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Keynes' Liquidity Preference Theory of Interest Rate Determination

The determinants of the equilibrium interest rate in the classical model are the 'real' factors of the supply of saving and the demand for investment. On the other hand, in the Keynesian analysis, determinants of the interest rate are the 'monetary' factors alone.

Keynes' analysis concentrates on the demand for and supply of money as the determinants of interest rate. According to Keynes, the rate of interest is purely "a monetary phenomenon." Interest is the price paid for borrowed funds. People like to keep cash with them rather than investing cash in assets. Thus, there is a preference for liquid cash.

People, out of their income, intend to save a part. How much of their resources will be held in the form of cash and how much will be spent depend upon what Keynes calls liquidity preference, Cash being the most liquid asset, people prefer cash. And interest is the reward for parting with liquidity. However, the rate of interest in the Keynesian theory is determined by the demand for money and supply of money.

Demand for Money:

Demand for money is not to be confused with the demand for a commodity that people 'consume'. But since money is not consumed, the demand for money is a demand to hold an asset.

The desire for liquidity or demand for money arises because of three motives:

(a) Transaction motive

(b) Precautionary motive

(c) Speculative motive

(a) Transaction Demand for Money:

Money is needed for day-to-day transactions. As there is a gap between the receipt of income and spending, money is demanded. Incomes are earned usually at the end of each month or fortnight or week but individuals spend their incomes to meet day-to-day transactions.

Since payments or spending are made throughout a period and receipts or incomes are received after a period of time, an individual needs 'active balance' in the form of cash to finance his transactions. This is known as transaction demand for money or need- based money—which directly depends on the level of income of an individual and businesses.

People with higher incomes keep more liquid money at hand to meet their need-based transactions. In other words, transaction demand for money is an increasing function of money income.

Symbolically,

$$T_{dm} = f(Y)$$

Where, T_{dm} stands for transaction demand for money and Y stands for money income.

(b) Precautionary Demand for Money:

Future is uncertain. That is why people hold cash balances to meet unforeseen contingencies, like sickness, death, accidents, danger of unemployment, etc. The amount of money held under this motive, called 'Idle balance', also depends on the level of money income of an individual.

People with higher incomes can afford to keep more liquid money to meet such emergencies. This means that this kind of demand for money is also an increasing function of money income. The relationship between precautionary demand for money (P_{dm}) and the volume of income is normally a direct one.

Thus,

$$P_{dm} = f(Y)$$

(c) Speculative Demand for Money:

This sort of demand for money is really Keynes' contribution. The speculative motive refers to the desire to hold one's assets in liquid form to take advantages of market movements regarding the uncertainty and expectation of future changes in the rate of interest.

The cash held under this motive is used to make speculative gains by dealing in bonds and securities whose prices and rate of interest fluctuate inversely. If bond prices are expected to rise (or the rate of interest is expected to fall) people will now buy bonds and sell when their prices rise to have a capital gain. In such a situation, bond is more attractive than cash.

Contrarily, if bond prices are expected to fall (or the rate of interest is expected to rise) in future, people will now sell bonds to avoid capital loss. In such a situation, cash is more attractive than bond. Thus, at a low rate of interest, liquidity

preference is high and, at a high rate of interest, securities are attractive. Now it is clear that the speculative demand for money (S_{dm}) varies inversely with the rate of interest. Thus,

$$S_{dm} = f(r)$$

Where, r is the rate of interest.