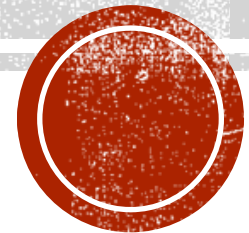


# **MAHATMA GANDHI CENTRAL UNIVERSITY**

**MONETARY ECONOMICS : ECON4010**

UNIT – 2 (Demand for Money)



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# Friedman's Demand for Money Function

Friedman's theory of demand is partly Keynesian and partly non-Keynesian.

Friedman's theory of demand for money is a wealth theory of demand. In his view, money is a durable consumer good held for the services it renders, and yielding a flow of services proportional to the stock. Money is demanded as an asset of capital, as such the theory of demand for money is a part of the theory of capital.

In examining the demand for money, Friedman presumes that people do hold money and rather than investigating the motive behind liquidity preference he sought to find out how much they would seek to hold under different conditions.



Considering money like a durable good, Friedman states that it is also subject to the law of diminishing marginal rate of substitution, i.e with an increase in the stock of money held, its value tend to diminish relative to the services other assets are rendering.

**Demand for money is assumed to depend on three major factors-**

- a) Total wealth to be held in various forms of assets.
- b) Relative price of and return on one form of wealth as compared to other forms.
- c) Taste and preference of the wealth holders.

**Cost of holding cash balance is influenced by-**

- a) The rate of interest
- b) The expected rate of change in price level.



An increase in the rate of interest or the price level causes a declining in the cash balances and vice-versa.

Thus, Friedman distinguishes five form of asset in which wealth can be held-

- a) Money
- b) Bonds
- c) Equities
- d) Physical and non-human goods
- e) Human capital.



The demand function for money, as formulated by Friedman-

$$M = f ( P , Y , 1/P \cdot dP/dt , r_b , r_e , w , u )$$

Where,

M = aggregate demand for money.

P = general price level.

Y = total flow of income.

$1/P \cdot dP/dt$  = size of a nominal returns in the form of appreciation or depreciation in money value, per rupee of real asset- physical goods- which together with P implies the rate of return on these assets.

$r_b$  = bond yield the market Bond interest rate.

$r_e$  = equity yield, the market interest rate of equities.

w = ratio of non human to human wealth, it is closely linked to the ratio of wealth to income.

u = Utility determining variables which tend to influence tastes and preference.



Demand function for money in equation 1st is independent of the normal unit used for measuring money variables.

Further, the amount of money demand changes proportionately to the changes in the unit in which prices and money income are expressed. Hence, The equation expresses the first degree homogeneous function of P and Y.

Thus,

$$\lambda M = f(\lambda P, \lambda Y, 1/P \cdot dP/dt, r_b, r_e, w, u)$$

If  $\lambda = 1/P$ , then

$$M/P = f(Y/P, 1/P \cdot dP/dt, r_b, r_e, w, u)$$

Thus, The equation represents demand for money as a demand for real balances, as a function of “real” variable, independent of monetary values.



According to Friedman,  
Money is a luxury like durable consumer goods, with a change in per capita income peoples standard of living changes and as result, they may desire to hold cash balances more or less accordingly to the change in the per capita income. But income to which cash balance are adjusted is permanent income rather than current income.



**Thank You**

