

Both Keynes And Friedmans Theories Of The Demand For Money Suggest That As The Relative Expected Return

Both Keynes And Friedmans Theories Of The Demand For Money Suggest That As The Relative Expected Return on holding money increases, the demand for holding money decreases. Conversely, when the expected return on alternative assets diminishes, individuals and firms tend to hold more cash balances. These theories provide foundational insights into the factors that influence liquidity preferences within an economy. Understanding these perspectives is essential for grasping how monetary policy impacts economic activity, inflation, and interest rates. This article explores both Keynesian and Friedman's theories of money demand, analyzing their similarities, differences, and implications for economic agents' behavior as the relative expected return varies.

Introduction to Theories of Money Demand

The demand for money is a central concept in macroeconomics and monetary theory. It refers to how much wealth individuals and firms choose to hold in the form of cash or liquid assets, rather than investing it elsewhere. Both Keynes and Friedman developed influential theories that explain the determinants of money demand, particularly focusing on how expectations about returns influence liquidity preferences.

While Keynes's approach emphasizes the role of transactions, precautionary motives, and speculative behavior, Friedman's theory centers on the idea that money demand is a stable function of income and interest rates, driven by the opportunity cost of holding money. Both perspectives highlight the importance of expected returns but differ in their assumptions and emphasis.

Keynes's Theory of Money Demand

Liquidity Preference Framework

John Maynard Keynes introduced the concept of liquidity preference, which describes why individuals prefer holding liquid assets like cash. According to Keynes, the demand for money is primarily influenced by three motives:

- **Transactions Motive:** Money is needed for everyday transactions, which depends mainly on income levels.
- **Precautionary Motive:** Money is held for unforeseen expenses or emergencies.
- **Speculative Motive:** Money is held to take advantage of future investment opportunities or to avoid potential losses from holding bonds whose prices may fall.

Among these, the speculative motive is directly linked to the expected return on bonds relative to holding money.

Role of Expected Return in Keynes's Theory

Keynes argued that the speculative demand for money varies inversely with the expected return on bonds. When bond prices are expected to fall (implying rising yields), investors prefer to hold more

cash to avoid capital losses. Conversely, if bond prices are expected to rise, the demand for money decreases as investors are willing to hold bonds for capital gains.

This behavior illustrates that the demand for money is negatively related to the expected return on alternative assets. When the expected return increases, the opportunity cost of holding money rises, leading to a reduction in money holdings.

Friedman's Quantity Theory of Money and Expectations

The Modern Quantity Theory Perspective

Milton Friedman proposed a more stable, predictive model of money demand, emphasizing that it depends primarily on income and the opportunity cost of holding money, represented by the interest rate. Friedman's approach is grounded in the Quantity Theory but incorporates expectations and behavioral stability.

His key proposition is that the demand for real balances (money holdings adjusted for price level) is a stable function of real income and the interest rate:

- Money demand increases with real income (Y).
- Money demand decreases as the interest rate (i) rises, reflecting higher opportunity costs.

Mathematically, Friedman's money demand function can be expressed as:

$$M_d/P = kY - hi$$

where:

- M_d = nominal money demand,
- P = price level,
- Y = real income,
- i = interest rate,
- k and h = parameters reflecting sensitivities.

Expected Return and Money Demand in Friedman's Model

Friedman emphasizes that the opportunity cost of holding money is represented by the nominal interest rate. When the expected return on alternative assets (like bonds or stocks) increases, the opportunity cost of holding money also increases, leading to a decrease in money demand.

He assumes that agents form expectations about future interest rates and inflation, which influence their liquidity preferences. The stability of the money demand function depends on the assumption that these expectations evolve smoothly over time.

Comparative Analysis: Both Theories and Expected Returns

Similarities Between Keynes and Friedman

Both theories agree that the expected return on alternative assets significantly influences money demand. Specifically:

- When the expected return on bonds or other assets increases, the opportunity cost of holding money rises, leading to a decrease in money demand.
- Conversely, a decrease in the expected return encourages holding more cash balances.
- Both models recognize that expectations about future interest rates and asset prices are key determinants.

Furthermore, both theories acknowledge the role of the opportunity cost (interest rate) as a primary driver of liquidity preferences.

Differences in Approach and Emphasis

Despite similarities, there are notable differences:

- **Scope:** Keynes's theory emphasizes the motives behind liquidity preference, especially the speculative motive tied to expected bond returns, while Friedman's model focuses on a stable demand function driven by income and interest rates.
- **Expectations:** Keynes's theory involves expectations about bond prices and yields affecting speculative demand directly, often emphasizing behavioral responses. Friedman incorporates expectations more systematically through adaptive or rational expectations, influencing the parameters of the demand function.
- **Stability:** Friedman's approach advocates for a stable, predictable demand for money based on observable variables, whereas Keynes's demand can fluctuate more markedly with changes in expectations and market sentiment.

Implications of Changes in Expected Return

Impact on Money Demand

As the relative expected return on bonds or other assets increases:

1. Individuals and firms reduce their holdings of liquid cash to invest in higher-yielding assets.
2. The speculative demand for money declines, leading to a downward shift in the money demand curve.
3. This reduction in money demand can influence interest rates, potentially leading to interest rate increases if the money supply remains unchanged.

Conversely, if expected returns decline:

1. Cash holdings increase as the opportunity cost diminishes.
2. The demand for money rises, which can exert downward pressure on interest rates.

Effects on Monetary Policy and Economy

Understanding the relationship between expected returns and money demand helps policymakers anticipate how changes in interest rates, inflation expectations, or asset returns can influence liquidity preferences:

- Expansionary monetary policy that lowers interest rates can increase money demand, stimulating economic activity.
- Expectations of rising returns on investments can lead to decreased liquidity, potentially tightening credit conditions.

Conclusion

Both Keynes's and Friedman's theories underscore the critical role of expected returns in shaping the demand for money. Keynes's liquidity preference model emphasizes behavioral motives and the speculative motive's sensitivity to bond market expectations. Friedman's approach offers a more stable, systematic framework where the opportunity cost, represented primarily by interest rates, guides liquidity preferences.

Understanding how the relative expected return on assets influences money demand provides vital insights for monetary policy, financial market behavior, and macroeconomic stability. As expectations about future returns fluctuate, so does the liquidity preference of economic agents, affecting interest rates, investment, and overall economic activity. Policymakers and economists must consider these dynamics to formulate effective strategies that maintain economic stability and growth.

References

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Frequently Asked Questions

What is the core idea behind Keynes and Friedman's theories regarding the demand for money?

Both theories suggest that the demand for money depends on the relative expected return of holding money compared to other assets, with individuals balancing liquidity benefits against opportunity costs.

How does the expected return influence the demand for money in Keynes and Friedman's models?

An increase in the expected return on alternative assets reduces the demand for money, while a decrease in expected return increases the demand, reflecting individuals' preferences for higher-yielding assets.

In what way does the concept of 'relative expected return' differ between Keynes and Friedman's theories?

While both recognize the importance of expected return, Friedman's theory emphasizes a stable, long-term relationship based on utility maximization, whereas Keynes's approach focuses more on liquidity

preferences driven by income and transaction needs.

What role does interest rate play in both Keynes and Friedman's theories of money demand?

Interest rates serve as a proxy for the expected return on alternative assets; higher interest rates decrease money demand, whereas lower rates increase it, according to both theories.

How do changes in the expected return on money itself affect the demand for money?

An increase in the expected return on holding money (e.g., through incentives or benefits) would increase money demand, whereas a decrease would reduce it, aligning with the theories' emphasis on relative returns.

Why do Friedman's and Keynes's theories emphasize the importance of the opportunity cost in money demand?

Because holding money involves forgone interest or returns from other assets, the opportunity cost directly influences individuals' willingness to hold cash instead of alternative investments.

How do both theories explain the stability or variability of the demand for money over time?

Friedman's theory suggests a stable, long-term relationship driven by income and interest rates, while Keynes's approach may account for more short-term fluctuations due to changes in liquidity preferences and expectations.

In what way does the concept of expected return relate to the liquidity

preference in Keynes's theory?

Keyness's liquidity preference depends partly on the expected return of holding money versus other assets; higher expected returns on alternative assets reduce liquidity preference, decreasing money demand.

Can both theories be integrated to better understand the demand for money in modern economies?

Yes, integrating Friedman's focus on income and interest rates with Keynes's emphasis on liquidity preference and expectations provides a comprehensive framework for analyzing money demand in contemporary contexts.

What implications do these theories have for monetary policy and interest rate management?

Understanding how expected returns influence money demand helps policymakers adjust interest rates and other tools to control liquidity and achieve economic stability, considering the behavioral responses outlined in both theories.

Additional Resources

Both Keynes And Friedmans Theories Of The Demand For Money Suggest That As The Relative Expected Return

Understanding the demand for money is fundamental to macroeconomic theory, monetary policy formulation, and financial market analysis. Two of the most influential theories explaining the demand for money are those proposed by John Maynard Keynes and Milton Friedman. While these theories differ in assumptions, mechanisms, and implications, both converge on the idea that the demand for money is significantly affected by the relative expected return on money compared to other assets. This piece explores in depth how each theory conceptualizes this relationship, the underlying

mechanisms involved, and the implications for economic agents and policy.

Introduction to the Demand for Money

The demand for money refers to the amount of wealth individuals and firms desire to hold in liquid form rather than in other assets such as bonds, stocks, or real estate. It is a crucial component of the broader money market and influences interest rates, inflation, and overall economic stability.

Key Aspects of Money Demand:

- Liquidity preference
- Transaction motive
- Precautionary motive
- Speculative motive

Both Keynes and Friedman focus heavily on the motives behind holding money, particularly emphasizing the role of expectations and relative returns.

Keynes's Theory of the Demand for Money

The Concept of Liquidity Preference

Keynes's approach, outlined in his seminal work *The General Theory of Employment, Interest, and Money* (1936), conceptualizes the demand for money primarily through the lens of liquidity preference.

According to Keynes, individuals and firms hold money for three main reasons:

1. Transactions motive: To facilitate everyday transactions.
2. Precautionary motive: To hedge against unforeseen needs.
3. Speculative motive: To capitalize on future changes in bond prices or interest rates.

Focus on the Speculative Motive:

The speculative demand for money is where Keynes emphasizes the importance of expectations about interest rates and returns. When interest rates are expected to fall, bond prices are expected to rise, making bond holdings more attractive, thus reducing the demand for money. Conversely, when interest rates are expected to rise, bond prices are expected to fall, increasing the demand for money as a safe, liquid store of value.

The Role of Expectations and Relative Returns in Keynes's Model

Keynes's theory posits that the demand for money is inversely related to the expected return on bonds or other interest-bearing assets. The core idea is:

- Expected Return on Bonds (or other assets): When investors anticipate higher returns (via higher interest rates or bond prices), they prefer to hold bonds rather than cash.
- Opportunity Cost of Holding Money: The forgone interest income from not holding bonds.

Mechanism:

- When the expected return on bonds increases, the opportunity cost of holding money rises.
- As a result, demand for money declines because individuals prefer to invest in interest-bearing assets.
- Conversely, if expected returns decrease, holding money becomes relatively more attractive, and the demand for money increases.

Implication:

- The demand for money is sensitive to changes in interest rates and expectations about future interest rates.
 - The relationship between money demand and the interest rate is typically represented as a downward-sloping demand curve, emphasizing the negative correlation.
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Friedman's Quantity Theory of Money and the Demand for Money

Theoretical Foundations

Milton Friedman, a leading figure in the development of monetarism, extended the classical quantity theory of money by emphasizing the role of expectations and the forward-looking behavior of individuals. His version of the demand for money is often called the "relexive" or "permanent income" approach, which emphasizes that money demand depends on long-term income expectations rather than just current income.

Main Tenets of Friedman's Theory:

- Money demand is primarily a function of wealth, income, and the interest rate.
- It is stable over time, making it predictable.
- The demand for money is proportional to the permanent income or wealth rather than transitory income fluctuations.

The Relative Expected Return in Friedman's Framework

Friedman's theory recognizes that the expected return on holding money relative to other assets

influences the demand for money. Unlike Keynes, Friedman emphasizes the importance of the real return and expected opportunity cost.

Key Factors:

1. Interest Rate (i): Represents the opportunity cost of holding money (lost interest income).
2. Expected Return on Other Assets: Bonds, stocks, or alternative investments.
3. Real Income and Wealth: As wealth increases, so does the demand for money.

Mechanism Linking Expected Return and Money Demand:

- When the expected return on bonds or other assets increases, individuals and firms prefer to hold fewer liquid assets and invest more in interest-earning assets.
- As the opportunity cost of holding money rises, the demand for money declines.
- Conversely, if the expected return on bonds falls, the demand for money increases.

Mathematically:

- Friedman posits a linear relationship:

$$L = k \times Y - h \times i$$

Where:

- L : Demand for real balances
- Y : Real income
- i : Nominal interest rate
- (k, h) : Positive constants

This indicates that demand for money increases with income and decreases with the interest rate, emphasizing the role of the expected return (via the interest rate) in shaping money holdings.

Comparison of Keynes and Friedman on the Role of Expected Return

Aspect	Keynes's View	Friedman's View
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Focus	Liquidity preference driven by expectations about bond prices and interest rates	Money demand as a function of wealth, income, and the opportunity cost (interest rate)
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Expectations	Expectations about future interest rates influence speculative motive	Expectations about the long-term return and real income levels determine demand
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Mechanism	Inverse relationship between bond expected returns and money demand	Direct relationship between opportunity cost (interest rate) and money demand
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Stability	Demand sensitive to interest rate fluctuations, more volatile	Demand is relatively stable; influenced by long-term income and wealth
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Both theories conclude that the expected return on alternative assets influences the demand for money inversely: higher expected returns on bonds or other assets make holding money less attractive, decreasing demand, and vice versa.

Implications of Both Theories for Monetary Policy

Understanding how the expected return affects money demand has profound implications for central banks and policymakers:

1. Interest Rate Policy:

- When central banks manipulate interest rates, they indirectly influence the opportunity cost of holding money.

- An increase in interest rates (expected return on bonds) reduces money demand, potentially leading to decreased liquidity in the economy.
- Conversely, lowering interest rates raises money demand, increasing liquidity but possibly fueling inflation.

2. Expectations Management:

- Both Keynes and Friedman recognize the importance of expectations.
- Central banks' communication strategies can influence expectations about future interest rates and returns, thereby affecting money demand.

3. Stability of Money Demand:

- Friedman's emphasis on the stability of money demand suggests that policy measures should account for long-term income and wealth trends rather than short-term fluctuations.
- Keynes's focus on expectations about future interest rates indicates that monetary policy must also consider market sentiment and speculative behavior.

4. Inflation Targeting and Expectations:

- Since expectations about inflation influence real returns and interest rates, managing these expectations is crucial to stabilize money demand and overall economic activity.

Limitations and Critiques of Both Theories

While both Keynes and Friedman provide valuable insights, they are not without limitations:

Keynesian Critiques:

- Overemphasis on speculative motives may underestimate the importance of transactional and precautionary motives.
- The theory assumes rational expectations, which may not always hold in practice.

- The demand for money can be influenced by factors like payment technology and institutional structures not fully captured.

Friedman's Critiques:

- The assumption of stable money demand functions has been challenged, especially during periods of financial crises or technological disruptions.
- The linear relationships may oversimplify complex behaviors.
- Expectations about long-term returns are difficult to measure and predict accurately.

Conclusion: The Central Role of Relative Expected Return

Both Keynes and Friedman converge on the fundamental insight that the relative expected return on money versus other assets is a key determinant of the demand for money. When the expected return on alternative assets (like bonds) rises, individuals and firms are incentivized to reduce their holdings of liquid cash and shift towards interest-bearing assets. Conversely, when these expected returns decline, the demand for money increases as it becomes relatively more attractive.

Key takeaways:

- The demand for money is not static; it is highly sensitive to changes in expectations about future returns.
- The opportunity cost of holding money, primarily represented by interest rates, plays a central role.
- Both theories highlight the importance of expectations in shaping liquidity preferences, influencing the effectiveness of monetary policy.

In essence, understanding the dynamics of expected returns provides a critical lens through which to analyze monetary behavior, policy impacts, and economic stability. Central banks and policymakers must consider these theoretical underpinnings when designing strategies to influence aggregate demand, control inflation, and foster economic growth.

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