Quadrant II – NOTES

Paper code: ECO0115

Module name: Keynesian liquidity preference theory of interest

Module No: 58

<u>Keynesian liquidity preference theory of interest</u>

- In his book" General theory of employment, interest, money" Keynes gave his view of interest.
- According to him "interest is the reward for parting with liquidity for specified period"
- Liquidity preference means the demand for money to hold or the desire of public to hold cash.
- **The Demand for Money or Liquidity Preference:**
- The three motives for keeping liquid are the transaction motives, the precautionary motive and the speculative motive. There are three reasons for which money is demanded.
- **We study them in detail:**
- **1. Transaction Motive:**
- Transaction motive refers to the demand for money for current transactions by households and firms. Households need cash so as **"to bridge the interval between the receipt of income and its expenditure."** Between the periods of receiving pay packets, house-holders have to enter into transactions for meeting their daily needs
- People are paid weekly or monthly while they spend day after day. A particular amount of cash, therefore, has to be kept for making purchases. The amount of cash needed for current transactions by a particular household depends upon its size of income, the interval of time after which income is received and the mode of payment
- **Precautionary Motive:**
- Households and business concerns need some money for precautionary purposes because they have to take precaution against unforeseen contingencies like sickness, fire, theft and unemployment.
- The amount of cash needed for taking this precaution will depend upon an individual's psychology, his views about the future and the extent to which lie wants to ensure protection against such unforeseen events.
- Similarly, businessmen also hold cash to safeguard against the uncertainties of their business
- **3. Speculative Motive:**
- The third and most important motive of the demand for money is the speculative motive. Keynes assumed that people hold either cash or bonds as wealth. They shift-from cash to bonds as they expect the rate of interest to change. People keep cash with them to take advantage of the changes in the price of bonds and securities in the capital market. In advanced countries, of

which Keynes was writing, people like to hold cash for the purchase of bonds and securities when they think it profitable.

- If people expect that the prices of bonds and securities are going to rise, they like to purchase them, for they are attractive, and do not keep cash with them. On the other hand, when they feel that the prices of bonds and securities are going to fall in the near future, they get detracted away from them and demand more cash

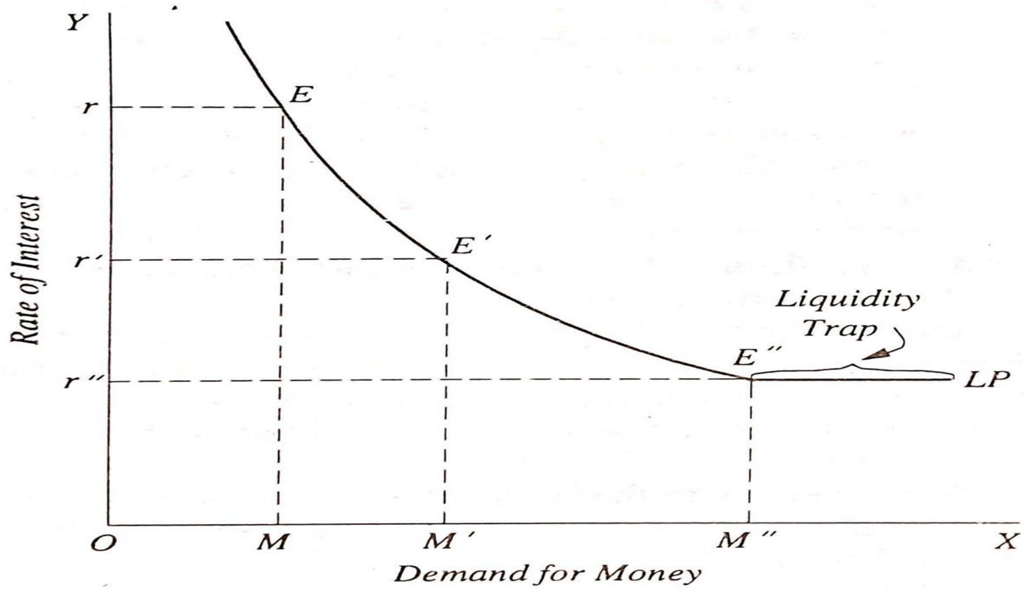

Fig. 52.5. Liquidity Preference for Speculative Motive.

- The demand for money under speculative motive at a higher current rate of interest, increasing as the interest rate falls and decreasing as the interest rate rises.
- Thus demand for money under this motive is a decreasing function of the rate of interest.
- The liquidity preference curve LP is a downward sloping towards right
- Which means high current rate of interest, the lower the demand for speculative motive and vice versa.
- At high current rate of interest Or a very small amount OM is held for speculative motive.
- This is because at high current rate of interest much money will be kept as inactive balances.
- If rate of interest falls to Or’ then greater amount OM’ is held under speculative motive.
- With further fall in the rate of interest to Or” morny held under speculative motive increases to Om”.
- Liquidity preference curve becomes quite flat i.e. perfectly elastic at a very low rate of interest, it is horizontal line beyond point E” towards the right.

- This perfect elastic portion of liquidity preference curve indicates the portion of absolute liquidity preference of the people.
- That is at very low rate of interest people will hold with them as inactive balances any amount of money they come to have.
- This portion of liquidity preference curve with absolute liquidity preference is called liquidity trap

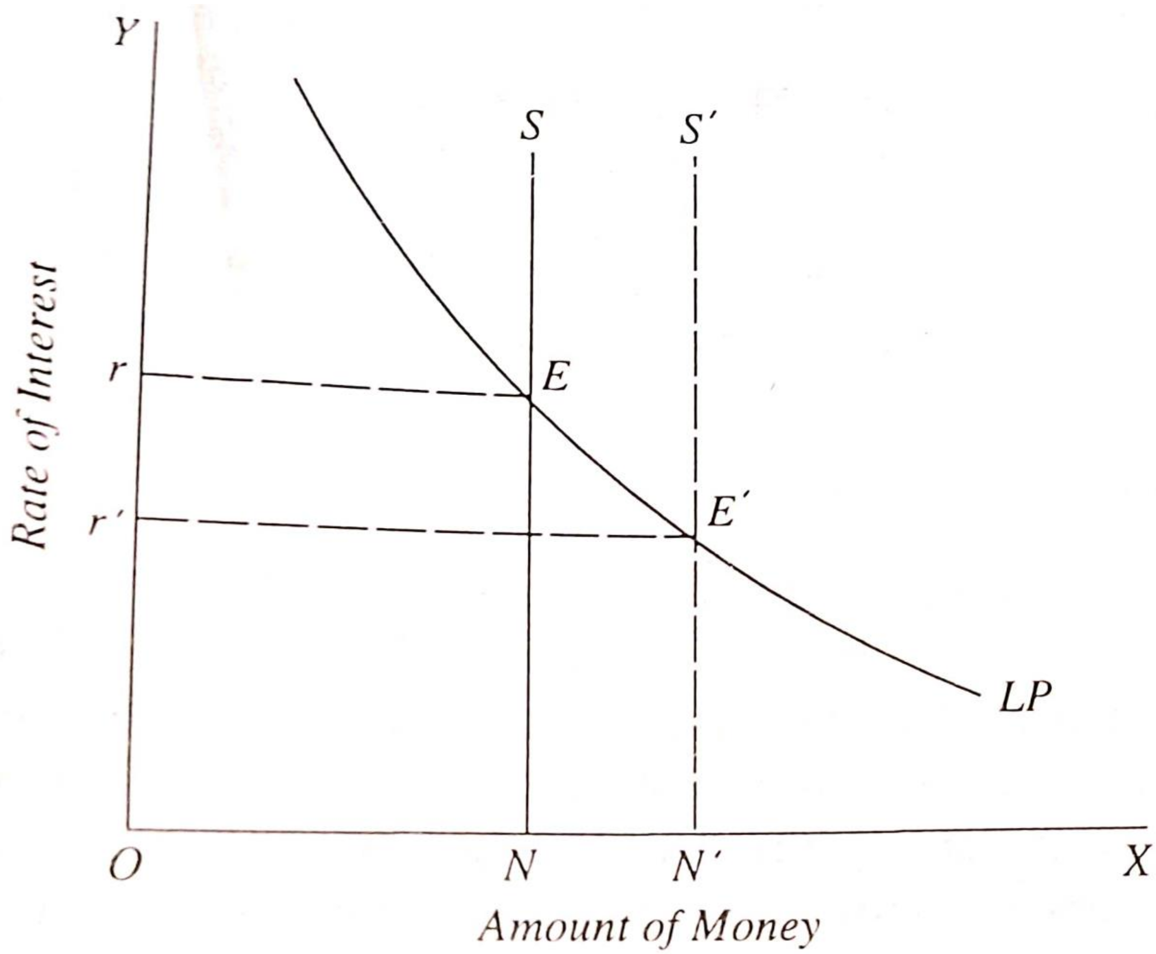

Fig. 52.6. **Equilibrium between Demand for and Supply of Money.**

- Determination of the rate of interest: interaction of liquidity preference and supply of money
- According to Keynes, the demand for money i.e. the liquidity preference and supply of money determines the rate of interest.
- It is in fact the liquidity preference for speculative motive which along with the quantity demanded of money determines the rate of interest.

- How the interest is determined is shown in diagram below
- LP is the curve of liquidity preference for speculative motive, it shows the demand for money for speculative motive.
- ON is quantity of money available for satisfying liquidity preference for speculative motive.
- Rate of interest will be determined where the speculative demand for money is in balance or equal to ON quantity of money at Or rate of interest.
- Hence ‘Or’ is the equilibrium rate of interest