Restatement of Quantity Theory of Money: Prof Milton Friedman’s Approach

Permanent Real Income Hypotheses

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Need for Restatement of QTM:

- **The Traditional QTM was having the impact of The Great Depression.**
- **The Theories were of the opinion that, there is direct and proportionate relationship between the Quantity of money supply and the Price Level, but during that period, many countries did not observed the same.**
- **Prof. Milton Friedman of Chicago University, America; published a paper "The Quantity Theory of Money- A Restatement" in 1956.**
- **Here again the concept of Velocity of circulation of money was the center of controversy as prof. Milton Friedman was not having similar approach as it was by the Traditional economists.**

Restatement of the QTM:

- The Medium of Exchange function of money is the main function that has to be taken into consideration at the time of talking about the QTM.
- The amount of real income is also an integral factor which affects the Price level, but Income elasticity of demand for money is not equal to unity. According to Friedman it is greater than Unity.
- An increase in Real Income lead to more than a proportionate increase in the demand for real cash balance.
- The demand for money depends on three major factors:
  1. The total wealth to be held.
  2. The price and the return on his form of wealth.
  3. The taste and preferences of the wealth owing class.

Concept of Permanent Real Income

- **The permanent real income refers to the amount of income which an individual can enjoy during a given period without in any way reducing his wealth.**
- **The concept of Permanent Real Income is , in fact, the concept of wealth. According to Friedman, there are five broad ways to hold wealth:**
  1. **Money: to hold purchasing power, to have command over goods and services and for the discharge of debts and obligations.**
  2. **Bonds: to earn interest**
  3. **Equities: This is the asset which ensures the perpetual income in the form of dividend.**
  4. **Physical goods: Movable or Immovable assets which can be the sources of Income.**
  5. **Human Wealth: Skill, Training and productive efficiency of an individual.**

Prof. Milton Friedman's Equation:

- $\frac{M}{p} = f\left[y, w, rm, rb, re, \frac{1}{p}, \frac{dp}{dt}, u\right]$
- Here,

M = money stock

P = price level

Y = permanent income

W = ratio of non human wealth to human wealth

Rm = expected rate of return on money

Re = expected rate of return on bonds

Re = expected rate of return on equities

$\frac{1}{p}\frac{dp}{dt}$ = the expected rate of return on real assets

U = other factors except income

Basic features of Friedman's theory:

- **Conceptual integration of Income and Wealth. Wealth is a means to earn income; and special emphasis on Human Wealth which was neglected so far.**
- **Introduction of Permanent Real Income i.e. expected yield on wealth. The demand for money is the function of Permanent Real Income.**
- **The term money has been used in a wider sense as currency, demand deposits and time deposits are included.**
- **To ensure price stability the supply of money should increase slightly more than that of the growth rate.**
- **In cash balance approach only cash balance or the bank's cash reserve was the main factor taken into account but here all types of assets are taken into account.**

Limitations of the Theory:

1. It is not advisable to include the time deposits in the course of Money, as on withdrawal of such deposits, the depositor have to lose interest or may have to pay some penalties. Therefore these kind of assets should be treated as Near money.
2. Friedman has also neglected the effect of rate of interest on the demand for money as all the other approaches has done.
3. The assumption that the money supply is independent to the changes in the price level and income is not true.
4. The Friedman's theory can not be said a Restatement as he just presented the general approach in his own words.
5. The ratio of non human wealth to human wealth and the other factors then Income (w and u) are subjective in nature. (cannot be measured)
6. It is difficult to keep the steady rate of money supply in the modern and dynamic economy.