Keynesian Liquidity Preference theory of Demand for Money

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Keynesian Liquidity Preference theorem of Demand for Money

- Keynes called demand for money as liquidity preference.

- People hold money because it is the most liquid asset .

- Liquidity means easy convertibility. Money can be converted into any commodity without any inconvenience.

Motives Behind Liquidity Preference

- **Transaction demand**- money is demanded for making payments to buy goods and services.

It is a function of the level of *y* income

Mt= K(y). K= constant proportion

- **Precautionary demand-** money is demanded as a precaution. To meet unforeseen contingencies like illness.

It is also a function of the level of income

- **Speculative demand for money**– Money held for speculation and it is an inverse function of the rate of interest

- $Msp = L (r)$
- The total demand for money Md= Transaction demand (including precautions) mt + speculation demand for money Msp

  - $$\mathbf{Md = Mt + Msp = K (y) + L (r)}$$

The Liquidity Preference Curve (LP)

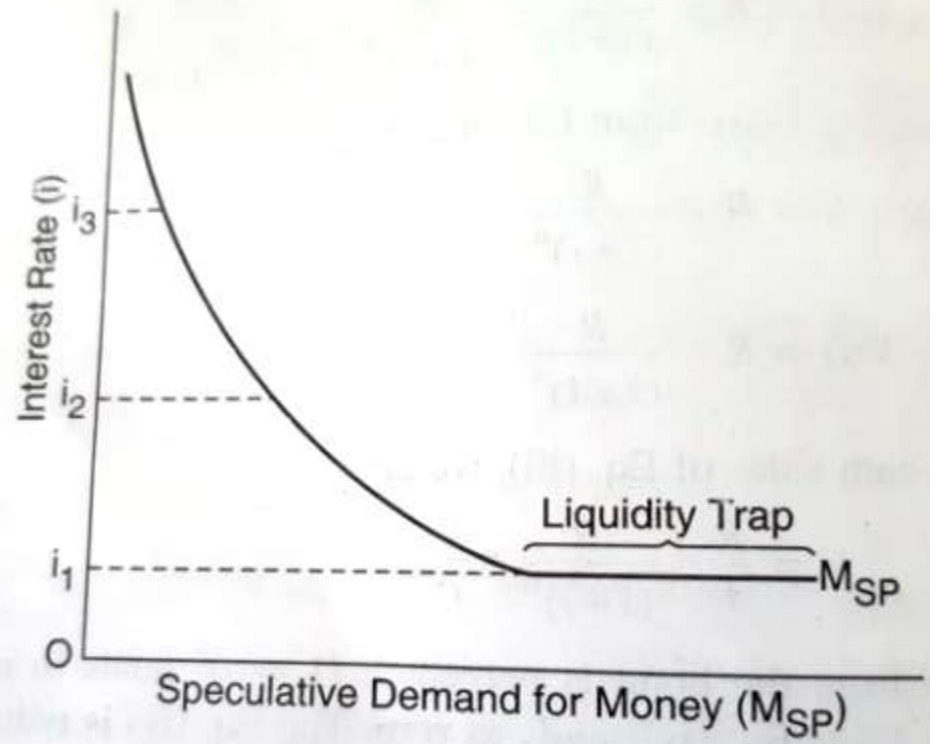

Fig. 14.3 The Speculative Demand for Money

The Liquidity Preference Curve (LP)

- It is drawn on the assumption that the level of income is constant– then the rate of interest. Therefore LP curve slopes downwards. But it has a horizontal portion which represents liquidity trap