

# Keynes' Theory of Demand for Money

**Keynes' approach to the demand for money is based on two important functions-**

- 1. Medium of exchange**
- 2. Store of value**

**Keynes explained the theory of demand for money with following questions-**

- 1. Why do people prefer liquidity?**
- 2. What are the determinants of liquidity preference?**

# Motives for Liquidity Preference-

## The Transactions Demand for Money-

People require money to carry out day-to-day transactions but most of them receive income once in a month- Individuals hold cash in order “to bridge the interval between the receipt of income and its expenditure”.

# Motives for Liquidity Preference-

## Precautionary Demand for Money-

It is necessary to be cautious about future which is uncertain. Precautionary motive for holding money refers to the desire of the people to hold cash balances for unforeseen contingencies.

## Speculative Demand for Money-

The cash held under this motive is used, to make speculative gains by dealing in bonds whose prices fluctuate.

# Motives for Liquidity Preference-

Keynes holds that the transaction and precautionary motives are relatively interest inelastic, but are highly income elastic.

The amount of money held under these two motives ( $M_1$ ) is a function ( $L_1$ ) of the level of income ( $Y$ ) and is expressed as

$$M_1 = L_1 (Y)$$

# Motives for Liquidity Preference-

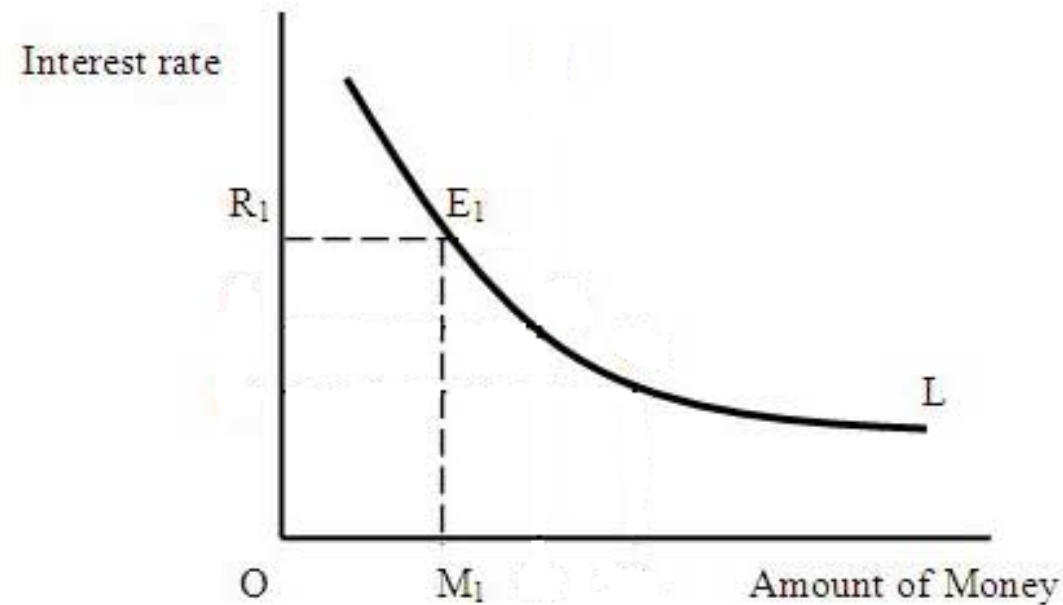
According to Keynes, the higher the rate of interest, the lower the speculative demand for money, and lower the rate of interest, the higher the speculative demand for money. Algebraically, the speculative demand for money is:

$$M_2 = L_2 (r)$$

Where,  $L_2$  is the speculative demand for money, and  $r$  is the rate of interest.

# Liquidity Preference Curve-

**LP Curve: Smooth curve which slopes downward from left to right.**



# Liquidity Preference Curve-

Total liquid money is denoted by  $M$ , the transactions plus precautionary motives by  $M_1$  and the speculative motive by  $M_2$ , then

$$M = M_1 + M_2.$$

Since  $M_1 = L_1 (Y)$  and

$$M_2 = L_2 (r),$$

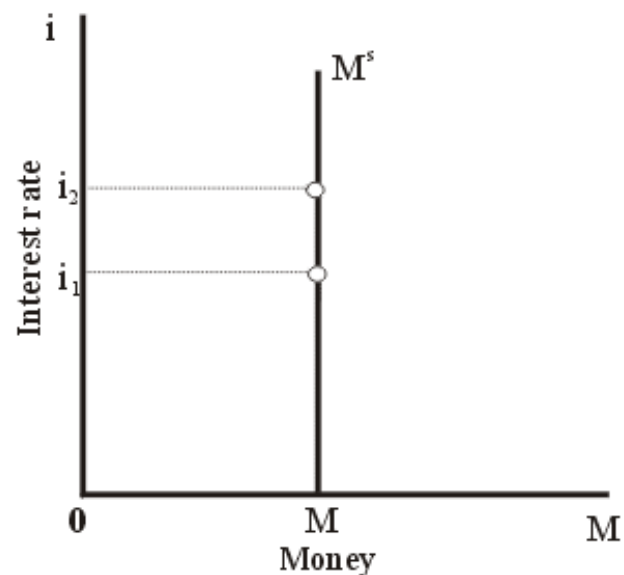
The total liquidity preference function is:

$$M = L (Y, r).$$

# Supply of Money-

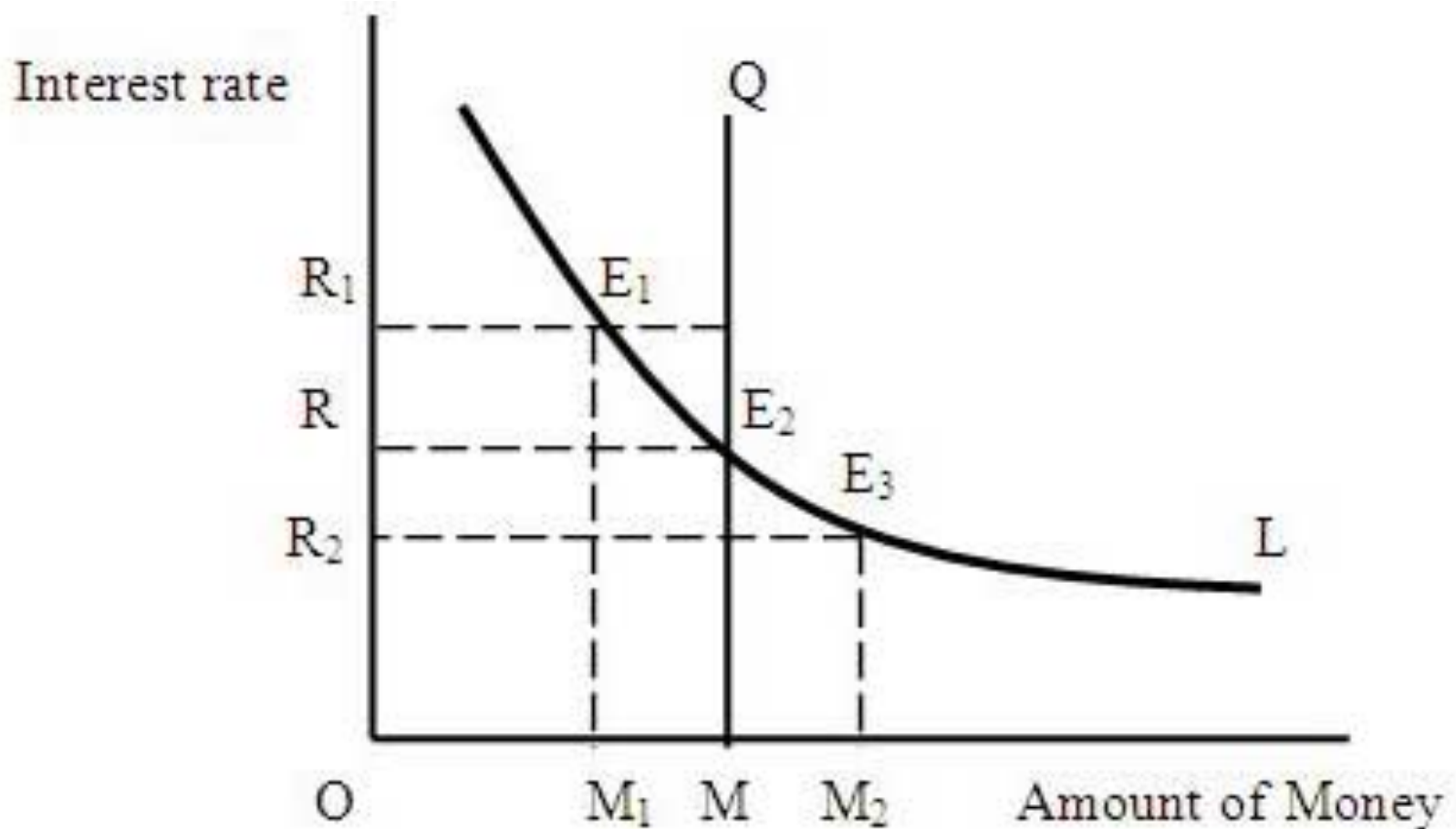
The supply of money assumed fixed by the monetary authorities.

Hence the money supply curve is: perfectly inelastic curve.





# Determination of the Rate of Interest-



# Determination of the Rate of Interest-

The rate of interest is determined at the level where the demand for money equals the supply of money.

In the following figure, the vertical line QM represents the supply of money and L the total demand for money curve.

Both the curve intersect at  $E_2$  where the equilibrium rate of interest OR is established.

# Determination of the Rate of Interest-

If there is any deviation from this equilibrium, an adjustment will take place through the rate of interest and equilibrium  $E_2$  will be re-established.

At the point  $E_1$  the supply of money  $OM$  is greater than the demand for money  $OM_1$ . So, the rate of interest will start declining from  $OR_1$  till the equilibrium rate of interest  $OR$  is reached. Similarly at  $OR_2$  level of interest rate, the demand for money  $OM_2$  is greater than the supply of money  $OM$ . As a result, the rate of interest  $OR_2$  will start rising till it reaches the equilibrium rate  $OR$ .

# Determination of the Rate of Interest-

**If the supply of money is increased by the monetary authorities, but the liquidity preference curve L remains the same, the rate of interest will fall.**

**If the demand for money increases and the liquidity preference curve shifts upward, given the supply of money, the rate of interest will rise.**