LIQUIDITY PREFERENCE THEORY

The cash money is called liquidity and the liking of the people for cash money is called liquidity preference.

According to Keynes people demand liquidity or prefer liquidity because they have three different motives for holding cash rather than bonds etc.

1. Transaction Motive
2. Precaution Motive
3. Speculative Motive

Transaction Motive

Day –to-day transactions are done by individuals as well as firms. An individual person has to buy so many things during a day. For this purpose people want to keep some cash money with them. This type of demand for liquidity is for carrying day to day transactions is called demand for liquidity for transaction motive. So we can say that money needed by consumers, businessmen and others in order to complete economic transactions is known as the demand for money for transactions motive. This demand depends upon the following.

i) Size of the income

If size of the income is high more will be the transactions and vice versa.

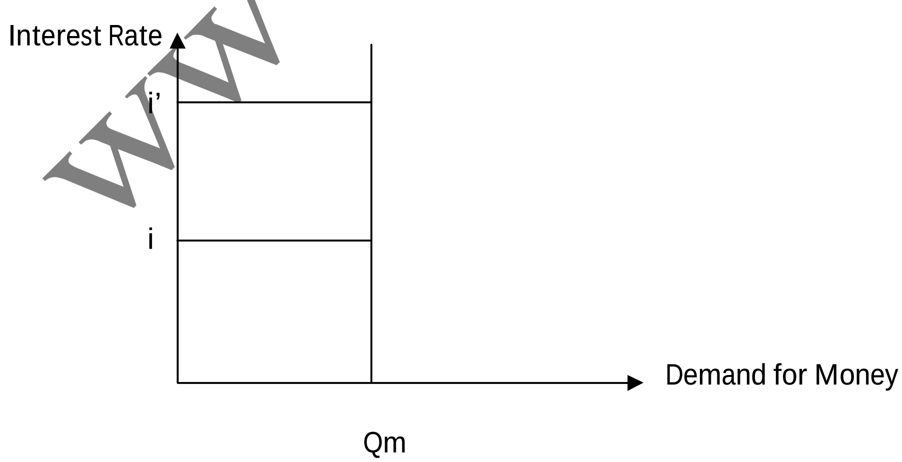
ii) Time gap between the receipts of income

If a person gets his pay daily he will demand less cash money. On the other hand if time gap is more a person will demand more money to carry on his daily transactions.

iii) Spending habit

If a person is spendthrift he will do more transactions. Naturally he will demand more money and vice versa.

The demand for money for this purpose is completely interest inelastic.



PRECAUTIONARY MOTIVE

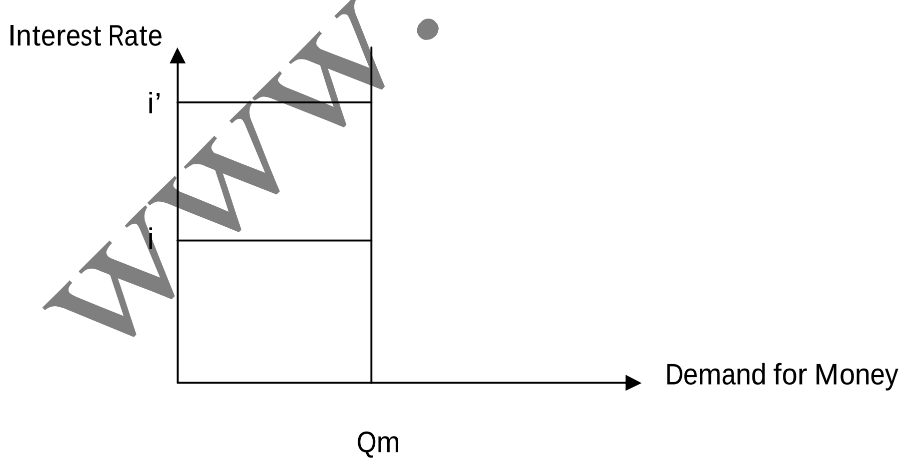
Every man wants to save something or wants to keep some liquid money with him to meet some unforeseen emergencies, contingencies and accidents. Similarly business firms also want to keep some cash money with them to safeguard their future. This type of demand for liquidity is called demand for precautionary motive. This demand depends upon many factors.

i) **Size of the income**
If the size of the income of a person or a firm is large, he will demand more money for safeguarding his future.

ii) **Nature of the person**
Some persons are optimistic while others are pessimistic .The former think always about the bright side of future. So they anticipates less, if any risk and danger in the future. Naturally such persons will demand less money for precautionary motive. On the contrary , pessimistic persons or firms foresee many dangers, calamities and emergencies in the future. In order to meet these, they want to have more cash with them.

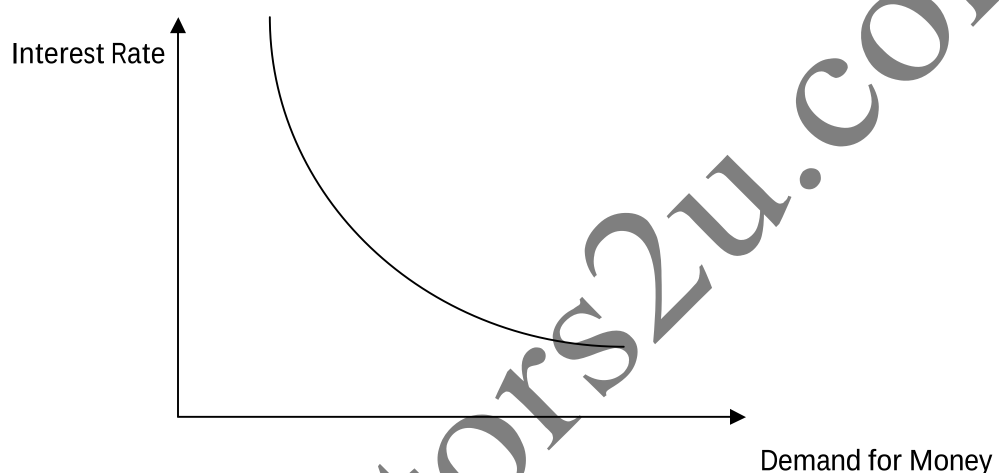
iii) **Farsightedness**
A farsighted person can see better about the future. He will make a proper guess of the future. Thus if he expects more emergencies, he will keep more money with him in cash and vice versa.

T he demand for money for precautionary motive is also completely interest inelastic.



SPECULATIVE MOTIVE

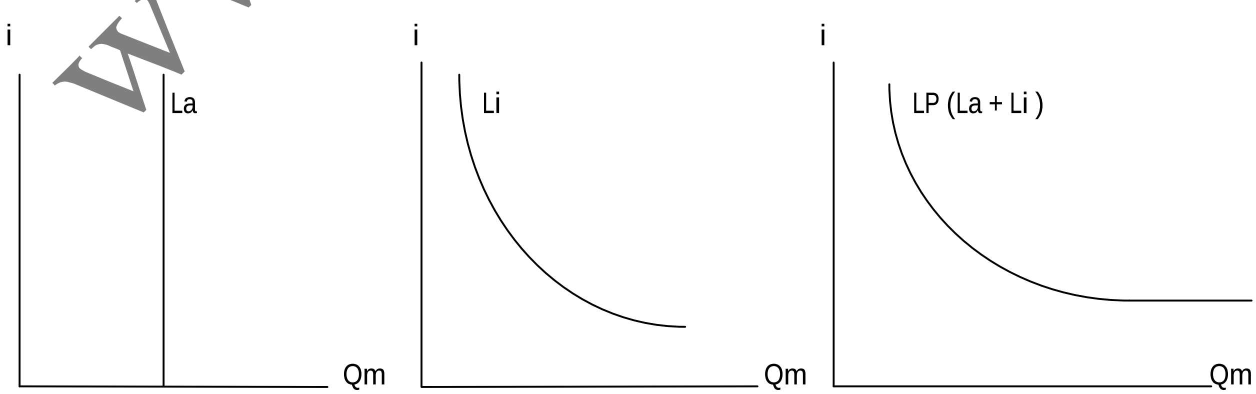
People want to keep cash with them to take advantage of the changes in the prices of bonds and securities. In advanced countries, people like to hold cash for the purchase of bonds and securities when they think it profitable. If the prices of the bonds and securities are expected to rise speculators will like to purchase them. In this situation they will not like to keep cash with them. On the other hand if prices of the bonds and securities are expected to fall people will like to keep cash with them. They will buy the bonds and securities with the cash only when their prices would fall .So liquidity preference will be more at lower interest rates.



THE LIQUIDITIY PREFERENCE CURVE

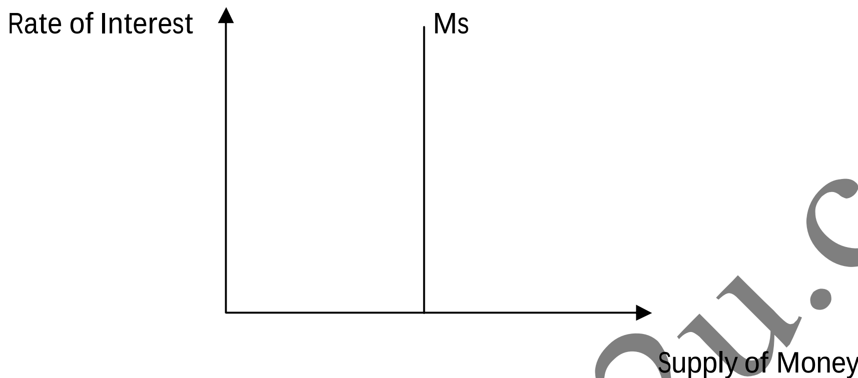
The transactions balances and precautionary balances are held with the intention of being used to make purchases as and when required, they are sometimes jointly referred as **demand for active balances**. The important point about the demand for active balances is that it is not responsive to changes in the rate of interest i.e . it is interest inelastic. T he demand for speculative balances, on the other hand is sometimes referred to as the **demand for idle balances**.

We can have the community's total demand for money or liquidity preference schedule by adding the demand for active (La) and idle balances (Li) together.



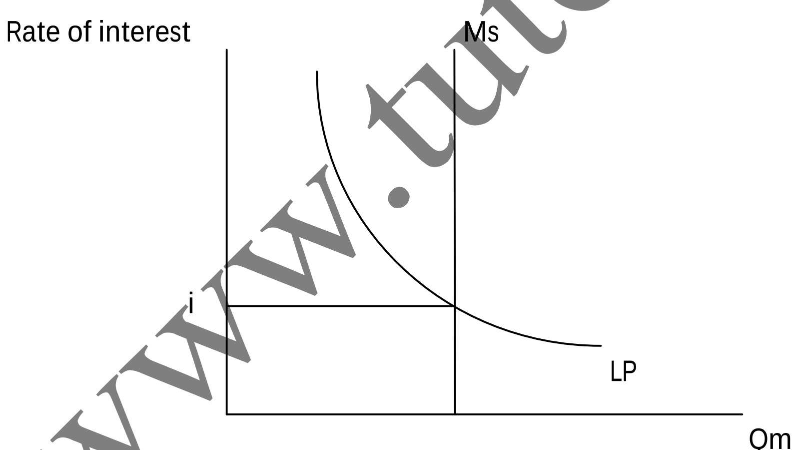
SUPPLY OF MONEY

The supply of money is quite different from the demand for money. No private individual can change it. Supply of money is controlled by the central bank or its government. Money supply depends upon the currency issued by the government and the policies of the central bank regarding with credit creation. In the short run at a particular period of time supply of money remains constant. That's why the supply curve money is perfectly inelastic.



What determines the interest rate?

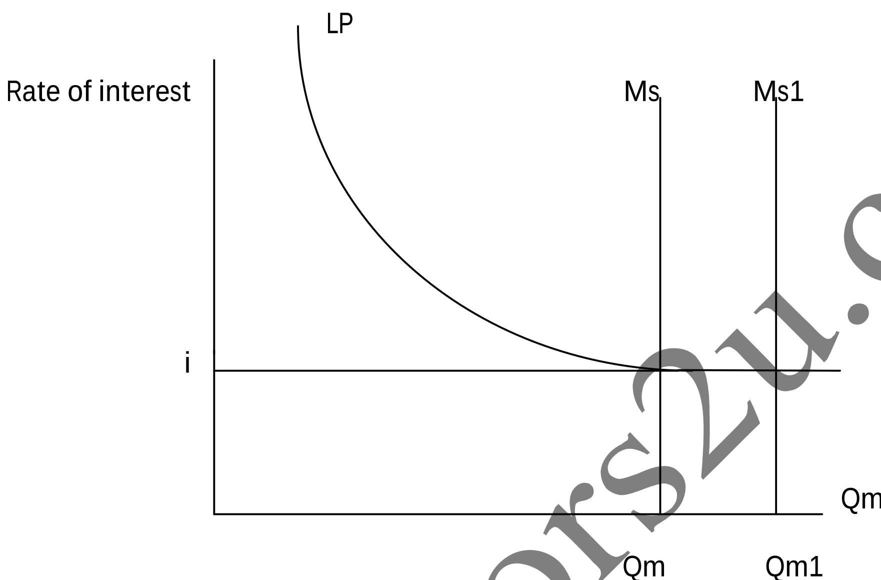
The interaction of demand and supply of money determines the interest rate.



In the above diagram LP is the demand for money and the Ms is the supply of money. This gives an equilibrium rate of interest i . At any rate of interest above i , the supply of money exceeds demand and this will pull down the rate of interest, while at any rate of interest below i the demand for money exceed supply and this will bid up the rate of interest. Once the rate of interest is established at i , it will remain at this level until there is a change in the demand for money and or the supply of money. This implies that the authorities have two choices

- They can fix the supply of money and allow interest rates to be determined by the demand for money; or
- They can fix the rate of interest and adjust the supply of money to whatever level is appropriate so as to maintain the rate of interest.

The liquidity trap



It is the situation in which changes in money supply have no influence on the rate of interest, monetary policy cannot be used to influence other variables such as consumption and investment when the rate of interest is i.