Nalanda Open University
Department of Economics

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- Course – BA Economics (Part –I)
- Paper – I (Micro Economics)
- Topic – Keynes Liquidity Preference Theory

Introduction of Liquidity Preference Theory of Interest

- Prof. J. M. Keynes propounded Liquidity Preference Theory in his book 'The General Theory of Employment Interest and Money'.
- Interest is purely a monetary phenomena. Interest is determined by the relative adjustment of demand and supply of money.
- Money may be stored in many form like, cash, liquid form, wealth, bond and others.

Definition of Liquidity Preference Theory of Interest

- ‘It is the price which equilibrates the desire to hold wealth in the form of cash with the available quantity of cash’. by Keynes
- Further, ‘interest is the reward for parting with liquidity for a specified period’. by Keynes

Demand of Money

Three types of demand of money by Keynes as,

Transaction Motive of Money

Precautionary Motive of Money

Speculative Motive of Money

Nature of Demand of Money

- Transaction Motive of Money and Precautionary Motive of Money is dependent on income. Both are directly related to income.
- Speculative Motive of Money is dependent on rate of interest. As Rate of interest increases liquidity decreases and vice versa. There is minimum rate of interest in the economy. Beyond this minimum rate of interest, liquidity trap exists.

Limitations of Liquidity Preference Theory of Interest

- Ignored many real factors like Saving.
- Indeterminate theory of interest.
- Ignores to explain depression in the economy.
- Ignores time element in the theory.
- Neglects the effects of changes in price.
- Bank deposits are not mentioned in this theory of interest.