costs; (iii) bottlenecks in production, such as shortage of raw materials, power cuts, lack of adequate transport, and immobility of factors; and (iv) heterogeneity of factors, especially labour