

MODULE I: (B) MACROECONOMICS

2. MONEY

After reading this unit you should be able to understand:

- *Demand for money*

Introduction

The old idea about the demand for money was that money was demanded for completing the business transactions. In other words, the demand for money depended on the volume of trade or transactions. As such the demand for money increased during boom period or when the trade was brisk and it decreased during depression or slackening of trade. The demand for money refers to the total amount of wealth held by the household and companies. The demand for money is affected by several factors such as income levels, interest rates, price levels (inflation), and uncertainty. The modern idea about the demand for money was put forward by the late Lord Keynes, the famous English economist, who gave birth to what has been called the Keynesian Economics. According to Keynes, the demand for money, or liquidity preference as he called it, means the demand for money to hold.

Broadly speaking, there are three main motives on account of which money is wanted by the people by the people, namely;

- (i) Transactions motive
- (ii) Precautionary motive
- (iii) Speculative motive

1. TRANSACTIONS MOTIVE:

The time of receiving income and the time of incurring expenditure by an individual/ firm general do not coincide. In order to meet the needs of transaction during the time gap some money is kept aside, known as the transaction demand for money. The smaller the gap between a person's receipt and payment lesser will be the transaction demand for money.

Business firms also need cash for meeting their day to day transactions. But their receipts and payments are not as regular as those of households. Compared to households therefore the firms must keep relatively larger cash balances at any point of time.

This motive can be looked at:

(a) From the point of consumers who want income to meet the household expenditure which may be termed the income motive, and

(b) From the point of view of the businessmen, who require money and want to hold it in order to carry on their business, i.e., the business motive.

(a) Income Motive:

The transactions motive relates to the demand for money or the need for cash for the current transactions of individual and business exchanges. Individuals hold cash in order "to bridge the interval between the receipt of income and its expenditure." This is called the income Motive'.

Most of the people receive their incomes by the week or the month, while the expenditure goes on day by day. A certain amount of ready money, therefore, is kept in hand to make current payments. This amount will depend upon the size of

the individual's income, the interval at which the income is received and the methods of payments current in the locality.

(b) Business Motive:

The businessmen and the entrepreneurs also have to keep a proportion of their resources in ready cash in order to meet current needs of various kinds. They need money all the time in order to pay for raw materials and transport, to pay wages and salaries and to meet all other current expenses incurred by any business of exchange.

Keynes calls it the 'Business Motive' for keeping money. It is clear that the amount of money held, under this business motive, will depend to a very large extent on the turnover (i.e., the volume of trade of the firm in question). The larger the turnover, the larger in general, will be the amount of money needed to cover current expenses.

(ii) PRECAUTIONARY MOTIVE:

Precautionary motive for holding money refers to the desire of the people to hold cash balances for unforeseen contingencies. People hold a certain amount of money to provide for the risk of unemployment, sickness, accidents and other more uncertain perils. The amount of money held under this motive will depend on the nature of the individual and on the conditions in which he lives.

(iii) SPECULATIVE MOTIVE:

The speculative motive relates to the desire to hold one's resources in liquid form in order to take advantage of market movements regarding the future changes in the rate of interest (or bond-prices). The notion of holding money for speculative motive is a new typically Keynesian idea. Money held under the speculative motive

serves as a store of value as money held under the precautionary motive does. But it is a store of money meant for a different purpose. The cash held under this motive is used to make speculative gains by dealing in bonds whose prices fluctuate. If bond prices are expected to rise, which in other words means that the rate of interest is expected to fall, businessmen will buy bonds to sell when the price actually rises. If however, bond prices are expected to fall, i.e., the rate of interest is expected to rise, businessmen will sell bonds to avoid capital losses. Nothing being certain in this dynamic world, where guesses about the future course of events are made on precarious bases, businessmen keep cash to speculate on the probable further changes in bond prices (or the rate of interest) with a view to making profits.

Given the expectations about the changes in the rate of interest in future, less money will be held under the speculative motive at a higher current or prevailing rate of interest and more money will be held under this motive at a lower current rate of interest.

The reason for this inverse correlation between money held for speculative motive and the prevailing rate of interest is that at a lower rate of interest less is lost by not lending money or investing it, that is by holding on to money; while at a higher rate, holders of cash balances would lose more by not lending or investing.

Thus, the amount of money required to be held under the various motives constitutes the demand for money. It may be borne in mind that, in economic analysis, demand for money is the demand for the existing stock of money which is available to be held. It is stock of money not a flow of it over time.