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The Role and Importance of Liquidity Preference, Marginal Efficiency of Capital, and Marginal Propensity to Consume in Keynes's General Theory

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Abstract

This article builds an understanding of Keynes' General Theory as an advancement upon the Classical theory of economics with the introduction of new postulates including analysis of the propensity to consume, marginal efficiency of capital and the concept of the rate of interest. Based upon Keynesian General Theory, the key concepts, and variables of Liquidity Preference, Marginal Efficiency of Capital, and Marginal Propensity to Consume are familiarized and elaborated in terms of their role and importance in theory. Different references have been cited to support the interpretations as originally presented in Keynes's General Theory. Literature has widely discussed the vital postulates of Keynes on the principle of effective demand, the consumption function, multiplier and interest rate, interest rate and investment. These postulates take account of the subjected variables and elaborate on the importance of these in Keynes General theory and models. Furthermore, the criticism of General theory is discussed, and conclusions are drawn at the end of the article.

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1. Introduction:

"Ideas shape the course of history."

John Maynard Keynes

The classical theory of economics thrived in the late 18th and early 19th century. The main contributors to classical theory are known to be Adam Smith, David Ricardo, Thomas Robert Malthus, John Stuart Mill, and Jean-Baptiste. Adam Smith's Wealth of Nations (1776) and the metaphor of the invisible hands formulated a base to translate the market economy into a self-regulating system. While J.M Keynes considered this school of thought to be led by David Ricardo (1772–1823), very well known for his work on Principles of Political Economy and Taxation (1817). Furthermore, he stated himself to be a habitual of the classical school of thought adding to it, unlike the other classical economists. In preliminary arguments, JM Keynes reverberates the importance and historical roots of classical economics and then presented the divergence in arguments with that of classical theory. One foremost limitation of the classical school of thought was that it was merely based upon a special case (such as Euclidean geometers) contrary to which he applied "General" conceptions in theory giving the name to his theory as General Theory. John Maynard Keynes (1883-1946) completed his General Theory in 1935 when the world was witnessing the great depression. As a result of that, an uncharacteristic situation regarding unemployment was created, which the classical views could not discuss. The general theory attempts to discuss that problem rejecting the classical view of "production creating its own demand" emphasizing that economy cannot recover to full employment equilibrium after the crisis. John Maynard Keynes, a renowned economist presented The General Theory of Employment, Interest and Money (1936). This theory proved to be a great philosophical contribution to economic history explaining the key theories of importance in the macroeconomic perspective regarded as the "Keynesian Revolution". As was discussed demand-side theory and short-run changes in the economy. Having influential consequences in economic policy. The theory provided theoretical support for government spending in general, as well as monetary policies. Keynes thoughts over unemployment and negating the adjustments in equilibrium led to the explanation of unstable expectations and markets causing crises and booms. The General Theory can be seen as an outbreak of the classical economics of the time. It familiarized the concepts of liquidity preference, the marginal efficiency of capital and the propensity to consume. Those are defined below shortly as covered in this study in detail, in terms of role and importance in General Theory in the discussion and analysis section. Keynes followed a thorough structure in stating his General Theory in which he explains the independent and dependent variables of consideration in great detail. The theory is organized into six books with subchapters on variables and key functions. In the introduction book, he explains the problem of unemployment discussing the limitations in classical views and the way forward. The second book "Definitions and Ideas" defines the key definitions in the study, including monetary and economic terms. The third book explains the concept of propensity to consume, explaining the principle of effective demand and multiplier. Book IV throws light on expectations, rate of interest and liquidity preference. Here, he argued the investment is determined by the expectations of investors and the rate of interest. Whereby, the rate of interest to base on liquidity preference and income. In the second last book, the fifth, General Theory explains the Money-Wages and price relationships, followed by the elaborations on trade cycle and general suggestions in the last book VI. Below are some introductory notes on the key variables of GT, as we shall look for the role and importance of these variables in General Theory in detail in forthcoming sections. In chapter 18 of General Theory, Keynes states the propensity to consume, the marginal efficiency of capital and the interest rate as independent variables in his model to affect the overall employment general income and supporting General Theory and its postulates.

Hicks (1936) reviewed The General Theory of Employment, Interest and Money stating the potential outlooks of theory in terms of development towards economics and urging new questions. Above all the author contemplates it on its merits and key how and about. This theory not only discussed employment but "output in general" and "shifting equilibrium", evidently imparting development in the pre-existing theories and re-construction of understandings in literature. The most contemporary and central aspects the author finds in this study are employment and unemployment, to which the theoretical contribution has been made in General Theory. The author identified the theoretical associations between the contributions of Marshal, Ricardo, and Pareto in terms of economic complications, equilibrium and disequilibrium[1]. Moreover, being a theory of money, it also caters for the monetary theory with argumentation on interests, liquidity, and investment. The general theory changes the viewpoint of saving and investment. As J. M. Keynes says in his book, accepted being raised in and influenced by the classical school of thought, Hicks has resounded this aspect in this paper discussing the trade cycle assumptions in Keynes treatise. The author argued that pre-existing literature expresses the theories as static economic theories discussing the normal state of economies while the anomalies to the normal are deviations (for instance deviations in money supply, rate of interest, savings, or investments). But as evident from the extended arguments in general theory, it necessitates that further considerations for ordinary or normal economic conditions are important as new definitions and savings and investment are referred to in Keynes General Theory, considering even in the changing economy, demands and supplies are equal. The author also referred to the reckoning of current prices and holding of stocks for the future (as J. M. Keynes argues) based on current willingness and future expectations. The author of this paper also appreciated the simplification and bundling of complex factors as discussed in theory, namely the principle of effective demand, the propensity to consume and multiplier, the marginal efficiency of capital, long-term expectations, theory of interests, liquidity, and trade cycle (Keynes, 1936; Hicks 1936). The most radical part of Keynes theory is the value and consideration of expectations, moreover, Hicks (1936) anticipated more novelties from J. M. Keynes in terms of the "method of anticipation"[2].

2.Literature Review and Background of Study

The general method of expectation is discussed by the author from a general perspective as an effective method to introduce determinateness. He argued the method to be effective in the analysis of disturbing causes but not otherwise, specifically when the long-term expectations are considered to be very limited in the short-term analysis of changes and anomalies. In long-term analysis, he argued it would cause errors in analysis (p. 241). Also, he criticized the limited interpretations of the long-term expectations as discussed in the Keynes theory and anticipated the difference of opinion. J. M. Keynes categorized the expectations of entrepreneurs into short-term (the expected price of the finished product at the time of production; referred to as current prices) and long-term expectations (future return on investment in additional purchase or manufacturing to his capital equipment). Hicks (1936) states the latter to be the most "brilliant" chapter in the General Theory. Keynes thoughts on the impact of the rate of interest on consumption disturbing the equilibrium. Where he introduces the "Propensity to Consume", focusing on the relation to increased demand and income, where disinvestment in stocks and flexible production stock play an important role. This needs to consider the rise in the rate of interest as a monetary problem, as in its principal interpretation from Wicksell. For an explanation of that he introduced the "Liquidity Preference Theory" translating personal

[1] https://www.cambridge.org/core/books/theories-of-value-and-distribution-since-adam-smith/the-jevonian-revolution/9BBFEC3891D805F64A35C367EB64A5DD

[2] https://www.jstor.org/stable/2764088, Ross, E. (1916). The Principle of Anticipation. American Journal of Sociology, 21(5), 577-600. Retrieved April 22, 2021, from http://www.jstor.org/stable/2764088

preferences to hold and liquidate money (Hicks, 1936, p. 245).Literature extended Keynes' consideration of the rate of interest, liquidity preference as well as the level of income. This eclectic approach in monetary analysis gives Keynes a comparative advantage in his method of interpretation that emphasizes the rate of interest rises with a rise in consumer prices i.e., inflation unless the supply of money is expanded (Hayek, Prices, and Production). Keynes considers "involuntary employment" as a factor in diminishing boom as he explained factors in trade crisis all over. Yet again, he presented another factor to influencing a boom with the introduction of "Marginal efficiency of Capital". It is the "rate of interest which would equate the present value of the net yields expected in future periods from an additional good of this kind with its supply price (Hicks, 1936, p. 135)". Therefore, changes in the marginal efficiency of capital (depending primarily upon expected and current prices) and rate of interest are crucial in investment capital industries.[3] Literature has very well summarized the standpoint of Keynes regarding capital accumulation in a boom pushing down the marginal efficiency and interest rate in the long run as the only viable option to maintain investment activity. Furthermore, in a longer period, the lower rate of interest will cause investors risk of capital loss. In such cases, the expectations are not as good as to maintain optimism (Hicks, 1936, p. 245). Here the author has sought more on this risk elaboration and grounds for his fundamental law of the Diminishing Marginal Efficiency of Capital, calling the Keynes interpretation as not "thorough as one could desire" regarding the trade boom collapse. (Hicks, 1936, p. 251). There are other reasons for the collapse stated as the imperfect elasticity of the supply of consumption goods followed by the hardening of interest rates.

General Theory is believed to be a sustained outbreak over classical economics, whereby Keynes' opposition regarding full employment in equilibrium, the importance of volatility and the uncertain psychology of the market in peaks and crisis gain much attention in the literature. In General, theory counted in many new concepts including revisiting the classical postulates and theories. Consumption function, effective demand, liquidity preference, multiplier, and the marginal efficiency of capital are key concepts of prominence in General Theory. Samuelson, (1946), appreciated the work of Keynes and his phenomenal contribution towards economics after a decade of the Keynes General theory, anticipating its long life in the field. The literature has already recorded the impact that Keynes theories have made in the development of economics. Moreover, he considered it a source of pride being in the era of classical economics to get an intensive grounding on classical economic matters as Keynes argued similarly in the starting statements of his General Theory (Keynes, 1936). It is very incomprehensible for post-Keynesian scholars to realize the total impact advisably called "The Keynesian Revolution" in comparison to those brought up within the orthodox convention. Many written works dealing with the classical economics school of thought, formally and systematically dealt with the employed resources, as J.M Keynes indicated. Arguing about the Ricardian practice, the employment considerations are simpler, based only upon the marginal consideration of labor and marginal disutility of employment as wage. Further of which explained in the literature by crediting Prof Pigou's Theory of Unemployment. In simple words, the classical theorists also emphasized a major reason for unemployment to be the diminished demand for employment at a current wage. Another important consideration to revisit shortly is the aggregate demand function. Factor cost, user cost, the excess of which is defined to be profit or income, and expectation of incomes has also been the decisive factor in employment. Aggregate supply and demand function $Z=\Phi N$ and $D=f N$ respectively, where Z, D and N are supplying price, expected profit and the number of employees respectively. So, for any N, if the expected profit is greater,

[3] Pp. 168-169, 201-202. In order that holding money should be a serious alternative to investing it, it is a necessary condition that the costs of holding money should be very small. This important point is brought out in Chapter XVII (Keynes, 1936)

more supply for employment is generated. The classical theory explained these functions to be the same for any values of N as believed that supply is adjusted with demand considering the elastic nature of this function later explained in Keynes general theory. Keynes has seen the analysis of the propensity to consume, the marginal efficiency of capital and the concept of the rate of interest as the three main gaps of classical economics to be filled by General theory. Leijonhufvud, (1967) stated that Keynes's Gestalt conception is a reflection of Cassel's thinking on eclecticism (Keynes, 1936, p.94) that stirs Keynes's liquidity preference theory and rate of interest. Wealth effects, capital uncertainty and the term structure of rate of interest show the promising reproductions in Keynes Liquidity preference theory that has been neglected by the Keynes- Hicks reviewers for a long time. As Keynes broadly explained liquidity preference as the demand for money in slight meanings among a choice of payments while defining money in General Theory. Contemporary monetary scholarship has come to an indistinct understanding of Keynes' theoretical approach, basically on the grounds that the fundamental presumption of inelastic expectations and speculative demand. Whereby Keynesian multiplier keeps the importance in making understanding these facets of monetary terms and "deviation-amplifying" manner-behaviour which cannot be analyzed with the pre-Keynesian approach.

2.1 Keynes' General Theory: A Broader Perspective on Macroeconomics

Barens, (2011) mentioned the reopening of interest in Keynes theories. As there has been a gap seen in past decades between the detailed understanding of instability of markets and unpredictability of economic activity has made its way through the terrible crises. Though it was not the main subject in General Theory it discussed very well the problem of instability in economics. Furthermore, it is elaborated that the logical assumption of full employment long-term equilibrium in Keynes was unstable in his theories and analyses referred to as the "banana parable" (Keynes, 1936, pp. 158-160) as he explained the consumption function and principal of effective demand (Barens, 1989) criticizing aggregate demand and saving relationship. He concluded that increased savings would result in decreased aggregate demand that would end up in nil production and employment. Keynes suggested a solution to this instability a marginal propensity to consume less than one i.e., to descent production and employment to adjust saving with the demand of investment (principal of effective demand). Minsky, 1976 considers that there's a need for clear thoughts on capitalist finance based on cyclical and speculative context as finance leads the economy. Also, he criticized the recovery approaches of full employment as he believed that neither the boom nor the recovery can go on forever. Each state sustains powers that lead to its claim of its own destruction. The 1930s was a period of the great depression. JM Keynes in that era put forwards his theory of being critical of classical economics that was later turned in by the Roosevelt administration. JM Keynes published several books as renowned literature on economics, key of those is this book that discussed the macroeconomics theories and discussed the role and justified the role of temporary government interventions to stabilize the economy, as a major distinguishing factor in classical view vs Keynes's view extended as expansionary fiscal policy. Though highly controversial, it stabilized and helped the economies grow.

2.2 Criticism of Literature and Contradictions in The General Theory

Presenting a review of General Theory, as he indicated the level of complexity in Keynes model, Samuelson stated, "Indeed, until the appearance of the mathematical models of Meade, Lange, Hicks, and Harrod, there is reason to believe that Keynes himself did not truly understand his own analysis" (Samuelson, 1946, pp. 316). As it took much time by leading academic groups to know what and about regarding the General Theory. Keynes strongly supported an expansionary monetary policy during the boom to keep employment as defined as full employment. Keynes's theory of prices was subjected to contradiction, in which he argued that

an increase in the money supply at the level of output which is close to full employment is almost entirely absorbed by an increase in the costs of production and therefore in the level of prices. He defined this phase in the economy as the state of true inflation. Keynes supported keeping the interest rate at a very low level by using expansionary monetary policy, but on the other side, the additional money supply in his theory of prices is almost completely absorbed by the increase in prices and thus has no effect on the real variables. Contradiction in Keynes's theory of keeping the capital relatively scarce by decreasing the rate of interest to a very low level when the actual output is close to potential output and increasing the money supply to keep full employment while facing the state of "true inflation" is possible to solve by including the technological change (innovation). The Horvat model of economic growth can be integrated into the General Theory to show mathematically that it is possible to keep inflation under control at the level of full employment as long as there are improvements in the structure of costs based on the increase in productivity.

3.Discussion and Analysis: General Theory and its Key Variables

3.1 The Principle of Effective Demand

In contrast to the classical view of production creating its own demand (Say's Law), Keynes presented aggregate function for supply and demand, differentiating the two. Where aggregate supply is production employing N resources and demand is the requirement of the finished product by N employees. Effective demand is illustrated at the point where these curves meet, depicting the effective demand (Fig 1.)

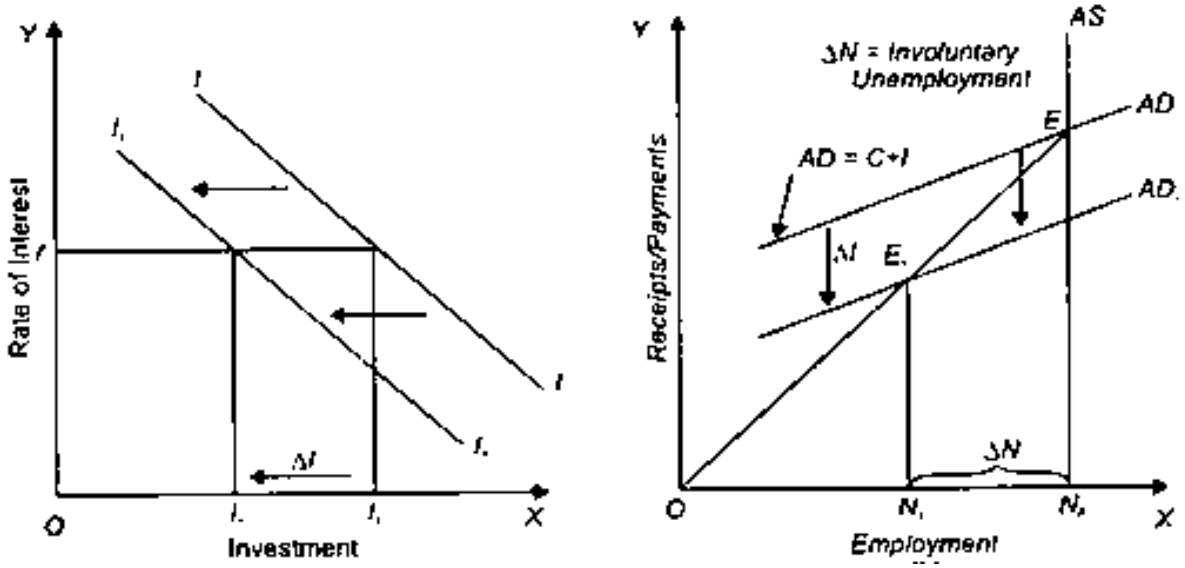

Figure 1: What causes depression and cyclical unemployment: Keynes Explanation [4]

In a state of disequilibrium, the demand cannot be sufficient to reach full employment. As in figure 1 above we can see that at low employment, the demand is more than the supply. The reason for that is deficient consumption or investment. No further elaboration in terms of the constituents of these functions is discussed hereafter.

3.2 The Consumption Function and Propensity to Consume:

Demand for consumption C and Investment I, make the aggregate demand together, AD = C+I. In the Keynes model, the consumption function is C = C' + cY. Income Y is explained as a function of two i.e., consumption and investment. The consumption functions' downward trend is

[4] Keynes' Theory of Employment (With Diagram) Article Shared by Subho Mukherjee, https://economicdiscussion.com

discussed largely in literature, its reason lies in the fact that more income renders less proportion of it towards consumption. That means Keynes' consideration of this function as nonlinear. Moreover, there are multiple factors that the consumption function account for, such as wage level, income fluctuations, and future income speculations including some subjective factors such as independence and luxury (Keynes, 1936, p. 108 as cited in The Keynesian Model in the General Theory: A Tutorial by Raúl Rojas[5]).

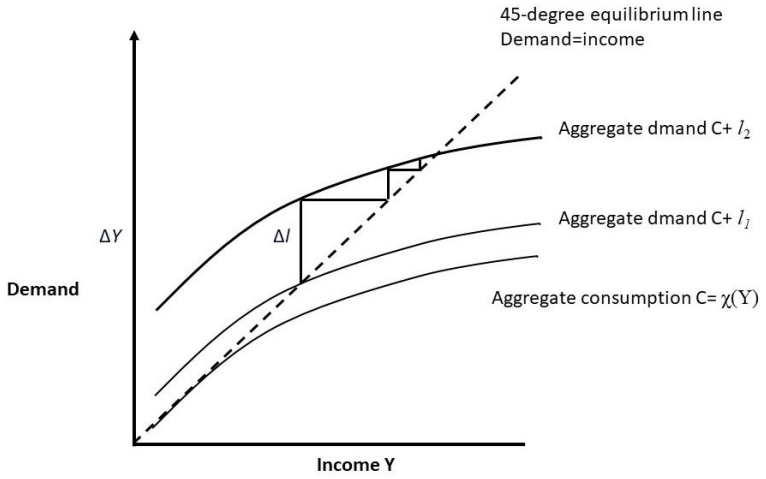

Figure 2: Aggregate Consumption Keynes, (1936, p. 108 as cited in The Keynesian Model in the General Theory: A Tutorial by Raúl Rojas[6])

Here in the figure above we can assume the wage unit to adjust the We can refer here in Fig 2, to the concavity of the consumption function as Keynes elaborated it as The Fundamental Psychological Law. Where the level of investment and wage factor can be seen to transfer the consumption function. Upon the interpretations of the consumption function as rather stable, here investment plays a crucial role in achieving full employment.

3.3 Investment and Multiplier:

In figure 2 investment displaces the aggregate demand curve to attain a new state of equilibrium with higher income and employment. More interestingly, the increase in investment makes a big gain in income Y. This is referred to as a multiplier in General Theory.

Referring to illustrations above, Y = C + I, As Y= cY +I, so ΔY= cΔY +ΔI

Implies that, ΔY= ΔI/1 – C = **k** ΔI

Where k is the multiplier that would be always interpreted as greater than one. Here Keynes argues the role of the state to take advantage of this effect to generate spillover (Keynes, 1936, p. 129). The multiplier effect of a decline in investment on employment can be seen in Figures 1 and 2. The fall in investment by Δl has led to a much larger decline (ΔN) in employment due to the reverse operation of the multiplier.

[5] A Cornell University Recourse: https://arxiv.org/ftp/arxiv/papers/1708/1708.07509.pdf

[6] Footnote 2: A Cornell University Recourse: https://arxiv.org/ftp/arxiv/papers/1708/1708.07509.pdf

3.4 Investment and the rate of interest:

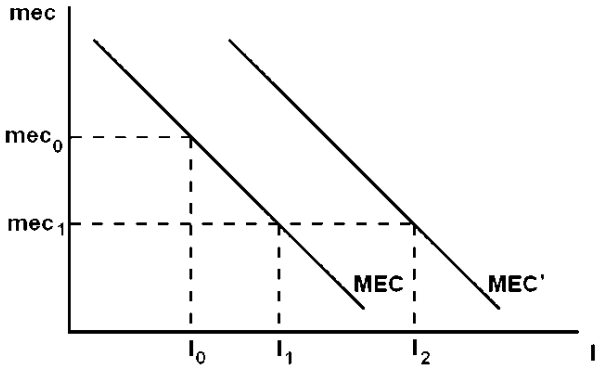

Figure 3: Schedule of Marginal Efficiency of Capital[7]

Keynes argued about the possibility to avoid the cyclical fluctuations of business activities over the longer term by keeping the interest rate low during the boom. As already mentioned in the introduction section, Keynes rejection of the rate of interest outlook from the classics. According to him, the rate of interest is based on the cash supply and liquidity preference. Here we discuss the schedule of "Marginal Efficiency of Capital". It can be referred to as a downward curve function that elaborates more investment opportunities at a lower rate of interest than at a higher one (Fig. 3: r and MEC along OY and I along OY axes). Also, expectations schedule the marginal efficiency of capital alongside r (rate of interest) and I (investment). Where the level of investment can be decided on the basis of these expectations and the rate of interest. More optimistic expectations can increase the level of investment at a given rate of interest. Here, the state monetary policy can induce investment setting a level of the marginal efficiency of capital.

3.5 Role and Importance of Marginal Propensity to Consume

Marginal Propensity to Consume is referred to as the share of income spent on services and goods for consumption, rather than saving. It is a key variable as discussed in terms of the multiplier effect of speculative spending suggesting that government spending increases consumer income. This increase in income results in spending by consumers, and this rise in investment generates increased aggregate demand. The marginal propensity to consume measures how much a buyer will spend or spare in connection to a total raise in wage. In general terms, the marginal propensity to consume is represented as variation in consumption based on the change in income. Agreeing with the Keynesian hypothesis, an increment in speculation and government investing increments buyers' wages, and as a result, they spend more. If we know what their negligible willingness to consume is, at that point, we are able to calculate how much an increment in a generation will influence investing. This extra investment will create extra generation, making a ceaseless cycle by means of the multiplier function elaborated by Keynes. As Robertson, (1936) illustrated that increase in consumption needs increased investment, consequently, providing more money to consume. We can see it as a cyclic function and phenomenon both in terms of consumption and instrumental goods. For a given percentage in demand in one, it creates an increased percentage in the second, being a familiar trade cycle feature. Carroll & Kimball (1996) stated that there is a long-standing debate on the concavity of the consumption function since the beginning of Keynesian

[7] Harvey, J. T. (2010). Keynes' Business Cycle: Animal Spirits and Crisis (No. 201003).

macroeconomics. There is much importance given to consumption function in the General Theory of Employment, Interest, and Money accenting its concavity. Lusardi (1992) and Souleles (1995) suggest the most vital fact concavity infers is that increased consumption depends on the level of assets and reserves, which is serially connected, as the suggestion of Hall (1978). Stone and Stone, (1938) stated that one of the numerous appealing highlights of Mr Keynes' General Theory is the victory of this sort of simplification of economic postulates missing in preexisting literature as there is no place clearer than Keynes thoughts on the propensity to consume and the multiplier. Mr. Keynes' "common psychological law" is prima facie profoundly conceivable, and if we are advocated in expecting that over a decently long period, the variability in a community's total consumption depends almost totally on the change in its income. Furthermore, Marginal Propensity to consume is important as it can be made to advantage financial advance by a fitting "monetary policy" which increments the amount of cash sufficiently to keep the "rate of interest" low, so as to compensate or maintain the equilibrium. What a long-term arrangement is conceivable depends on the structure of the monetary and overall economic system.

3.6 Role and Importance of Marginal Efficiency of Capital

The "Marginal Efficiency of Capital" is defined as "the rate of discount which would make the present value of the series of annuities given by the returns expected from the capital asset during its life just equal its supply price" (Keynes, 1936, p. 136).[8] Generally, the marginal efficiency of capital can be understood as the expected rate of return from the business investment. Firms consider marginal efficiency of cost when it comes to an investment project. It is calculated considering the depreciation of capital and future input costs. In Keynes' rate of return approach for economic interpretation and calculation, the marginal efficiency of capital is used by stakeholders to rank investment plans and projects. Another definition in this context states that the marginal efficiency of capital is the "rate of discount which would make the present value equal to its supply price" (Keynes, p. 135 as cited in Kregal, 1985). The marginal efficiency of capital is what General Theory's demand function is based upon, playing a prominent role in demonstrations of Keynes's theory. As a critique to demand function leaving out two important elements in Keynes's analysis is considered a good measure of the model to determine how about of investment. In explaining the determination of investment in Keynes Model, Asimakopulos, (1971). proposed two functions, one, a forecast function relating investment choices to probable profits, and another after-the-fact function relating actual and anticipated profits side by side of the investment. Though Hicks 1937 did not completely interpret Keynes's theory, this made Keynes economic school of thought a "majority school" (Leijonhufvud, 1967). Literature suggests that the association between saving and interest rate is of less quantitative significance, nonetheless, Keynes's thoughts on the subject are of substantial interest, whereby the theory of liquidity preference takes significance. The "psychological law" on which Keynes based the relationship between income and consumption is criticized for neglecting wealth as a variable. But stated as the windfall effect that Keynes considered should be classified amongst the major factors capable of causing short-period changes in the propensity to consume" answers the criticism (Keynes, 1936, pp. 92-94). Lange, (1938) elaborated on the aforementioned psychological law as the propensity to consume will be higher if the domestic net worth is higher than is to consume more consumer goods. The reasons for the decline in the propensity to consume are primarily deterioration in the marginal efficiency of capital or escalation in the long-term rate of interest (Keynes, 1936, pp 94-197). In the short run, the marginal efficiency relates becomes of least concern but the

[8] Keynes, John Maynard; The General Theory of Employment, Interest, and Money (1936), p 135. (online resource, docstoc.com)

interest rate. (Leijonhufvud, 1967). The marginal efficiency of capital is practically higher than the rate of interest (r), for investment (I) to take place.

3.7 Liquidity Preference and Money Supply:

Keynes defined interest rate as investors' pay in exchange for liquidity. Here we can discuss the reasons. According to the liquidity preference theory, as explained by John Maynard Keynes (1936), investors prefer to keep their money liquid. Investors prefer cash and short-term fixed treasuries for faster access to money. Long-term fixed assets cost liquidity but higher rates of interest. Liquidity theory explains that such preferences are made on the basis of speculative increases in interest rates, precautionary motives and domestic transactions. Simply, the faster an asset flips to cash is more liquid.

Money: Cash held for unforeseen events and speculative motives

L: Liquidity Preference as Function of interest rate r (it is also a function of demand Y)

Here, consider, Money =L (r) (here in fig. 4 rate of interest r is shown as MP along OX)

Fig. 3 shows the curves of liquidity preference determining the rate of interest at a given quantity of money supply. Different curves show different levels of income and preferences to liquidate money. As Keynes states "Liquidity-preference is a potentiality or functional tendency, which fixes the quantity of money which the public will hold when the rate of interest is given; so that if r is the rate of interest, along OY, along OX the quantity of money and L the function of liquidity-preference, we have Money = L (MP where MP is the interest rate). This is where, and how, the quantity of money enters into the economic scheme" (Keynes, 1936).

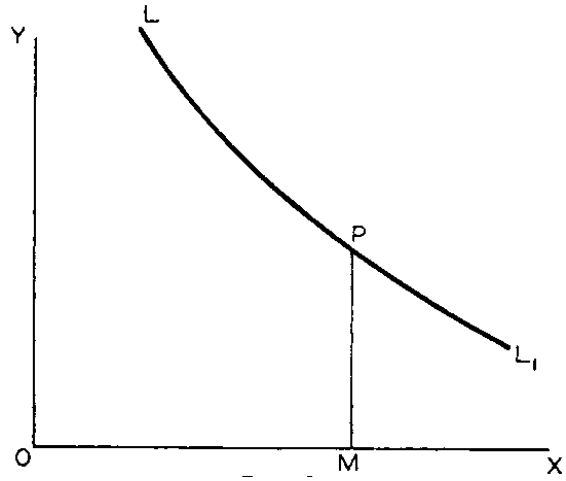

Figure 4: Graphical representation of Liquidity Preference and Money Supply (Robertson,1936: notes on Keynes, 1936[9])

3.8 Role and Importance of Liquidity Preference

Liquidity Preference Theory refers to the higher interest rate demand by investors on long-term fixed assets (securities with long-term maturities) as there is a general liquidity preference in regard to holding money for a long time. This theory refers to money demand as measured over liquidity as Keynes explained relating interest rates and supply-demand as illustrated in figure 4. Followed by the brief definition we will see how important liquidity preference plays a part in Keynes General Theory. It is not only a refined theoretical approach to explain the under-employment equilibrium but also the rate of interest dependence on money, together with fixed wages. Liquid money depends not only on the total amount of money together on the rate of interest. It also takes propensities to save and invest into

[9] Robertson, D. (1936). Some Notes on Mr. Keynes' General Theory of Employment. The Quarterly Journal of Economics, 51(1), 168-191. doi:10.2307/1882506

consideration (in a flexible wage system). On the other hand, in fixed-wage systems, these propensities are also important in explaining employment and real income. Wray (1995; 1992) argued the importance of liquidity preference in the banking sector where banks and borrowers are central in shaping credit amounts. He added in his discussions about interpretations of liquidity preference on balance sheets in rise and fall translating the Keynesian proposal that liquidity preference makes a price system for liabilities and assets affecting demand prices. It furthermore relates to the portfolio decisions depending upon ownership of assets to determine asset prices to balance gain. High liquidity preference accounts for low prices of capital assets decelerating production. This also drops the rate of interest, affecting the quantity and price of credit reducing the borrower's desire to spend and the bank's buying. Keynes's hypothesis follows to mention that liquidity preference is based on asset demand price costs and in which current yield supply costs are independently decided to permit endogenic cash as characteristic of a capitalist economy. There's an argument in literature on the endogeneity of the money indicated by Moore and Keynes, until it was realized that deep institutional analysis of banks is needed to call out the role of liquidity preference in terms of interest rate. Moore's Black Box Horizontalism and Keynes's General Theory are not so much sufficient to explain the money characteristics although "finance motive" was indicated in the explanation of liquidity preference by Keynes. Though, liquidity preference, being a simple consideration in Keynes's theory, is a vital theoretical approach pointing to complex behavior and institutional analysis of the economy. Tobin, (1958) explains further extended concerns in his paper about decision-making units of the economy and their behavior criticizing the doubtful behavior explained in literature since the arrival of General Theory and emphasizing the need to elaborate such aggregate functions of the economy. If we further elaborate Liquidity preference can be seen as a basic functional relationship in the Keynesian economic view, inversely related to the demand for cash balances and the rate of interest. Literature deliberated two primary conditions in holding cash are for transactions and investment purposes. In consideration of investment balance and portfolio decisions first, we discuss the investment balance as the balance of cumulative expenditures and receipts, not in terms of paper money. Therefore, the conversion cost into paper money from other assets is not part of a condition favoring holding cash, but here the "speculative motives" of investors regarding expectations of a loss of other assets play a role in liquidity preference. As discussed previously, Liquidity preference relates to all sorts of monetary assets as well as other varied assets to invest in including stocks, real estate, businesses, and services. in which wealth may be invested: corporate stocks, real estate, unincorporated business, and professional practice. It is regardless of what choice an investor makes to invest in liquidity preference but not, necessarily, when it comes to theories of capital and consumption in General Theory. However, liquidity preference involves decisive consideration towards wealth investment and its distribution among cash and other multiple assets. It has been indicated in General Theory that there are two conceivable sources of liquidity preference recognized as mutually exclusive i.e., inflexibility in expectations for future interest rates and uncertainty about the future interest rate. Keynes has extensively centralized the liquidity preference to explain the under-employment equilibrium that was criticized in terms of logical appropriateness. Rochon (1997) argued in his paper and criticizes the firm standalone position of liquidity preference explanation from Keynes in General theory, as not aligned with the monetary circuit as no other way to interpret this has been guided by Keynes. In the same way, Post-Keynesians have stated in numerous arguments that the definition of liquidity preference within the General is as well prohibitive (Mott, 1985-1986), even though a well-suited interpretation in its two-asset demonstrates. We would not negate the broad perspective in General Theory as used for several postulates. A few post-Keynesians have argued for an eclectic proposition of liquidity preference, explained as to take Keynes's experiences on uncertainty and 'animal spirits' into

account. That would create an inversely proportional relation of liquidity preference to that of future uncertainty.

4.Conclusion

In the emergence of General Theory, Keynes proposed a solution towards the economic crisis. Where he used the three most important variables of the propensity to consume, the liquidity preference, and the marginal efficiency of capital in the study. As we have discussed in the article their psychological nature, like Keynes interpretations gains importance in the literature of economics. In which the role of governments to initiate investment in filling the gap between savings and investment is emphasized. The theory emphasizes the role and determination of these variables for Expansionary fiscal policy. Monetary policy is also important in coping with the economic crisis by inducing supply, keeping the rate of interest low and increasing the marginal efficiency of capital. Incentives for entrepreneurs to invest more are encouraged by increasing prices that keep real wages low. Furthermore, the interplay of speculative demand for money and interest rate is important in investment. Expectations of entrepreneurs take years to change and during a crisis propensity to consume thus depressed causing high involuntary unemployment, thus the role of government intervention in bridging the gap between aggregate demand and supply is important in business cycles. The subjected variables of General Theory are important not only as standalone concepts in economics but how they interrelate as Lange, (1938) argued the importance of "liquidity preference" upon how it co-operates with the "marginal efficiency of investment" and with the "propensity to consume" in deciding the rate of interest. Literature also demanded some support for Keynes theory of long-period unemployment to elaborate the factor that supported the high marginal efficiency of capital in the 19th century including the growth of population, opening up of new lands, state of confidence and frequency of war (Keynes, 1936, p. 307 as cited in Hicks, 1936, p. 251). Hicks declared the Keynes approach as more conservative in arguments as compared to that in *Treatise.* It is further stated that Keynes used the technique of Marshall to elaborate on what Marshall and his school of thought never discussed, appreciating the novelty in Keynes arguments and theory. General Theory is stated to be appreciated in long-wanted testing for Ricardians' conclusions.

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