# THE INAPPLICABILITY OF THE QUANTITY THEORY OF MONEY IN IRAN*

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Some 12 years ago Professor Alvin Hansen of Harvard declared that the Quantity Theory of Money was a more or less correct explanation of price fluctuations in "poor and underdeveloped" countries.

In 1956 Alexander Chabert, a French writer inured in the Hansen teaching, confirmed the latter's theory in his "Structure Economique et Theorie Monetaire". Around the same time Don Patinkin provided further general evidence in support of the Quantity Theory.

If the theory is applicable in Iran, then we should expect "the general level of prices" to be invariably a direct function of the volume of money in circulation.

In this paper we shall deal with:

1. A brief review of the theory.
2. Arguments put forth by the proponents of the theory.
3. Arguments refuting the validity of the theory in Iran.

## 1. A Brief Review of the Theory

The Quantity Theory of Money is one of the oldest and most well-known economic theories and has unshakably held on throughout the 19th. and early 20th century. Until the advent of the writings of Wicksell and Keynes no one dared question its validity.

It aims to explain long-run fluctuations in the general level of prices and goes on to show a direct functional relationship between the quantity

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of money in circulation and the level of prices. It relies on the principle that money affects the level of prices only and not the other variables; that it is, in short, neutral and devoid of a dynamic role in the economy.

The first writer to present the Quantity Theory of Money in mathematical symbols was Ricardo with his simple equation

$$M=PT$$

Later economists, like John Stuart Mill, Irving Fisher and Alfred Marshall elaborated it further but at the same time they reduced its simplicity and rigidity. For in Ricardo's formula a variation in M (volume of money in circulation) caused a proportionate variation in P (the level of prices) because T ( the volume of trade ) was considered to be constant. Irving Fisher's introduction of M' ( bank accounts ) , V ( velocity of circulation of money) and V' (velocity of circulation of bank money) produced the celebrated equation

$$MV+ M'V'=PT$$

which did away with the Ricardian simplicity.

The proponents of the Quantity Theory, which had once been presented as a theory of general application,now consider it to be a valid expression of economic phenomena generally throughout underdeveloped economies but only in certain circumstances in industrial countries .

**Arguments Put Forth by the Proponents of the Theory**

Chabert argues that if the theory held good in 18th century France it should also hold good in present day economies which are in somewhat similar circumstances. The reasons put forth by the proponents of this view are:

a) Underdeveloped countries are in general producers of either agricultural products or of raw materials which are almost wholly exported.

In the first case agricultural production is subject to natural causes and hence price variations can affect production only to a very small extent. In the second case production of materials depends upon world markets and not upon internal conditions in the producing country.

b) Underdeveloped countries do not exploit all their resources and the labour force is subject to chronic under-employment, with the result that labour productivity is low ; they live for the present and do not save; their spatial mobility is low. Thus their whole ecnomic structure is such that production is not readily expandable in response to increased money flow.

c) Banking and credit institutions are undeveloped: even if production is increased its effect is neutralized by population increase.

Under these conditions, even if money incomes are increased (through a budget deficit, bank credits or foreign loans) the result is that prices will go up rather than production.

## Arguments Refuting the Validity of the Quantity Theory

It should first be pointed out that contrary to what is generally thought the Iranian economy is not a « simple» one where the Quantity Theory would hold its own. In fact it is anything but simple owing to State intervention, the Third Plan and the existence of numerous banks. Secondly, it should be realized that I8th century French economy was very much different from the present day Iranian econmoy, because:

- If France was undevloped in the 18th century, so were the other countries; and the general productivity of the French worker was not lower than that of other workers so as to put a premium on imports.
- If the French economy was based on agriculture it did not have oil, with which foreign goods could be imported to neutralize inflationary tendencies.
- 18th century France was not subject to State intervention to the extent that Iran is; neither were there so many banking facilities.

Other arguments against the applicability of the analogy are:

1. Whilst it is true that Iranian agricultural production is dependent upon climatic conditions and has little bearing upon prices, it must be realized that dam construction programmes, road building and communication networks and agricultural credit facilities are helping both to increase agricultural production and to market a larger proportion of the product that used to go to waste because of lack of transportation.

2. Even though income from oil is determined by factors outside of the Iranian economy, it is still possible to utilize the foreign currency so earned for the import of essential commodities and machinery.

3. It is said that the propensity to consume is high in Iran and that there are no savings. This is not true–savings are admittedly low, but statistics of bank deposits show a continual increase in savings.

4. It is contended that the Iranian «lives for the present.» But the Iranian peasant stores a good part of his product at harvest time; the civil servant purchases a good portion of his months requirements at the beginning of the month; and in particular, during periods of inflation the businessman delays to-day's sales for to-morrow and the public generally puts forward to morrow's purchases for to-day.

5. Finally, conclusive evidence refuting the validity of the contention that increases in the volume of money in circulation cause direct and proportionate increases in the level of prices can be furnished by quoting, without comments, statistics compiled by the Bank Melli Iran.

Table 1. Volume of Money in Circulation, Wholesale Prices and Cost of Liviny in Iran (1951-1960)

| Year | Vol. of Money in Circulation[1] (MillionRls.) | Index | Index of Wholesale Prices | Index of Cost of Living |
|---|---|---|---|---|
| 1951 | 13,418 | 100 | 100 | 100 |
| 1952 | 15,399 | 115 | 106 | 107 |
| 1953 | 20,067 | 149 | 136 | 117 |
| 1954 | 21,632 | 161 | 150 | 136 |
| 1955 | 23,078 | 172 | 145 | 138 |
| 1956 | 26,447 | 197 | 156 | 150 |
| 1957 | 31,387 | 234 | 153 | 157 |
| 1958 | 38,917 | 290 | 151 | 158 |
| 1959 | 37,924 | 283 | 158 | 175 |
| 1960 | 48,344 | 360 | 170 | 188 |

1. Current bank deposits, bank notes and coins in circulation.

**Source: Bank Melli Iran.**

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