P.G. II

Liquidity Preference Theory of Interest

Keynes in his book "The General Theory of Employment, Interest and Money" propounded his theory of Interest which is popularly known as Liquidity Preference Theory.

= Keynes considered the rate of interest as a purely monetary phenomenon which is determined by the demand for money and supply of money.

A man with a given income has to decide first how much he is to consume and how much he is to save. The consumption depends on the propensity to consume.

= Given this propensity to consume, the individual will save a certain proportion of his given income.

= Liquidity means to keep cash at hand. In other words liquidity preference means the demand for money to hold or the desire of the public to hold cash.

Demand for money

Liquidity preference of a particular individual depends upon several considerations. But the question is why people want to keep cash at hand. The desire for liquidity arises because of Three motives.

1. Transaction Motive
2. Precautionary Motive
3. Speculative Motive

This is in conformity with the laws of diminishing returns.

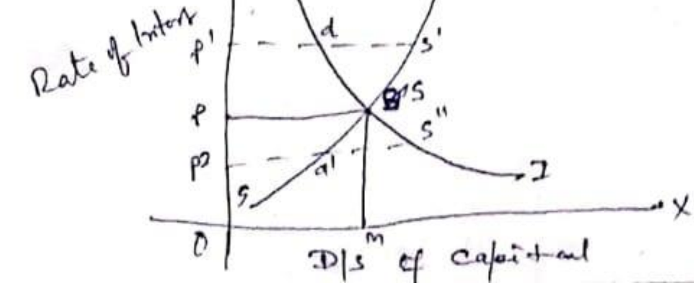
It will use that amount of capital where the marginal productivity of capital equals the market rate of interest. If the ~~marginal~~ market rate of interest rises, the firm will use less capital so as to equate the marginal productivity of capital with the market rate of interest at the lower level. The demand curve of capital of the firm slopes downwards to the right. The lower the rate of interest, greater shall be the demand for capital.

<u>Supply of capital (Saving Schedule)</u>

The supply of savings in a community is determined by several factors such as the level of income, standard of living, family affection, peaceful political conditions etc. If we assume all these conditions to remain constant, then the most powerful factor that influences the supply of saving is the rate of interest.

= Higher the rate of interest higher shall be the rate of saving of the people and vice versa. Thus the supply ~~curve~~ curve of capital rises upward to the right.

The rate of interest is determined by the equality of saving and investment.



criticism.

1. Keynes ignored real factors in the determination of interest. (Monetary phenomenon)

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(1) Productivity of capital (2) Thriftness or Saving.

2. Keynesian theory is also intermediate.

3. No liquidity without saving.