

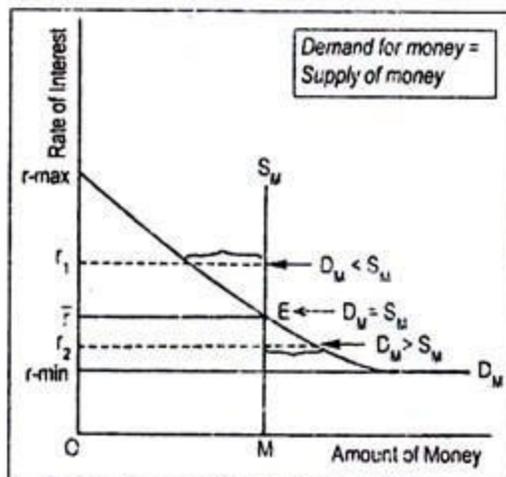
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## **Total Demand for Money:**

The total demand for money ( $D_M$ ) is the sum of all three types of demand for money. That is,  $D_m = T_{dm} + P_{dm} + S_{dm}$ . The demand for money has a negative slope because of the inverse relationship between the speculative demand for money and the rate of interest.

However, the negative sloping liquidity preference curve becomes perfectly elastic at a low rate of interest. According to Keynes, there is a floor interest rate below which the rate of interest cannot fall. This minimum rate of interest indicates absolute liquidity preference of the people.

This is what Keynes called '**liquidity trap**'. In Fig.,  $D_m$  is the liquidity preference curve. At minimum rate of interest,  $r_{\min}$ , the curve is perfectly elastic. However, there is a ceiling of interest rate, say  $r_{\max}$ , above which it cannot rise. Thus, interest rate fluctuates between  $r_{\max}$  and  $r_{\min}$ .



## Money Supply:

The supply of money in a particular period depends upon the policy of the central bank of a country. Money supply curve,  $S_M$ , has been drawn perfectly inelastic as it is institutionally given.

Determination of Interest Rate:

According to Keynes, the rate of interest is determined by the demand for money and the supply of money.  $OM$  is the total amount of money supplied by the central bank. At point  $E$ , demand for money becomes equal to the supply of money. Thus, the equilibrium interest rate is determined at  $r$ . Now, suppose that the rate of interest is greater than  $r$ .

In such a situation, supply of money will exceed the demand for money. People will purchase more securities. Consequently, its price will rise and interest rate will fall until demand for money becomes equal to the supply of money.

On the other hand, if the rate of interest becomes less than or, demand for money will exceed supply of money, people will sell their securities. Price of securities will tumble and rate of interest will rise until we reach point E.

Thus, the rate of interest is determined by the monetary variables only.

### **Limitations:**

Even Keynes' liquidity preference theory is not free from criticisms:

Firstly, like the classical and neo-classical theories, Keynes' theory is an indeterminate one. Keynes charged the classical theory on the ground that it assumed the level of employment fixed.

Same criticism applies to the Keynesian theory since it assumes a given level of income. Keynes' theory suggests that  $D_m$  and  $S_M$  determine the rate of interest. Without knowing the level of income we cannot know the transaction demand for money as well as the speculative demand for money. Obviously, as income changes, liquidity preference schedule changes—leading to a change in the interest rate.

Therefore, one cannot, determine the rate of interest until the level of income is known and the level of income cannot be determined until the rate of interest is known hence indeterminacy. Hicks and Hansen solved this problem in their IS-LM analysis by determining simultaneously the rate of interest and the level of income.

It is indeed true also that the neo-classical authors or the pro-pounders of the loanable funds theory earlier made attempt to integrate both the real factors and the monetary factors in the interest rate determination but not with great

successes. Such defects had been greatly removed by the neo-Keynesian economists—J.R. Hicks and A.H. Hansen.

Secondly, Keynes committed an error in rejecting real factors as the determinants of interest rate determination.

Thirdly, Keynes' theory gives a choice between holding risky bonds and riskless cash. An individual holds either bond or cash and never both. In the real world, it is the uncertainty or risk that induces an individual to hold both. This gap in Keynes' theory has been filled up by James Tobin. In fact, today people make a choice between varieties of assets.