# The Liquidity Preference Theory of Interest

The Liquidity Preference Theory presented by J. M. Keynes in 1936 is the most celebrated of all. According to Keynes, the rate of interest is a purely monetary phenomenon. It is the reward for parting with liquidity for a specific period of time.

Thus, like the price of a commodity, the rate of interest is deter­mined by the demand for and the supply of money. It is, therefore, necessary to introduce the concepts of demand for money and supply of money.

The supply of money refers to the stock of money in circulation and is a fixed quantity at a particular point of time. It is the sum of currency (notes and coins) and commercial bank deposits. It remains fixed in the short rim because it is determined and controlled by the central bank of a country.

So it plays a passive role in interest rate determination. By contrast, the demand for money plays an active role in determining the equilibrium rate of interest. Therefore, a background knowledge of demand for money is essential in order to understand Keynes’ theory.

#### The Demand for Money:

Wealth can be held in various forms— money, fixed interest securities (bonds), shares, property, jewelry, valuable paintings etc. Keynes first analyzed, in detail, the reasons why people will hold wealth in the form of money.

At a fixed point of time, a certain stock of money is held, i.e., people wish to hold a certain amount of wealth in ‘liquid’ form. ‘Liquidity’ refers to the ease with which assets can be changed into cash without loss or delay. It is property which is enjoyed by all assets to some extent. Obviously, money is the most liquid of all assets. **The demand for money was, therefore, termed by Keynes ‘liquidity preference’.**

J. M. Keynes gave three reasons for holding money the transactions motive, the precautionary motive, and the speculative motive **(TPS)**.

**1. Transactions Motive:**

Individuals and business firms hold money in order to carry out day-to-day transactions.

Each individual or firm has a time gap between receipts (income) and payment (expenditure) and will need to hold money to cover this.

The average amount held will depend primarily on the system of payments, i.e., on the frequency of the receipts. For example, if a weekly paid person receives Rs. 300 a week and he has spent it all by the next pay-day, his average cash holding is Rs. 150, i.e., the amount he had at the beginning (Rs. 300) and the amount he has at the end (zero), divided by 2. If he receives monthly salary of Rs. 1,200 then, assuming that his spending habits do not alter, his average cash holding will rise to Rs. 600, i.e., (Rs. 1200 + 0) ÷ 2.

The amount of cash held for transactions and precautionary purposes also depends on incomes and prices. If income increases, then more money will be held. Similarly, if prices rise, more money will be required to purchase the same amount of goods and services.

**2. Precautionary Motive:**

People and business firms hold some money as a reserve to meet unforeseen contingencies, such as sickness or accidents or the need to take advantage of an opportune to buy something which is being offered at a specially reduced price for only a limited period, e.g., during a sale.

**3. Speculative Motive:**

The classical economists considered it irrational for people to hold wealth in the form of money other than that held for transactions and/or precautionary purposes. It is because any money left over could be invested in interest-earning assets like bonds. Keynes, however, argued that it was not necessarily irrational to hold idle money balances.

He pointed out that at times it might be preferable to hold idle money (cash) than to buy government securities (bonds). If a person holds money, he loses interest, but he does not suffer capital loss (due to fall in the value of his assets) either. In fact, it costs money to hold money. Therefore, the rate of interest is called the opportunity cost of money holding. By holding money an individual loses the opportunity to earn interest.

(Here we ignore the effect of inflation and leave aside any reduction there-from). By holding securities, however, he earns a fixed sum as interest, but its market value can (and does) vary.

Therefore, in certain situations, money is preferable to securities. For example, if a person pays Rs. 100 for a Rs. 100 bond whose rate of interest is 10%, then at the end of the year he receives Rs. 10 (or Rs. 110 in all, i.e., including the principal). But if in the mean­time the value of the bond has fallen to below Rs. 90, the loss on this amount more than offsets the interest.

According to Keynes, the speculative demand for money will be determined by people’s expectations regarding the market rate of interest. If the rate of interest is very low and people expect it to rise (or the. value of bonds to fall), then they will consider it more judicious to hold money rather than bonds. If, on the other hand, the rate of interest is very high and people expect it to fall, then they will prefer to hold bonds instead of money.

Thus, there is an inverse relation between the rate of interest and the demand for money. At high rates of interest people hold less money and vice versa. Another reason is that if the rate of interest is high, it is ‘more expensive’ to hold money, i.e., the interest which is foregone by not investing the money is at a high level.

For these two reasons, the demand for idle money balances is inversely related to the rate of interest. Keynes assumed that the demand for money for the other two motives is not affected by changes in the rate of interest, i.e., is perfectly inelastic with regard to the rate of interest. Therefore, if all three elements in the demand for money are added together to derive the total demand curve for money, the result would be a curve of the type shown in Fig. 15.2. (A demand curve for money is also known as a ‘liquidity preference curve’.)

 

The curve shows that if the rate of interest falls, e.g., from O0to Or1, the demand for money increases, from OM to OM1. According to Keynes, at some low rate of interest the demand for money becomes perfectly elastic because if the rate falls below this level, no one would be prepared to buy bonds.

### Liquidity Trap:

Liquidity trap refers to a situation where the rate of interest is so low that people prefer to hold money (liquidity preference) rather than invest it in bonds (to earn interest). Keynes pointed out that at low rates of interest the demand curve for money (or liquidity preference curve) becomes completely (infinitely) elastic. So the liquidity preference curve is not down­ward sloping throughout.

**Criticisms of the Theory:**

Keynes’ liquidity preference theory has been severely criticized.

1. In the construction of the figure, speculative demand for money is included and the other two sources of demand are ignored. It implies that they are known and subtracted from total money supply. But they can be known only when income is in equilibrium, i.e., Y – C + I or S = I.

Hence, liquidity preference theory requires as a pre-condition saving-investment equality, already postulated by classical scholars. Hence, the rate of interest is neither a purely monetary phenomenon nor a purely real phenomenon.

2. So far as the main content of the Keynesian interest theory is concerned, it is the determination of the rate of interest through equality between demand for, and supply of, money. But one of the components of total money demand—known as speculative demand-is assumed to depend on rate of interest. Hence, the logical circularity in the model can be mentioned as one of its principal sources of weakness.

3. Keynes ignored real factors like productivity of capital and thriftiness in the determination of interest rate.

4. As Jacob Viner has remarked: “Without saving there can be no liquidity to surrender.” According to Keynes, interest is a reward for parting with liquidity and in no way an inducement for saving, but it is ridiculous to think of surrendering liquidity if one has not already saved money.