Vivekanand College, Kolhapur (Autonomous)

Department of Economics

Subject- Business Economics (Macro)

Topic- Demand for Money (Theory)

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Demand for Money

- Money is what we use when we demand other goods.
- The Liquidity Preference Theory says that the demand for money is not to borrow money but the desire to remain liquid (holding cash). In other words, the interest rate is the 'price' for money.
- **John Maynard Keynes** created the Liquidity Preference Theory in to explain the role of the interest rate by the supply and demand for money. According to Keynes, the demand for money is split up into three types – Transactionary, Precautionary and Speculative.
- He also said that money is the most liquid asset and the more quickly an asset can be converted into cash, the more liquid it is.

- the demand for money is preference for liquidity.
- People have a very strong desire to hold money cause money is the most liquid asset.
- It can be used to buy anything immediately.
- The desire to hold money creates demand for money.
- This is known as the liquidity preference.
- People demand for money for three purposes-

1. Transaction demand
2. Precautionary demand
3. Speculation demand

Transaction demand-

- People require certain amount of money for meeting their day-to-day transactions.
- Firms and business also need for money for meeting current transactions.
- The demand for meeting such needs is known as transaction demand for money.
- Income received periodically, but expenditure has to be incurred on a day-to-day basis.
- To bridge this gap between income and expenditure, people keep a certain amount in cash.
- The level of income, payment habits, intervals or frequency of receiving income and level of business activities are the various factors that determine transaction demand for money.

Precautionary demand-

- There are certain unforeseen, unwanted and sudden expenditure.
- Everyone likes to take precaution against such expenditures. People also keep certain proportion of their income to meet such expenditures.
- This type of demand for money is known as precautionary demand for money.
- Not only people, but also business firms and other organizations require money for this purpose.

Speculative demand-

- Speculation is an important activity in the market.
- People desire to hold money for speculative purpose to take advantages of market movements (fluctuations).
- This type of demand for money is known as speculative demand for money.
- This demand is highly sensitive to the changes in the rate of interest.

- Keynes also given liquidity trap concept.

A liquidity trap is when monetary policy becomes ineffective due to very low interest rates combined with consumers who prefer to save rather than invest in higher-yielding bonds or other investments.