Q1. What are the weaknesses of the original Keynesian Income determination Model?

Ans Weaknesses of the original Keynesian income determination Model are :-

Good

(1) Keynes fails to explain price behaviour in commodity market. In the entire Keynesian Model, $P=1$ as long as Y_e is below Y_F. which is highly unrealistic because in India unemp. exists & price index keeps rising. P cannot be constant.

(2) Keynes fails to show non-neutrality of money because in entire income determination model there is no mention of money market. If money markets are not introduced how does Keynes explain non neutrality of Money.

(3) Keynes criticised the classical QTM income determination model where

(i) $Y = Y_F$ always

(ii) V - transaction velocity of money is constant

Keynes rejected both because he believed that $H = \bar{k} P Y$ cannot be solved uniquely because it is a single eqn with multiple unknowns.

⇒ classical economists believed that k value is constant but Keynes believed that k is not stable value it changes but Keynes failed to prove this point in his income determination model because money market is missing.

(4) Keynes completely ignored the supply side factors like technology, resources, labour, land, capital formation etc. And explained income determination model from demand side.

(5) Keynes spoke of liquidity trap but there is no mention of liquidity trap in income determination model. Many economist argued that income a liquidity trap is an imaginary situation & is a possibility only when speculative demand for money is sensitive infinitely to rate of interest. This is possible when LM curve is horizontal & $h \to \infty$. Empirical data do not support Keynes because in reality $h \not\to \infty$.

(6) Keynes does not clarify how govt. expenditure is financed. If govt. govt. is financed by increase in taxation then fiscal drag will arise due to which fiscal policy does not becomes fully effective.

(7) Keynes considered investment to be autonomous of income level but in reality investment

$$I = \bar{I}$$

is dependent upon income level also.

(8) Keynes believed transaction demand for money to be independent of the rate of interest but in real world people's transaction demand for money depends on both the income level as well as r.o.i. which was further proved by Prof Tobin & Baumol in their theories.

KEYNES INTEREST RATE DETERMINATION THEORY

Keynes used the term liquidity preference for the demand for money to hold in cash. The desire to hold money arises due to 3 motives

(a) Transaction motive :- It is demand for money for current transactions of the individuals and business firms. It depends upon income level and the interval at which income is received.

(b) Precautionary Motive :- It is desired to hold cash balances for unexpected expenditures such as medical or repair bills etc. It depends on the income, psychology of individual and the condition he live in.

The amount of Money, M_1, held for transaction & precautionary Motive = $M_1 = L_1(Y)$

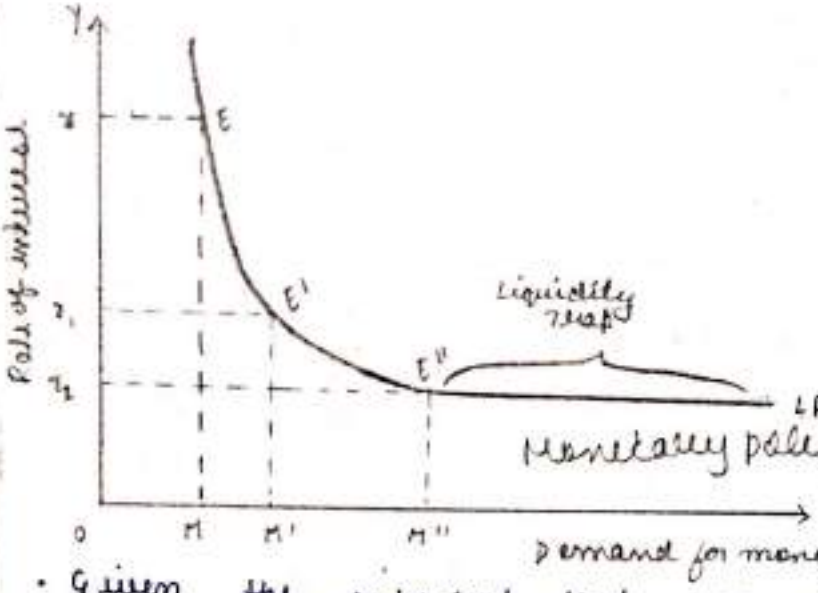
(c) Speculative motive :- It is the desire of people to hold money balances in highly liquid form in hope of taking advantages of ~~unforeseen~~ future market conditions i.e change in rate of interest or change in bond prices in future. It was Keynes revolutionary idea. The cash held under this motive is used to make speculative gains by dealing in bonds, whose prices fluctuate. If bond prices are expected to rise, or in other words rate of interest is expected to fall, businessman will buy bond to sell in future when prices actually rise but if bond prices are expected to fall & rate of interest is expected to rise then they sell their bonds now to avoid capital losses.

Acc. to Keynes, Money held for Speculative Motive, i.e M_2

$$M_2 = L_2(r)$$

Total demand for Money $M_d = L_1(Y) + L_2(r)$

Speculative demand for money is a decreasing function of rate of interest, it increases as r.o.i falls and vice versa.



- In the ~~above~~ diag, X-axis represents speculative demand for money & Y-axis shows rate of interest.
- The liquidity preference curve LP is downward sloping.

Monetary policy ineffective

- Given the expected rate of interest, At higher rate of interest Or, a very small amount OM is held for speculative motive due to high current rate of interest less money is kept idle and more & more is lent out for ~~the~~ buying of bonds or is lended. At Or, interest rate, greater amount OM, is held under this motive. But if interest rate falls further to r_2, the liquidity preference curve ~~does~~ becomes perfectly elastic, this portion of perfectly elastic liquidity preference indicates the position of absolute liquidity where people hold any amount of cash as idle cash balance. This is a situation where increase in money supply has no effect on rate of ~~interest~~ investment & gets trapped. Thus makes this region liquidity trap due to ineffective monetary policy.

However, speculative demand for money depends upon expected rate of interest. So, any change in expected interest rate shifts the whole speculative demand for money curve.

This is essence of Keynesian interest rate determination.