DEMAND FOR MONEY – NOTES

Definition

- Demand for money refers to the **total amount of wealth** that the population of an economy wishes to hold in the form of **money balances** rather than other assets such as bonds, equity, or commodities.
- It is a **stock concept** measured at a point in time.
- Money is demanded for its functions as **medium of exchange**, **store of value**, and **unit of account**.

Key Motives for Holding Money (Keynes's Liquidity Preference Theory)

1. **Transactions Motive**
   - Money held to finance day-to-day purchases of goods and services.
   - Also called **transaction money balances**.
   - **Determinants:**
     - **Macroeconomic conditions**: Higher nominal GDP, lower unemployment, and rising wages → greater transactions demand.
     - **Propensity to spend**: Higher tendency to consume → greater demand for transaction balances.
   - Example: A shopkeeper keeping cash for daily sales and purchases.

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2. **Precautionary Motive**
   - Money held to meet **unexpected contingencies** or emergencies.
   - **Determinants:**

        - Level of economic activity: Higher GDP → higher precautionary balances.
        - Availability of credit: Easy, low-interest credit reduces precautionary demand; scarce, costly credit increases it.
        - Size of regular expenses: Larger monthly spending requires proportionally higher precautionary balances.
    - Example: A family keeping extra cash for sudden medical expenses.

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3. **Speculative Motive** (Portfolio Demand for Money)
    - Money held to **take advantage of future investment opportunities** or to protect against adverse asset price movements.
    - **Situations increasing speculative demand:**
        - **Deflation or expected deflation** → money's purchasing power will rise.
        - **Unfavourable asset markets** → e.g., low bond yields or poor stock returns.
        - **Currency speculation** → holding foreign currency to profit from exchange rate changes.
        - Common in volatile, high-inflation economies where people prefer stable foreign currencies.
    - **Relation to other assets:**
        - **Inverse relationship** between speculative demand for money and returns in other assets.
        - **Direct relationship** between speculative demand for money and perceived risk of other assets.
    - Example: Investors holding cash during a stock market downturn waiting for better buying opportunities.