

Keynesian theory of demand for money

Keynes used the new word "Liquidity preference" to the demand for money in their book "General theory". Keynes said that demand for money in the economy is to following purpose -

- i) Transaction motive
 - ii) Precautionary motive
 - iii) Speculative motive
- } → Aggregate demand for money.

Notice that, The demand for money in the Keynesian sense is the demand to hold money.

- i) Transaction motive → It refers to the demand for money daily life to solve their problem related to transaction motive.

If the time between income receipt and income spent is short then demand for money to the transaction motive is short and vice-versa.

According to Keynes, if other things are remain, The demand for money to the transaction motive is positive and directly proportional to level of income. It is denoted as

Like -

$$L_t = KY$$

Where, L_t = Demand for money to transaction motive

K = part of the income which hold for transaction motive.

Y = income

The above equation has illustrated with following diagram -

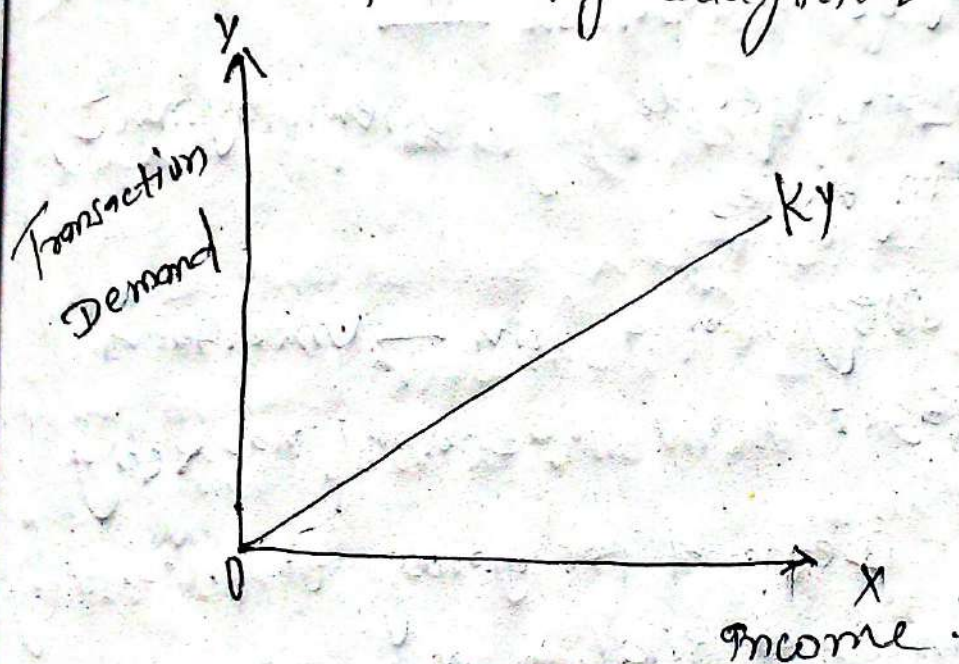


Fig:- Demand for money to transaction motive

Notice that there is no any Relation b/w. Rate of interest and Demand for money to transaction motive. It means Demand for money to transaction motive is inelastic with rate of interest. According to Keynes.

ii) precautionary motive \Rightarrow In the emergency situation there is multiple problem ~~has~~ faced by a person or firm to overcome this problem. The person or a firm hold extra money in the form of cash. It is called demand for money for precautionary motive.

(A) Emergency may be for a person —
illness, Accident, unemployment,
unforeseen contingencies.

(B) Emergency may for a firm — uncertain situation, ~~to~~ get profit to abnormal market

Demand for money for precautionary motive is functional relation with income like demand for money for transaction motive according to Keynes.

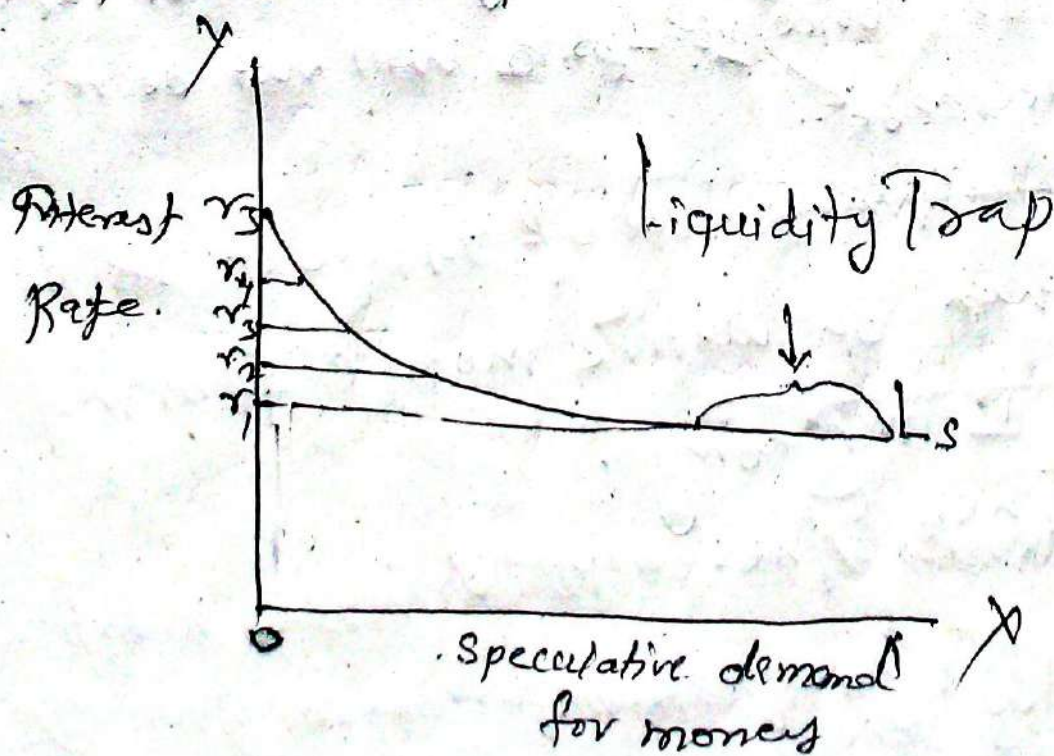
(iii) Speculative motive \Rightarrow The speculative motive for demand for money arises when ~~it~~ investing the money in

same asset or bond is considered wiser than simply holding the money.

The speculative motive for ~~money~~ demand for money is also affected by the expected rise or fall of the future interest rates and inflation of the economy.

$$L_s = f(r)$$

Thus, Speculative motive for demand for money is functionally related to rate of interest.



The above diagram illustrate the Relation b/w speculative demand for money and Rate of interest.

If interest rates are expected to raise the opportunity cost of simply holding the money will lose its purchasing power and again speculative income will drop.

In the above diagram, if the interest rate is r_5 then speculative demand for money is zero due to investor invest their ~~all~~ Aggregate Cash in bond because they believe that there will no any increasing in interest rate ~~but~~ and the price of bond will not decrease but also decrease.

When rate of interest is decreased then speculative motive demand for money is increasing.

Thus, there is inverse Relation b/w Demand for money for speculative motive and Interest rate.

□ Liquidity trap

A liquidity trap is a situation " after the rate of interest has fallen to a certain level, liquidity preference may become virtually absolute in the sense that almost every one prefers holding cash rather than holding a debt which yields ~~so~~ so low a rate of interest.

in diagram, L_s curve is perfectly elastic when interest rate is very low r_1 and speculative demand for money has infinite elasticity. This part of ~~the~~ the L_s curve is called "liquidity trap".

□ Aggregate demand for money

According to Keynes the total demand of money is summation of demand for money for transaction motive, demand for money for precautionary motive and demand for money for speculative motive.

Hence, demand for money for transaction motive and demand for money

for precautionary motive is function of
 directly proportional to level of income
 and there is inverse relation between
 demand for money for speculative motive
 and rate of interest. Thus, we
 can write the aggregate demand
 as like —

$$\begin{aligned}
 L &= L_t + L_s \\
 &= f(Y) + f(r) \\
 &= f(Y, r)
 \end{aligned}$$

Where, L = Aggregate demand of money

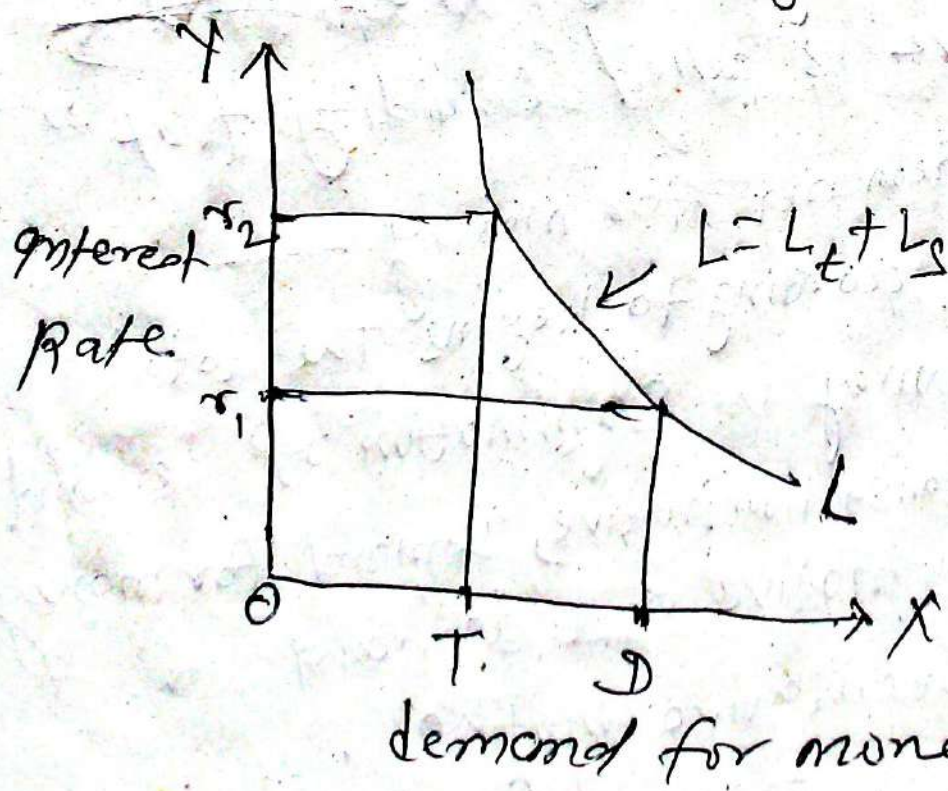


Fig - Aggregate demand of money (Keynes)

in the above diagram, L is the Aggregate demand of money which include the three types of demand for money.