4. CRITICISM OF THE CASH BALANCE APPROACH

Although the cash balances approach seems to be a distinct improvement upon the transactions approach, yet it suffers from certain shortcomings which are given below :

(i) *Tautology* : Whichever way the Cambridge equation is stated, M = KPO, M = KPT or M = KY, it is just as much a tautology as the transactions equation. The theory suffers from the circular reasoning since, on the one hand, it assumes that the value of money or price level is determined by the cash holdings (K) of the community and, on the contrary, it suggests that the value of money or price level determines the amount of cash held by the people.

(ii) ***Not dynamic proper analysis*** : The cash balances approach provides a set of equations which are merely exercises in comparative statics and are too simple to analyse a dynamic economic system. As a part of monetary theory, the approach proves to be inadequate to explain the dynamic price behaviour in the economy.

(iii) ***Narrow approach*** : A very notable drawback in the cash balance equations is that they deal with the value of money in terms of consumption goods alone. This is a very narrow view of the determination of price level. It is quite illogical to restrict the concept of the purchasing power of money only to the consumption goods like wheat.

(iv) ***Excessive emphasis on real income*** : This approach lays excessive emphasis upon the real income as a determinant of K. This tendency makes the Cambridge economists ignore other important determinants of K like the price level, extent of business integration, monetary and banking habits of the people and the level of economic development.

(v) ***Constancy of K and T*** : The cash balances approach, just like the transactions approach, assumes K and T as constant. Thus it is liable to all such criticism as is levelled against Fisher's transactions approach.

(vi) ***Purposes of holding*** : The levels of income, output and employment are also influenced by the changes in the proportion in which deposits are held for different purposes, *viz.*, saving, investment *etc*. The cash balance equation fails to take into account such changes.

(vii) ***Neglect of thrift, productivity etc.*** : In any comprehensive theory of the value of money, it is essential to consider the elements like thrift, productivity and liquidity preference etc. but the cash balance equation tends to overlook these elements.

(viii) ***Neglect of distribution of general demand between consumer and capital goods*** : Another flaw in the Cambridge equation is that it fails to take cognisance of the distribution of general demand between the capital goods and consumer goods and its effect upon income, output, employment and prices.

(ix) ***Fails to determine the extent of change in prices and output in relation to variations in money supply*** : The Cambridge approach, no doubt, recognises that changes in the quantity of money can bring about short run changes in prices and output, yet it fails to explain by what extent the prices and output change as a consequence of a change in the supply of money.

(x) ***Ignores liquidity preference among different groups*** : The changes in the cash balances held by different groups of the people exercise a significant impact upon the prices and output. The cash balance equations take into account simply the overall changes in the proportion of cash held by the community out of their real income. But it fails to take into account the changes in the liquidit preference among different groups.

(*xi*) ***Absence of complete analysis of demand for money*** : A very significant flaw in the cash balances approach is that the total demand for money in the community has not been properly analysed. The theory essentially supposes that the cash is held by the community to buy the total output. Thus the demand for money is regarded primarily as a medium of exchange. The precautionary motive for holding cash finds a vague and incidental mention in this analysis and speculative demand for money or the assets demand for money has been entirely neglected.

(*xii*) ***Omission of rate of interest*** : If the asset demand function of money is ignored, it amounts to the assumption that money is used exclusively for carrying out transactions and that the changes in the quantity of money leave rate of interest unaffected and hence there is no explicit role for interest rate in economic activity. In this respect, the cash balances approach, therefore, remains secluded from the whole body of the monetary theory. In the words of Patinkin, "In particular, they cannot serve to validate the classical proposition that a change in the amount of money leaves the rate of interest unaffected. Indeed, not only can they not help, they hinder. For the omission of the rate of interest from the cash balance equation creates the misleading impression that the classical invariance of this rate holds only in the special case where it does not affect the demand for money."

(*xiii*) ***Uniform unitary elastic demand*** : The cash balances approach rests on the proposition that the demand for money has uniform unitary elasticity, since an increase in K leads to an equi-proportionate fall in the price level and vice-versa. Such a possibility, according to Patinkin, does not exist as the demand function for money is less than uniform unitary elastic.

(*xiv*) ***Neglect of real balance effect*** : This approach is deficient, according to Patinkin, also because it fails to recognise the real balance effect.

Despite all these shortcomings, the cash balances approach has made positive contribution to the monetary theory in respect of approaching the problem of determining the value of money from a more strategic angle—the demand for money.