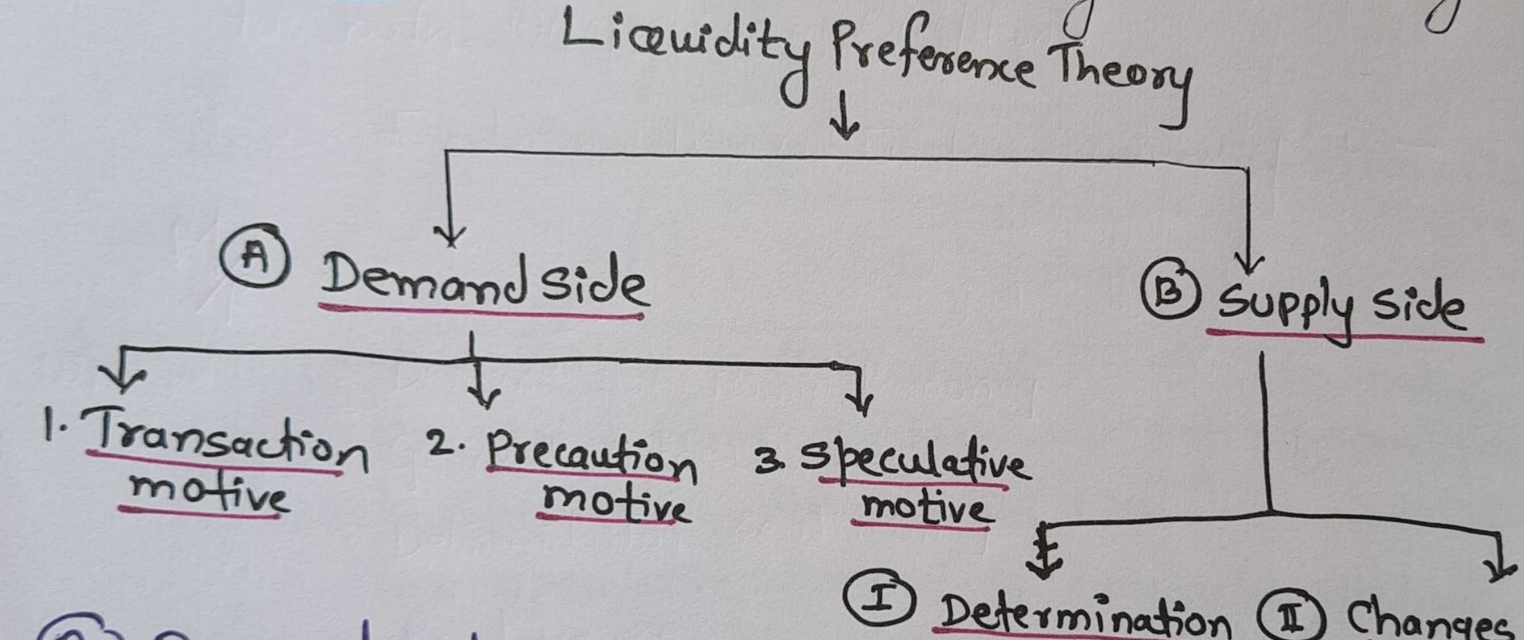
10. Liquidity Preference Theory of Interest

Q:1 Explain Keyne's Liquidity Preference Theory of Interest?

(A) Keynes Liquidity Preference Theory of Interest:-

Theory of Liquidity Preference Theory is well developed by modern Economist - J. M. Keynes. According to him Rate of Interest is a Purely monetary concept which is determined by Demand for and Supply of money. Interest is a reward for parting with Liquidity.



(A) Demand Side:- The desire of People to hold assets in the form of liquid Cash is known as Liquidity Preference. Greater the liquidity Preference higher the rate of interest and Vice Versa.

According to Keynes People have three motives to hold cash -
1) Transactionary Motive
2) Precautionary Motive
3) Speculative Motive.

1. **Transactionary Motive:-** " People need cash to meet day-to-day transaction is called Transaction Demand for money "

It is affected by – Level of Income,
Time interval of Receipt of Income,
Price Level,
Standard of living etc.

Symbolically $L_t = F(y)$

2. Precautionary Motive :- " Demand for cash to meet Unexpected Contingencies like- accidents, Sickness, Unemployment etc. is called Precautionary Demand for Cash. "

It is also affected by Level of Income.

Symbolically $L_p = F(y)$

Now - Active Cash balance = Transaction motive + Precaution motive

$$L_1 = L_t + L_p$$

3.) Speculative motive :- " Demand for cash to make Speculative gains from Purchase and Sell of securities is called Speculative Demand for Cash."

This speculative demand is inversely related with Rate of Interest. It is Interest-elastic

Symbolically - $L_2 = F(r)$

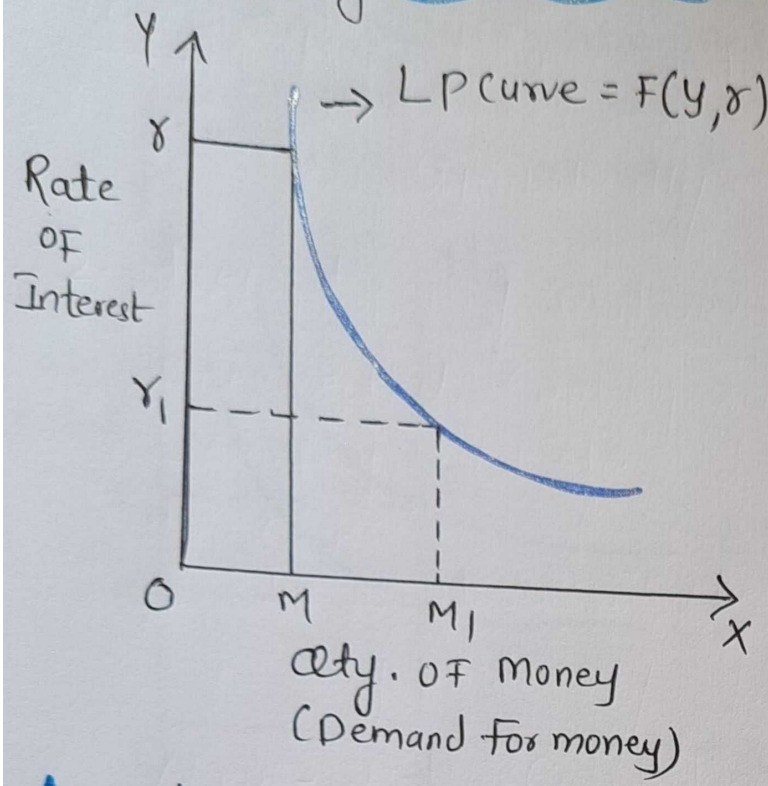
4) Total Demand for money :- The aggregate demand for money include Demand for Transaction, Precaution and Speculative motives

$$L = L_1 + L_2$$

L_1 = Active Cash balance
$= L_t + L_p$

L_2 = IDLE cash balance.

★ Liquidity Preference Curve :-



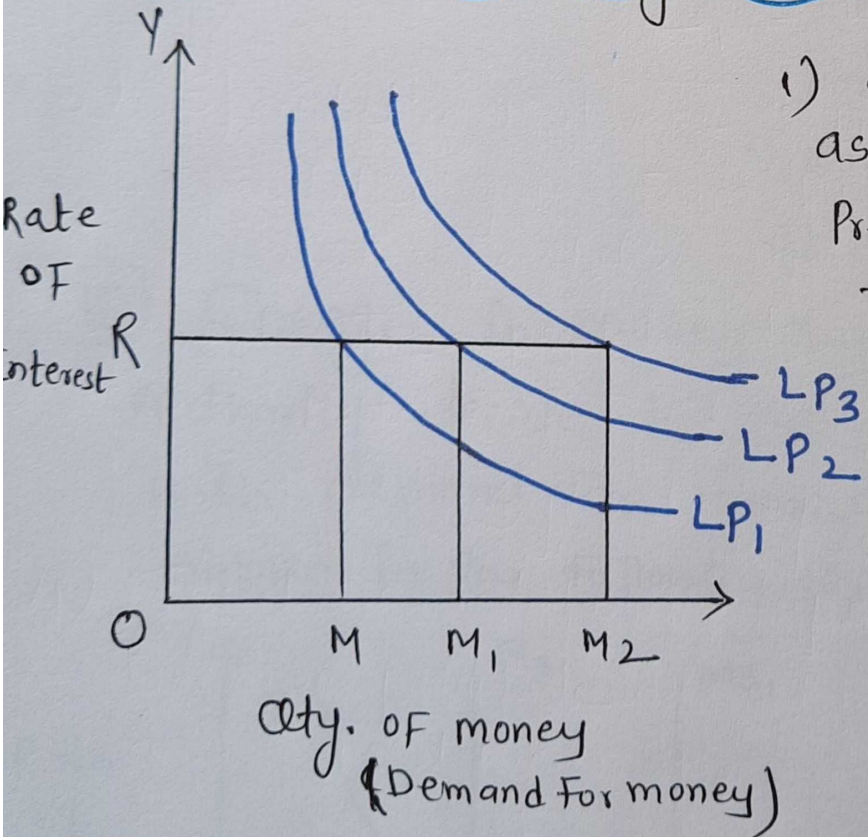
i) Demand for money is shown on x-axis and Rate of Interest on Y-axis.

ii) LP curve is sloping downward from left to right

iii) There is inverse relationship between R.O.I and Demand for money.

iv.) As R.O.I Fall from Or to Or_1, Demand for money increase From OM to OM_1.

★ Shift in Liquidity Preference :—



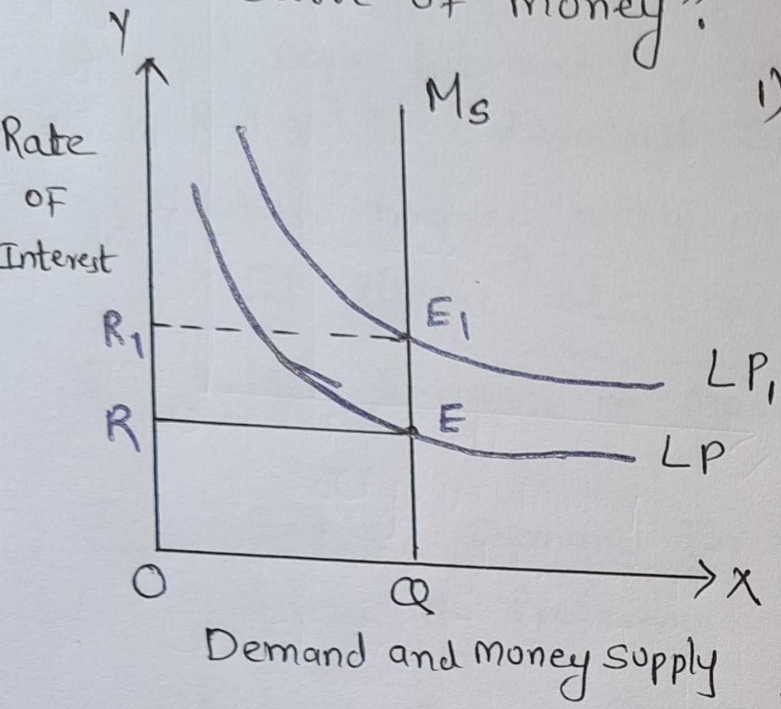
1) In diagram we observe, as income increase, Liquidity Preference curve is shifted to Right side at same R.O.I - R.

2) More Quantity of money is demanded due to increase in income.

(B) **Supply Side :-** The supply of money is fixed by Monetary Authority (RBI). So it is assumed to be constant. Thus real determinant of R.O.I is the Demand for money (Liquidity Preference)

(I) Determination OF Rate OF Interest :-

"An Equilibrium rate of Interest is determined by intersection between Demand Curve and the Supply Curve of money".



Demand and Money Supply

1) In diagram, Demand Curve (LP) interseet supply Curve (M_S) at Point E. Here Equilibrium R.O.I is determined at Point E.

2) At Equilibrium E, $M_S = M_d$ at OR R.O.I

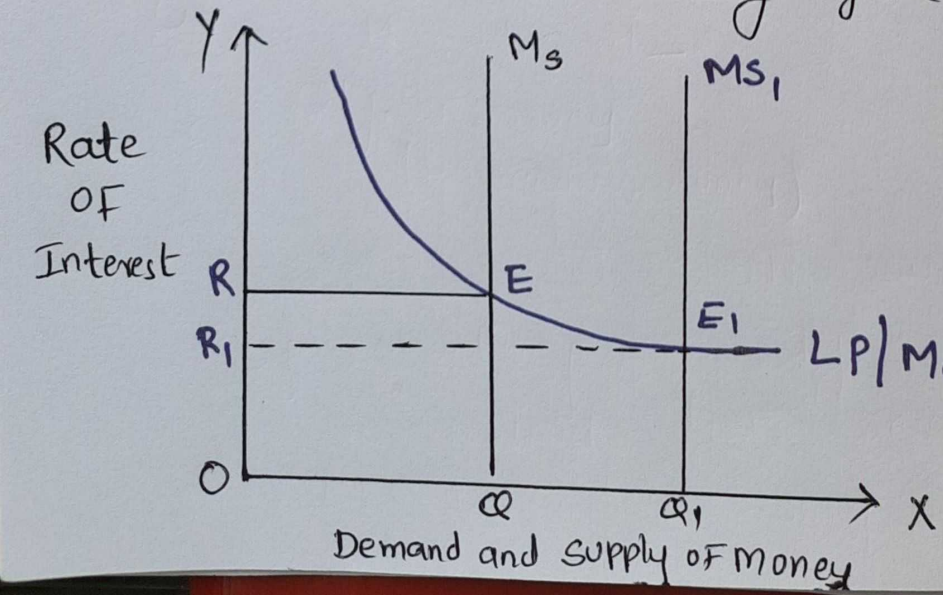
Md = Demand for money.

3) As Income increase, Demand for money shifted to upward - LP_1.

4, Now we get New Equilibrium = E_1 at New R.O.I = OR_1

(II) Changes in Money Supply :-

If Monetary Authority decide to put more money to adjust with demand for money then R.O.I will decline shown in the following figure :-



Demand and Supply of Money

1) In above figure - LP/Md is demand for money curve sloping downward from left to right.
2) M_s is supply of money curve, which has Vertical slope.
3) Md curve interseet M_s curve at point E. where equilibrium R.O.I is determined OR.
4) when money supply increased, we get New Equilibrium E_1 where $Ms_1 = Md$ at OR_1
5) With Increase in Money supply R.O.I will decline.

Q:2 Explain Demand for money. Explain motives for Liquidity Preference.

Refer - Q:2 - Chapter-14- Demand for money.

Q:3 Write Shortnote - Liquidity Trap.

Refer - Q:3 - Chapter-14. Demand for money.

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