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Liquidity Preference or Loanable Fund Theory? A New Wiew

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ABSTRACT

In Keynes's approach, interest rates are driven up by rises in demand for money and scaled down by rises in money supply. On the contrary, this paper argues that neither of these propositions will stand the test of scrutiny. Keynes traced demand for money to three main factors, the transaction, precautionary and speculative motives, but rises in demand associated with the transaction motive do not necessarily drive up the rate of interest. The paper shows also that the liquidity preference theory and the loanable funds theory are different theories and that the former is faulty, while the latter is correct.

KEY WORDS: interest rate, liquidity preference theory, loanable funds theory.

INTRODUCTION

It is years since I first argued that Keynes's liquidity preference theory is untenable (see Jossa 1960, chap. 9 and Jossa 1984). In Keynes's (Marshallian) approach, this theory postulates that interest rates are driven up by rises in demand for money and scaled down by rises in money supply. In point of fact, neither of these propositions will stand the test of scrutiny. Keynes traced demand for money to three main factors, the transaction, precautionary and speculative motives, but rises in demand associated with the transaction motive do not necessarily drive up the rate of interest.

Keynes's focus is on the equilibrium which arises in commodity markets when saving equals investment and in money markets when demand for and supply of money level out.

Although his model envisages three aggregates, specifically the commodities and services produced and provided, money (notes and bank deposits) and securities, the securities market, though existing, is not considered. This is in accord with Walras's law, which teaches that in three-market models the third market need not be specifically taken into account since the equilibrium in the two remaining markets will necessarily be matched by equilibrium in the third market also.

Based on Walras's law, in a three-market system equilibrium situations can either be analysed by maintaining a focus on the commodities and securities markets without considering the money market, or by leaving the commodities market out of account and focusing on the money and securities markets only. Obviously, it should be considered that every rise in the demand for a given commodity which is observed in the exchange model (due to changes in consumer preferences) is counterbalanced – with everything else constant and unchanged – by a drop in the level of demand for another commodity. Specifically, a rise in the amount of money demanded may either drive down demand for securities or demand for commodities. The weak point of Keynes's liquidity preference theory is the assumption that each rise in demand for

money will invariably generate a fall in demand for securities without producing any impact on demand for commodities.

This point can be analysed using the well-known IS/LM diagram which is still widely used notwithstanding the criticisms that were raised against it some time ago (but with the important specification that the validity of the point made in this paper is unrelated to the correctness of Hick's diagram).[1]

As is well known, the IS curve reflects equilibrium situations in the commodities and services market and slopes downward from left to right because at a certain supply level demand for commodities is seen to soar in relation to rises in income levels and drops in the rate of interest. The LM curve, which reflects equilibrium situations in the money market, slopes upward because at a given level of money supply demand for money increases in relation to rises in income levels and declines in relation to rises in the rate of interest.

In point of fact, the Hicks diagram includes a third curve – here named the TT curve – that reflects equilibrium conditions in the securities market (a market which, let this be repeated, is not specifically considered since it is necessarily in equilibrium when the remaing two are). The TT curve may either slope upwards or downwards because at a given level of bank credit supply demand for credit will soar in proportion to drops in the interest rate, but in the event of rises in income levels it may either soar in consequence of boosts in production volumes or, conversely, decline as a result of the lesser credit requirements of high-income individuals. Let me repeat that the shape of the third curve is not independent, but is determined by the movements in the other two curves plotted in it.

THE LIQUIDITY PREFERENCE THEORY IS UNTENABLE

Let us consider a diagram with an upward sloping TT curve and the usual IS and LM curves. The points at which the three curves intersect mark the equilibrium situations of the three markets.

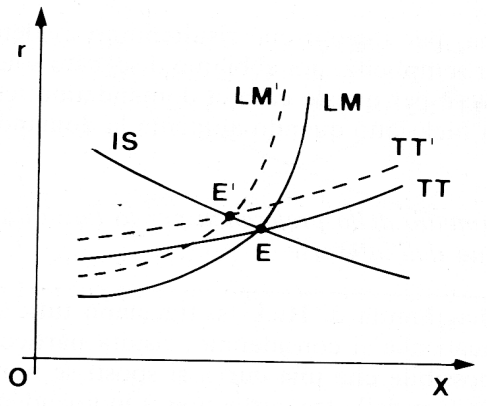


Figure 1

In the situation reflected in Fig. 1, each rise in money demand and corresponding drop in securities demand will produce a shift upward to the left of the LM curve and an upward movement of the TT curve, without any effect on the IS curve. The result will be a rise in the

[1] **For early criticisms of the IS/LM model, see Leijonhufvud 1968, chap. III, and 1983, Weintraub 1978 and 1982, and Robinson 1979.**

rate of interest, as posited by Keynes. Conversely, in the situation reflected in Fig. 2, when demand for money is driven up by a rise in savings, the IS curve will shift to the left, while the TT curve will remain stable. In this situation, the result of a rise in demand for money will be a *fall* in the rate of interest – in contrast with the liquidity preference theory.

The TT curve in the diagram has been plotted with a slope upwards to the right, but the result would be the same even if the TT curve should be sloping downwards.

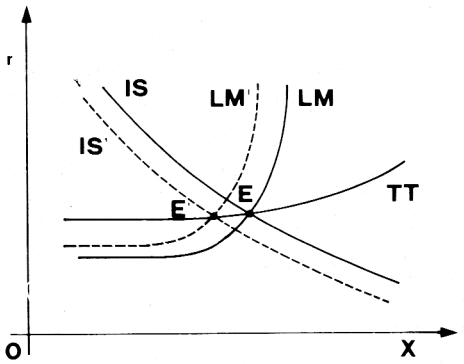


Figure 2

Let me specify that where it should be objected that Keynes's liquidity preference theory was intended to show that each rise in demand for money necessarily drives down demand for securities, this would by no means invalidate my research thesis because no such effect is observed in a real-world scenario. Raising this objection would be tantamount to positing as given a proposition which in actual fact needs to be demonstrated.

THE LOANABLE FUNDS THEORY IS CORRECT

It is well known that in loanable funds theory the rate of interest is held to be a function of demand for and supply of credit, i.e. to move upward in situations of rising demand for credit and to slope down in conditions of rising supply of credit. It is worth considering that rises in demand for credit entail, by definition, rises in securities supply (and, hence, in borrower indebtedness) and that any rise in securities supply levels generates increased demand for money, and vice versa. This means that any upward movement in credit demand drives up demand for money and vice versa. In the third diagram, which will be used to test the loanable fund theory (Fig. 3), each rise in demand for credit pushes the TT curve upwards and each rise in supply results in a shift downwards, and vice versa.

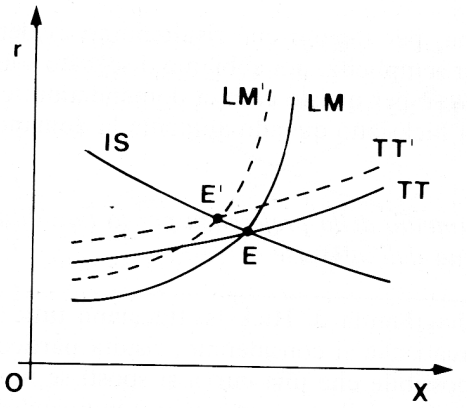


Figure 3

Here TT has again been plotted as an upward sloping curve. In this situation, each rise in demand for money – and, hence, in demand for securities also, let this be repeated – drives the LM curve upward to the left while producing a downward shift of TT, whereas each rise in demand for securities drives down both the LM and TT curves. As a result, the equilibrium point moves from E to E', which means that rises in demand for money are matched by rises in the interest rates. On the contrary, a rise in credit supply results in a drop in the rate of interest. All this is clear evidence that this diagram goes to validate the loanable funds theory.

The result would obviously be the same if TT should be plotted as a downward sloping curve. Neither can this conclusion be challenged by objecting that borrowers applying for bank credit do so because they are poised to purchase commodities and that a rise in demand for lending will therefore produce a simultaneous rise in demand for commodities. In actual fact, the two actions considered are not only dissimilar, but staggered in time. Based on Walras's law, any credit application is to be construed as an instance of demand for money in exchange for a security, whereas demand for commodities is a subsequent event, specifically (as argued by Walras himself) the offer to pay money in exchange for the commodity to be purchased.

THE ASSUMED EQUIVALENCE OF THE LIQUIDITY PREFERENCE THEORY AND THE LOANABLE FUNDS THEORY

Although the above reflections show that the liquidity preference theory and the loanable funds theory are different theories and that the former is faulty, while the latter is correct, the theorists who engaged in a well-known debate in the nineteen-thirties unanimously reached the opposite conclusion, i.e. they held them to be identical.

A much praised contribution by Hicks can be of help at this point.

Walras's law – Hicks wrote in 1939 – teaches that when *n-1* markets are in equilibrium, the odd market will also be in equilibrium as a matter of course and that in determining the equilibrium conditions in three markets it is consequently possible to leave one of them out. Accordingly, to obtain the equilibrium point of the rate of interest we can either eliminate the money market and determine the interest rate based on the levels of demand for, and supply of, loanable funds, or eliminate the credit market and determine the rate of interest by reference to the level of demand for, and supply of, money.

For all its historical importance, Hicks's approach is marred by a gross mistake. Whereas Keynes's interest theory was intended to disprove the neo-classical assumption that the interest rate is determined by saving and investment, Hicks's approach is barely suited to call into question the validity of mainstream theory. Indeed, the moment the securities market is left out of account, what can prevent us from determining the rate of interest by reference to demand for and supply of goods and services, in place of money, and consequently, from arguing that the rate of interest is in equilibrium when saving and investments balance out?

As Hicks himself pointed out, "the argument merely enables us to eliminate one of the *n* equations; it does not matter in the least which equation we choose to eliminate" (Hicks 1939, p. 172).

In this connection, Lerner jokingly asked himself what would happen if, instead of eliminating the securities market in line with Hicks's suggestion, we should resolve to eliminate the peanuts market (see Klein 1947, p. 118).

On closer analysis, Hicks's demonstration proves that the rate of interest, which is one of the *n* prices in the system, must be determined simultaneously with the remaining prices, in full accordance with the rationale governing general economic equilibrium analyses. What it fails to tell us is why a partial equilibrium analysis, for all its importance, should be conducted with the aim of determining the rate of interest in the credit or money market.

Ultimately, it seems to me that when it is assumed that Hick's demonstration necessitates equating the liquidity preference theory with the loanable funds theory we must also accept the extension of this identity to the saving and investment theory and admit that the rate of interest can be determined in the peanuts market.

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