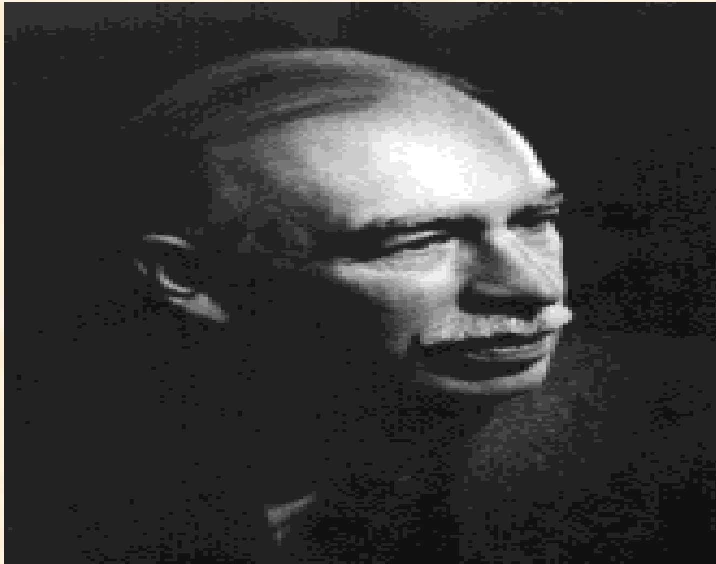
Liquidity preference theory of interest



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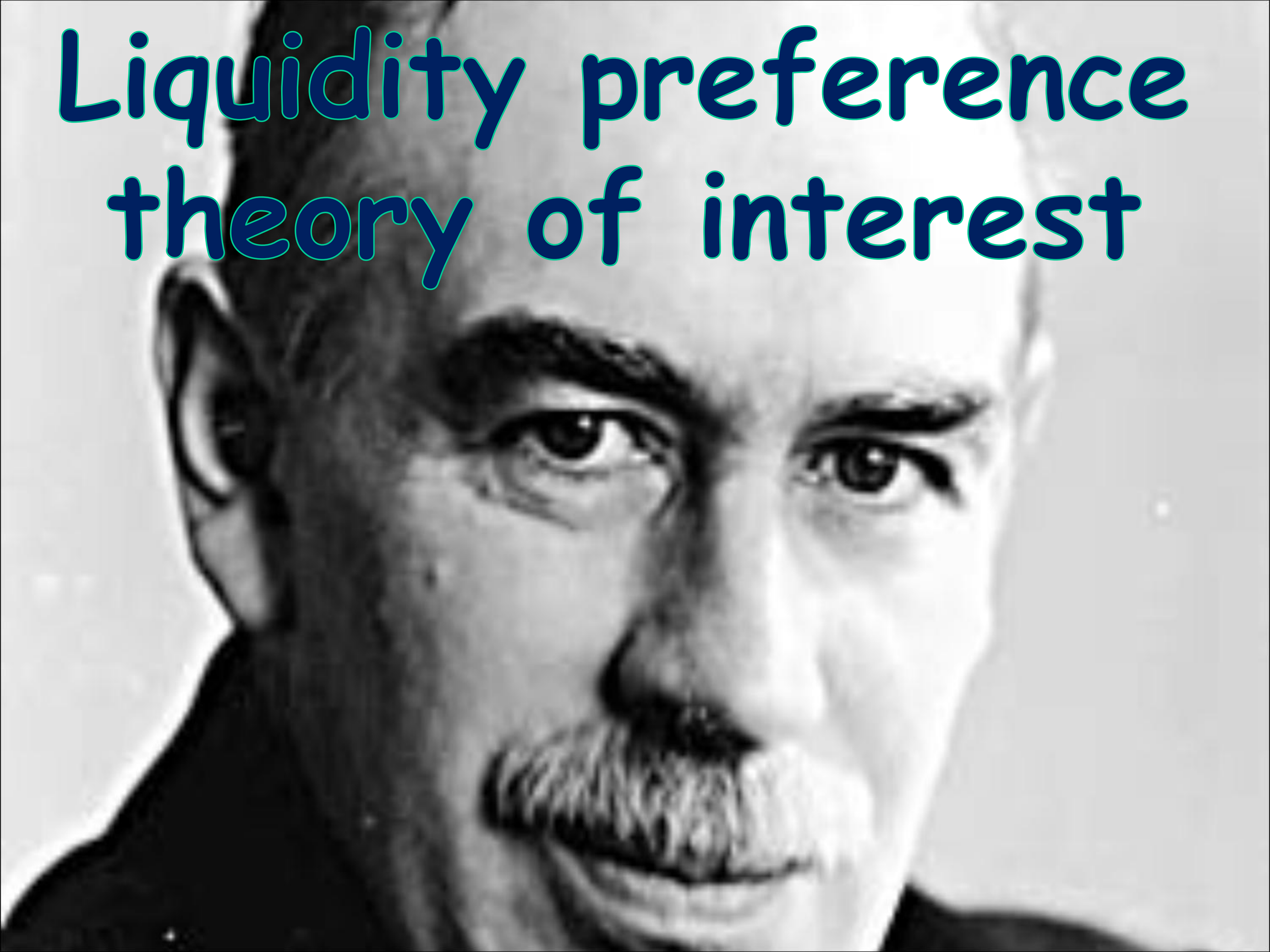
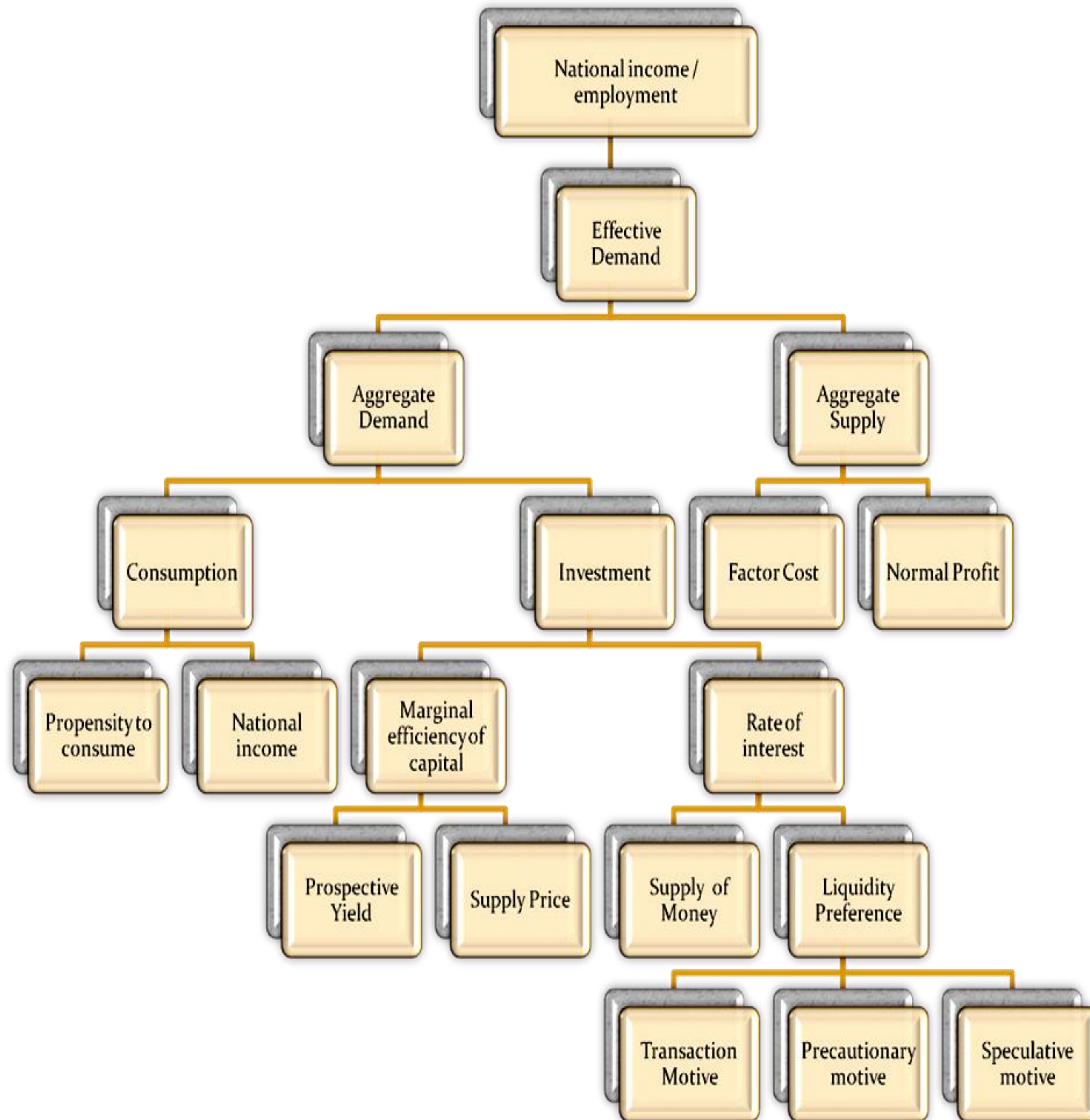

Liquidity preference
theory of interest


National income / employment
Effective Demand
Aggregate Demand
Aggregate Supply
Consumption
Investment
Factor Cost
Normal Profit
Propensity to consume
National income
Marginal efficiency of capital
Rate of interest
Prospective Yield
Supply Price
Supply of Money
Liquidity Preference
Transaction Motive
Precautionary motive
Speculative motive

Introduction

According to this theory, interest is the price of the services of money. Interest is a monetary phenomenon, because it is determined by the demand for and supply of money. Supply of money depends upon money in circulation and bank deposits in a country. Demand for money is made in order to hoard it in liquid form.

Definition of interest

In the words of Keynes, "*interest is the reward for parting with liquidity for a specified period.*"

"*The rate of interest is the premium which is to be offered to induce the people to hold wealth in some form other than the hoarded money.*" Keynes

Determination of interest

According to this theory, interest is determined by demand for and supply of money. It is the equilibrium point between demand and supply. Demand for money has two functions i.e., medium of exchange and store of wealth.

Demand for money

People demand money for three motives

Transaction, precautionary and speculative

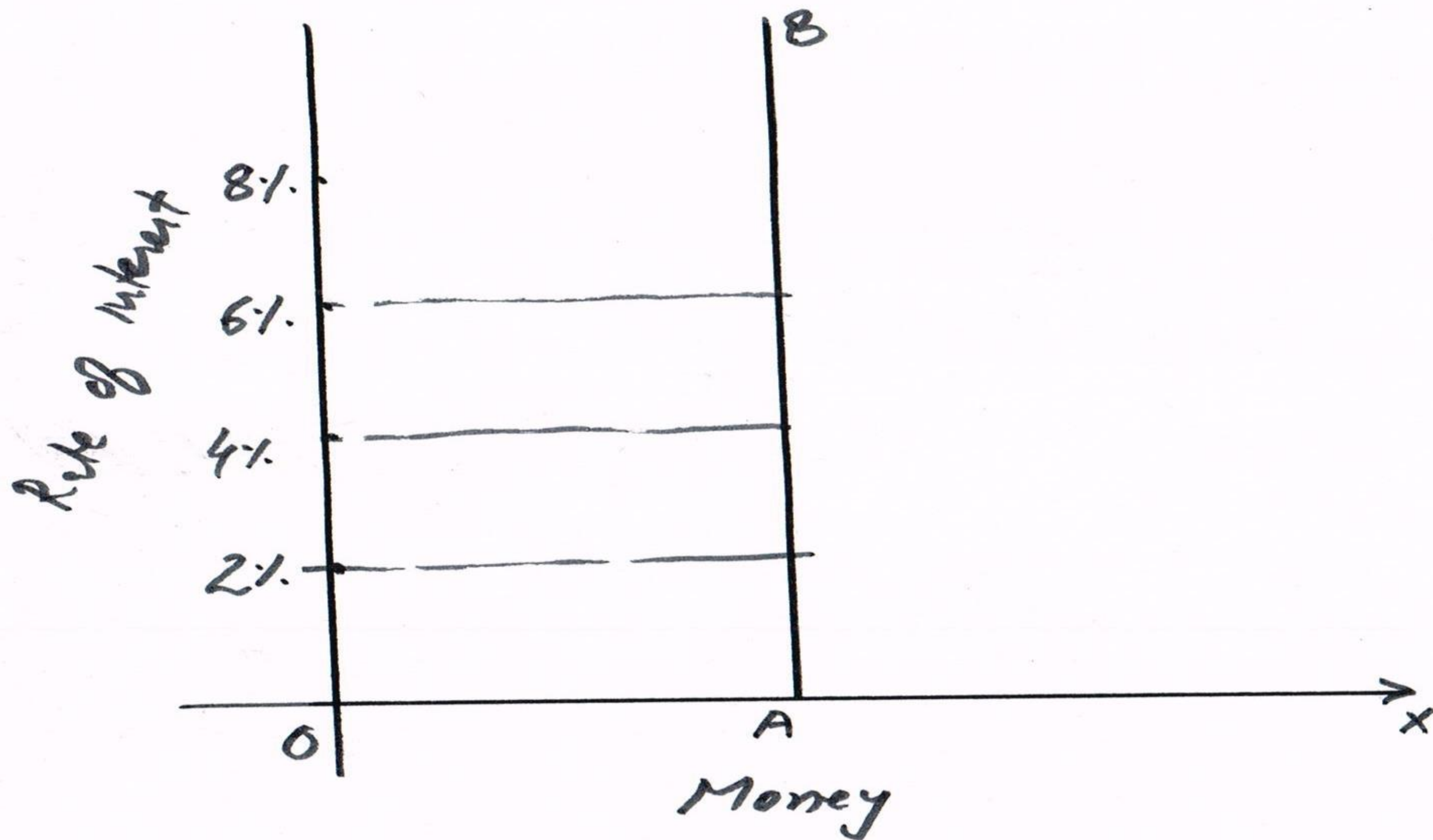
Transaction motive and precautionary motive both are function of income is a function of income.

Thus $M1 = Lt + Lp = f(Y)$

Besides speculative motive is a function of rate of interest

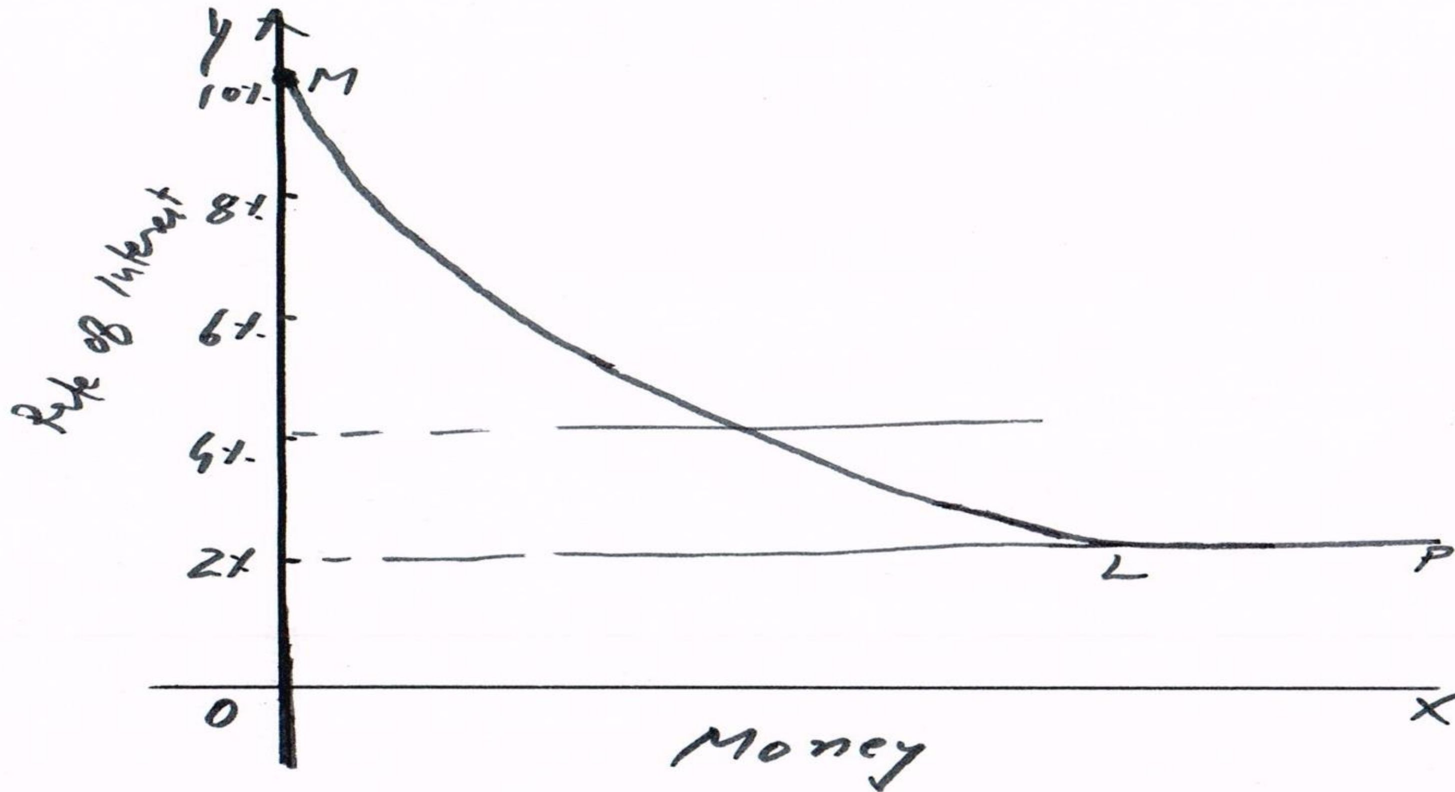
Thus $M2 = Ls = f(r)$

Transaction and Precautionary Motive



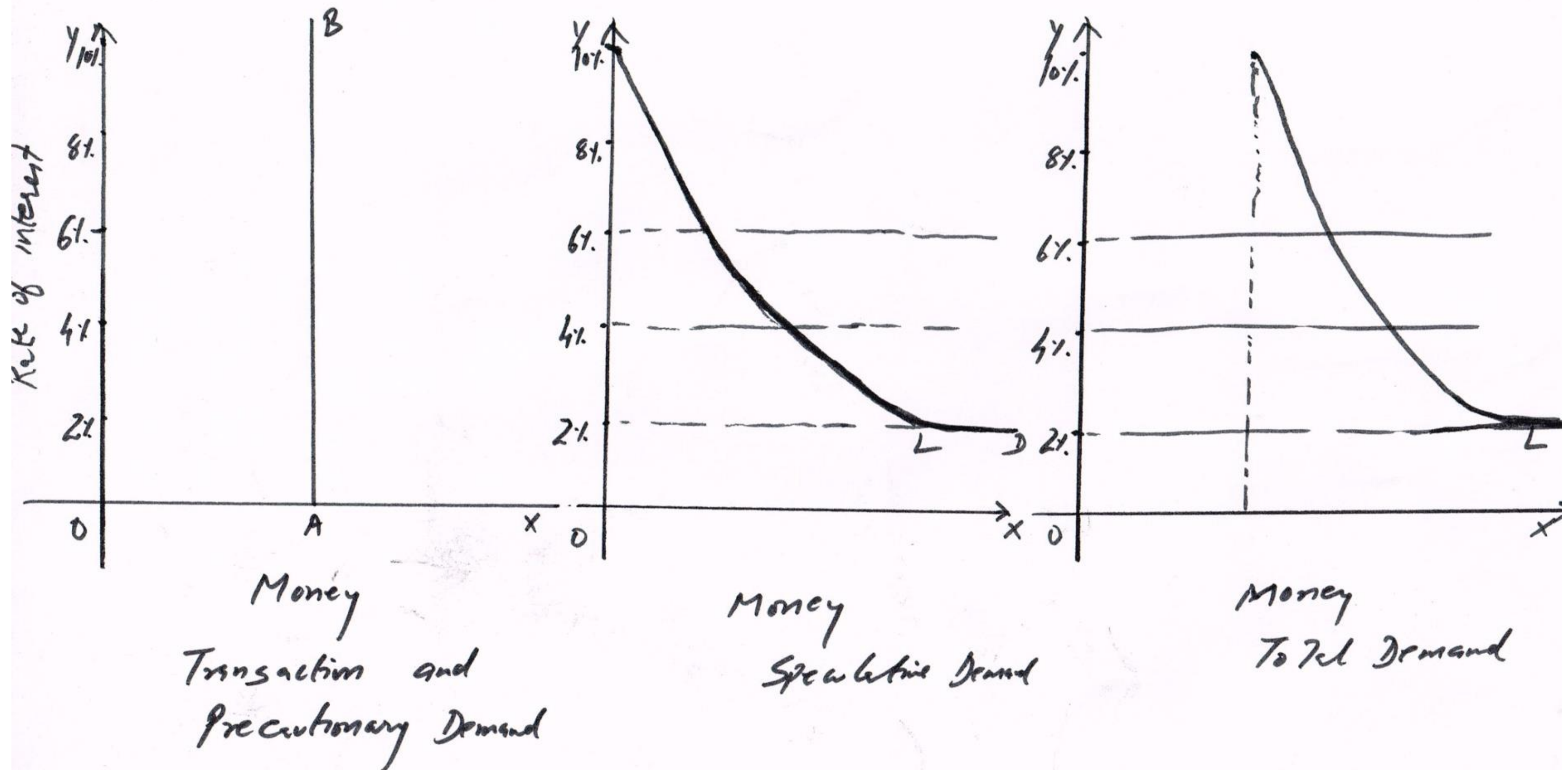
$$M_1 = L_t + L_p = F(Y)$$

Speculative Motive



$$M_2 = L_s = F(r)$$

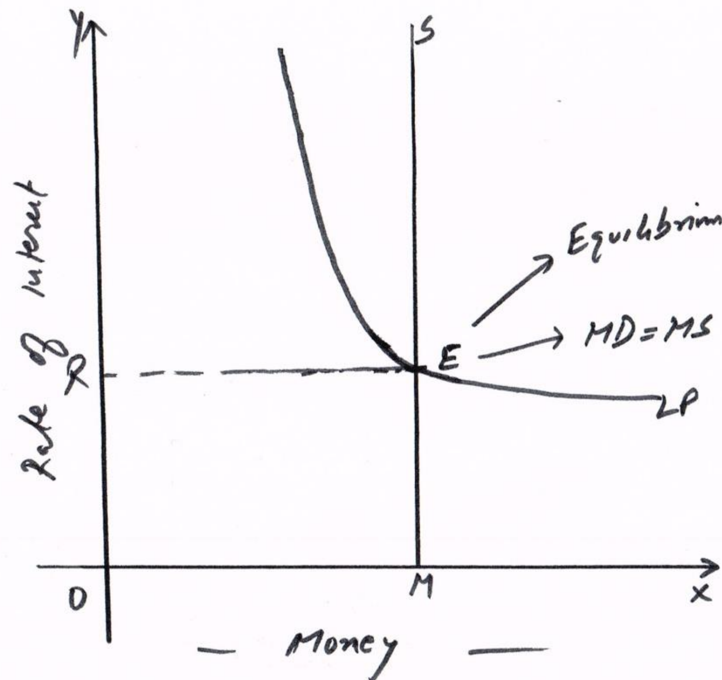
Total demand for money= M1+M2=f(y, r)



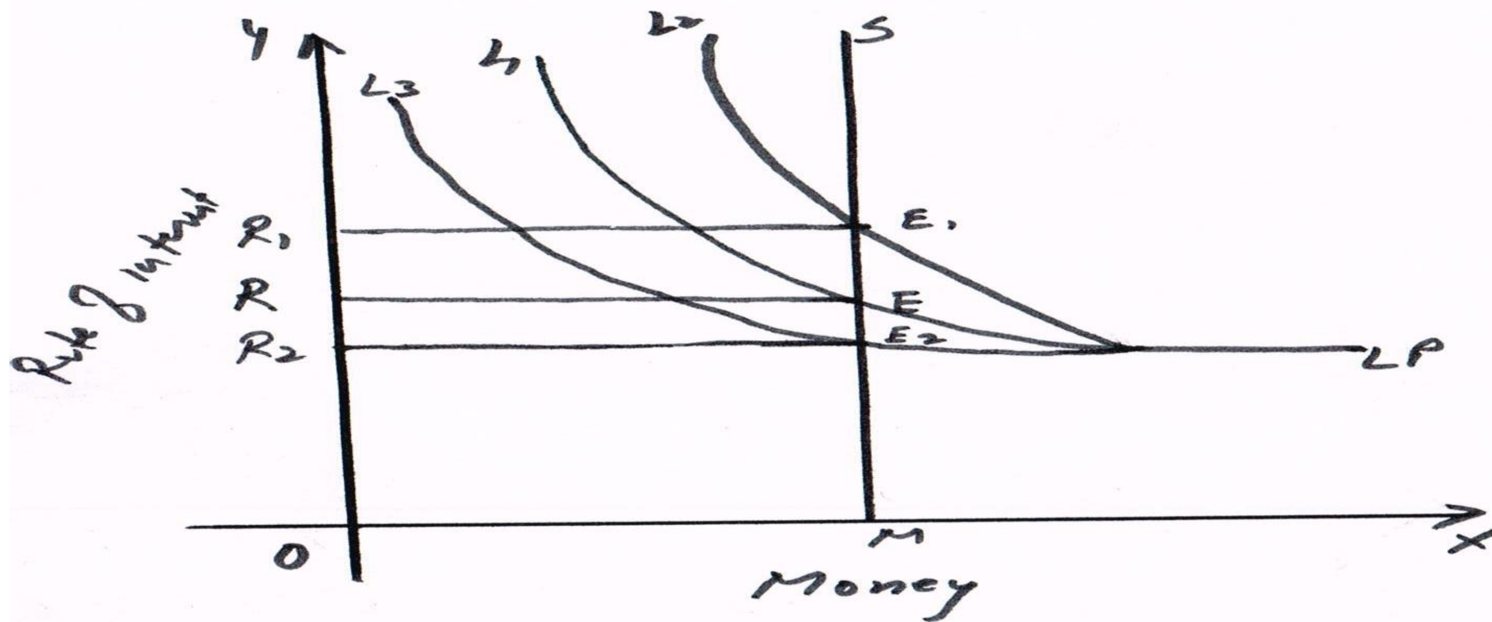
Supply of Money

According to Keynes, supply of money depends upon money in circulation and bank deposits in a country. Money in circulation is the quantity of currency notes and coins, is determined by central bank. Increase in supply of money can lower the rate of interest and decrease in money supply raises the rate of interest.

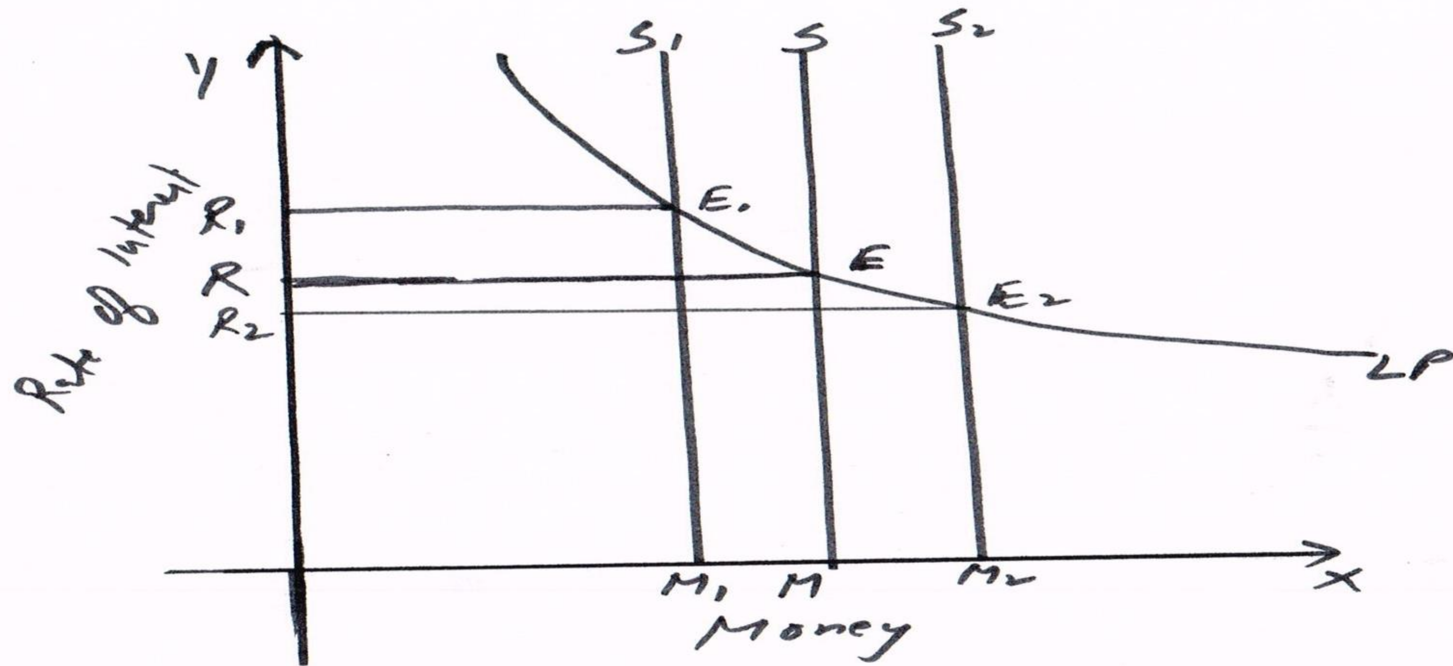
Determination of equilibrium



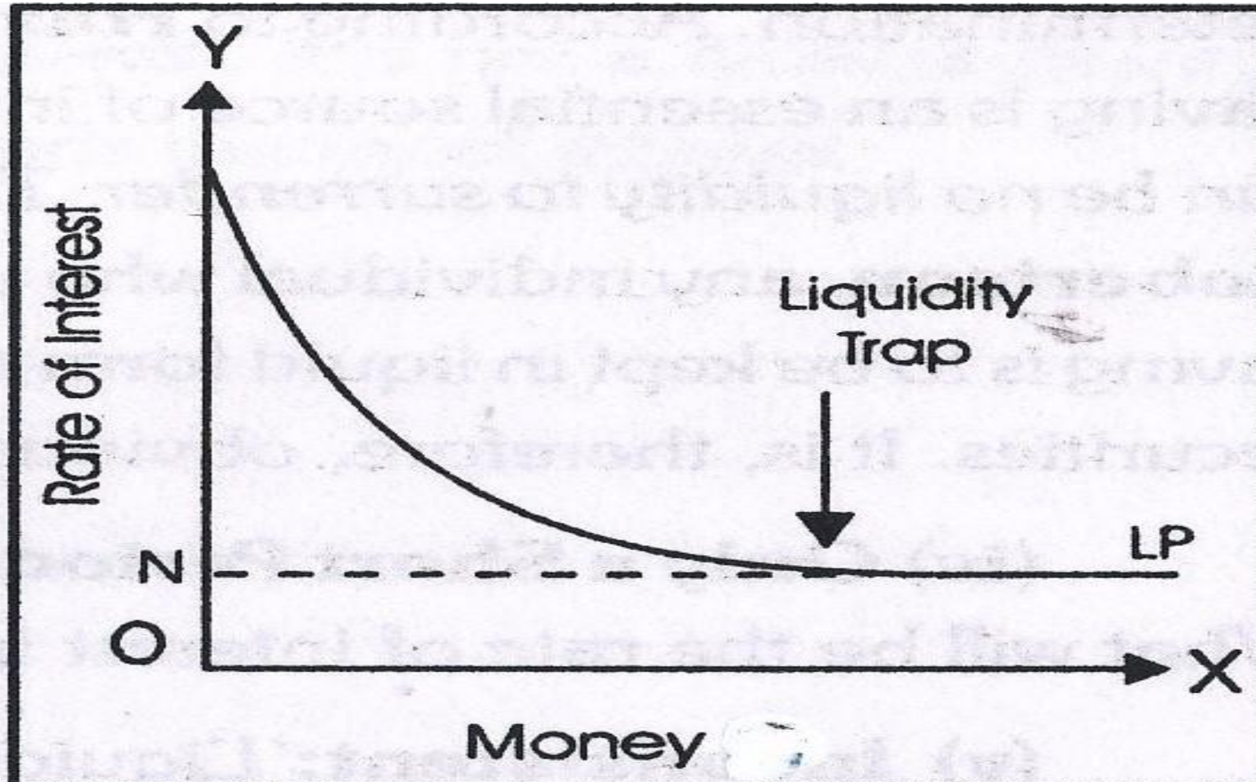
Shifting of equilibrium when demand changes



Shifting of equilibrium when supply changes



Liquidity trap



Criticism

1. The concept of equilibrium is self contradictory
2. More emphasis on monetary factors.
3. Only a short period analysis.
4. Theory is inconsistent during depression.
5. Liquidity is not related with three motives only.
6. Keynesian analysis is not so empirical.
7. An unrealistic assumption.
8. Criticism of liquidity trap.