

CIE Economics A-level

Topic 4: The Macroeconomy

f) The demand for money and interest rate determination

Notes



Liquidity Preference theory

This refers to the demand for cash money, which is liquidity.

Keynesians argue that people prefer cash money (liquidity) to assets because of the transaction motive, the precaution motive and the speculative motive.

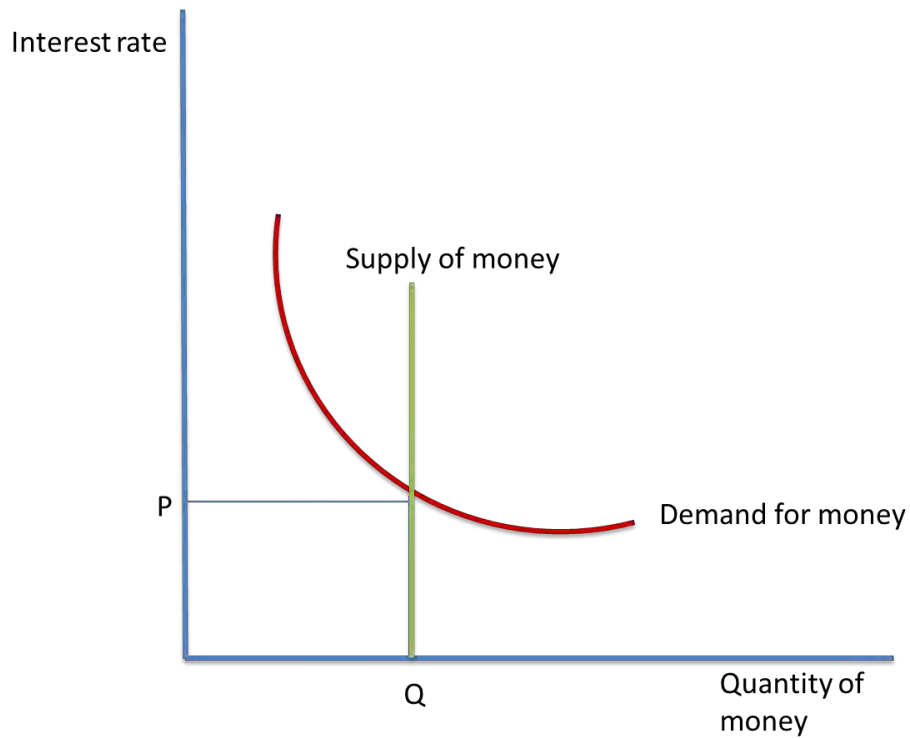
The transaction motive refers to how consumers and firms need cash money to make daily transactions. This is influenced by the consumer's spending habits (those more likely to spend will demand more money), the frequency of income (being paid more often means a consumer will demand less cash) and how much they get paid (a higher income results in more expenditure, and therefore a higher demand for money).

The precautionary motive refers to consumers keeping money aside 'for a rainy day'. Consumers want to be prepared for unforeseen circumstances. If a consumer's income is large, they demand more money for precautions. Optimistic people will demand less money for precautionary purposes, because they believe the risk of unforeseen circumstances is small. Those who consider the long term might demand more money for precautions, because they expect more unforeseen circumstances.

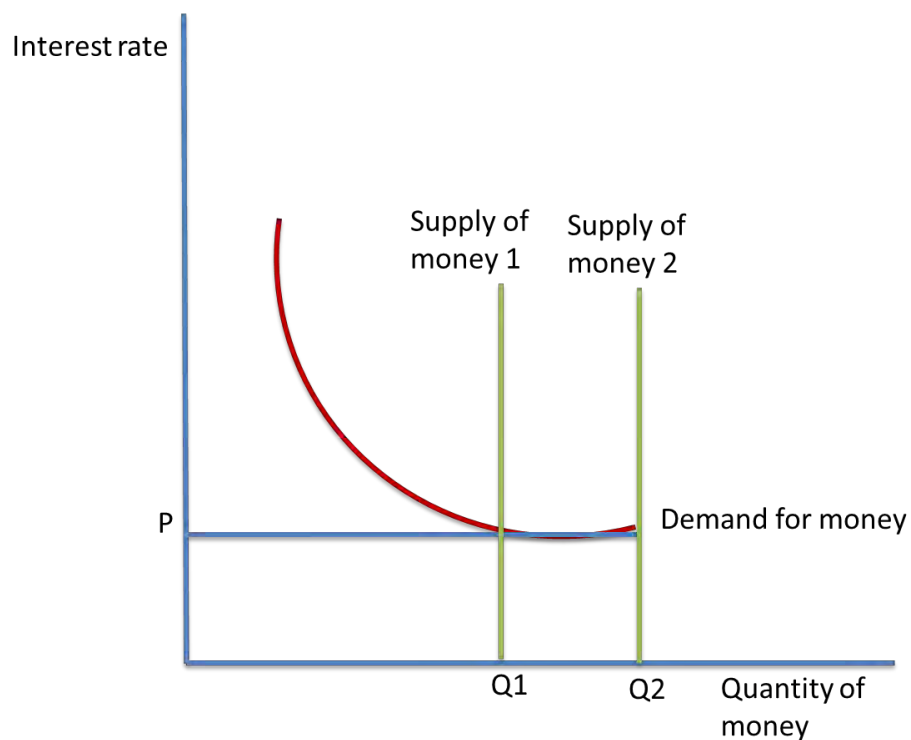
Both of the above motives are interest rate inelastic. This means the demand for money is not affected by changes in the interest rate.

The speculative motive refers to how consumers and firms want to keep money aside for potential increases in the value of bonds and securities, which they might then purchase and make a profit on. If prices are expected to rise, speculators purchase bonds, people do not keep their cash, since the bonds give a high return. If prices are expected to fall, people keep hold of their cash.





Interest rates are determined as shown in the diagram above. The supply of money meets the demand for money at P, Q. A rate of interest above P means the supply of money exceeds demand. This causes the rate of interest to fall. The interest rate remains at equilibrium unless there the demand for or supply of money changes.



The above diagram shows a liquidity trap. This is when a change in the supply of money does not change the interest rate. This means monetary policy cannot be used to influence consumption and investment.

