

DETERMINANTS OF LIQUIDITY PREFERENCE THEORY: THE VIEWS OF BAUMOL AND TOBINS' ON PORTFOLIOS OF INVESTMENTS

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ABSTRACT

The research examines the variables that influence the liquidity preference theory, focusing on Baumol and Tobin's perspectives on portfolio investments. The Keynesian economic model, which emphasises the value of investing in liquid assets, serves as the foundation for both studies. Tobin (1956), in the framework of liquidity preference theory, focuses on investment balances and explains interest rates as the result of the interplay between the money supply and savers' inclination to keep cash. On the other hand, Baumol (1952) believes that transaction balances are necessary to fulfil working capital requirements. The study comes to the conclusion that the best opportunities should be the basis for investment decisions since both points of view have their roots in Keynesian economics. It also highlights how important it is to comprehend not just why people want cash, even though it usually yields lower returns than other assets, but also how the total demand for cash and different yield levels are inversely related. The study suggests that politicians and monetary authorities should back Baumol's strategy and see money balances as a reserve of buying power that can be used to finance projects when needed. It also emphasises how crucial it is for investors and stakeholders to handle the transactional, speculative, and precautionary reasons why people keep money in the economy as well.

Keywords: Determinants, Liquidity, Preference Theory, Baumol and Tobin Views

INTRODUCTION

In reaction to the Great Depression and the ongoing unemployment issues that the quantity theory of money was unable to address, Keynes developed the liquidity preference theory in the early 1930s. The primary components of this theory were expounded upon in Keynes' 1936 publication, "The General Theory of Employment, Interest, and Money," as noted by Uchendu (2017). The theory argues that a number of intricate elements affect money's income velocity, challenging the idea that people and corporations aim for stability in their investments. It also challenges the notion that money moves in a steady-state manner, contending that this presumption distorts the actual dynamics of economic causation. According to Ankinyede's (2018) research, a number of variables, such as non-bank financial institutions, interest rates, liquidity preferences, income fluctuations, projected costs, and the availability of money substitutes, might influence income velocity.

Keynes (1936) distinguished between three primary motivations for retaining cash on hand: (i) the transaction motive, which entails preserving purchasing power for unforeseen costs; (ii) the precautionary motive, which addresses the lag between income receipt and scheduled expenditures; and (iii) the speculative motive, which entails retaining cash in liquid form when interest rates on other assets are anticipated to increase, potentially resulting in capital losses. Agbaje (2018) makes the connection between the requirement for cash levels to support current assets and business operations and the transactional demand for money.

People's wants and earnings do not always line up precisely, which leads to a desire for money for transactions (Eudouma, 2018). Parker (2017) points out that variables that affect changes in transaction balances include employment, income levels, pricing, firm turnover, and the average

amount of time that passes between receiving money and disbursing cash. Robinson (2018) expresses this relationship as $L1 = KY$, where Y represents income, K represents the proportion of income allocated for transactions, and $L1$ represents the transaction demand for money. Aliyu and Daida (2018) suggest a direct and positive relationship between income levels and the proportion of income set aside for transactions, denoted as L . Jhingan (2006) concurs that the desire to preserve for unanticipated costs and take advantage of unforeseen buying opportunities is connected to the public's cautious need for money. This demand is contingent upon certain components of interest rates, as well as the unpredictability of uncertainty (Orsota, 2017). As stated by Akinyede (2017), transaction and mindful incentives are income-elastic, although they are rather indifferent to interest rates.

Agbaje (2018) notes that as interest rates rise, there is a decline in the need for currency for transactions and precautionary measures. The L function may account for these demands. Orsota (2017) defines $M1 = L1Y$, a function ($L1$) of income level (Y), as the need for money under these two reasons ($M1$). The primary finding is that income levels, not shifts in the percentage of income allotted to transactions, are what mostly influence transaction balances (Aliyu & Daida, 2018).

Andabai (2018) discovered that predictions of changes in bond prices or existing interest rates generate speculative demand for money, which is represented by $M2 = L2(r)$, where $L2$ signifies speculative demand. This is a speculative drive driven by expected changes in market interest rates or bond prices.

Theoretical Review

Keynes' 1936 liquidity preference theory, which explores savers' propensity to hold onto the money they save in cash or its equivalent and examines the effect this has on interest rates, serves as the foundation for the research. Keynes (1936) separates the theory from the actual theory of the classical school and labels it as a monetary theory of interest by proposing that it incentivises people to forgo liquidity for a predetermined duration rather than hoarding cash. Andabai (2018) noted that although there are three elements that influence the appetite for money, the money flow is decided externally by the money market, which sets interest rates. Keynes (1936) contended that money is maintained for speculative objectives, predicated on expected changes in market interest rates, in addition to serving as a means of transaction facilitation and income management. In accordance with Nzotta (2019), people will often maintain liquid assets since doing so might reduce the capital losses that come with holding long-term assets. This is especially true if they anticipate rising market interest rates.

Liquidity preferences were found by Aliyu and Daida (2018) in people who think cash balances will perform better than other assets. Akani (2017) also pointed out that individuals are more inclined to predict future rate hikes when interest rates are high. The inverse link between current interest rates and the need for liquidity, especially for speculative purposes, was also highlighted by Andabai (2017). In this case, the degree of risk aversion and the expected returns on alternative financial assets have an impact on the preference for liquidity. In the view of Okpara (2018), the whole demand for money, or what Keynes called $M1$, is driven by nominal income and includes transactional, speculative, and precautionary reasons. Market interest rates impact the amount of money known as $M2$, or money retained for speculative purposes. As stated by Uchendu (2017), $M1$ and $M2$ are not the same as the definitions of the money supply. The demand for money (liquidity preference) is therefore controlled by real income and the real interest rate, or by nominal income and the market interest rate, if the price level is constant or if money demand is stated in real terms.

The cost of borrowing money, commonly stated as the ratio of credit expenses to the total amount of credit obtained, is what Roseline (2017) described as the interest rate. For savers, investors, lenders, and borrowers, interest rates are price signals. Lower lending rates, for example, incentivize borrowing and investment, while higher deposit rates encourage saving and increase the amount of money available for loans. Uchendu (2017) emphasised the various responsibilities of interest rates: they govern credit flow, guarantee that existing savings are directed into investments that promote economic development, assign funds to projects with the best predicted returns, and maintain a balance between the supply and demand for money. Akpantan (2017) underlined that interest rates are a vital weapon for governments to impact savings and investment levels.

Interest rate determination is explained by three main theories: loanable funds theory (classical theory), liquidity preference theory (Keynesian theory), and general equilibrium theory (Hicks' theory). In accordance with Arestis, Demetriades, and Luintel (2017), the loanable funds theory sees interest rates as a price for credit that is in equilibrium and is determined by the supply and demand for money. As stated by Arnold, Kool, and Raabe (2018), this theory also shows the equilibrium price at which interest seekers' supply and demand for credit are balanced. According to Tokunbo (2018), there are three primary sources of demand for loanable money: consumers, businesses, and the government. These sources use the funds to make financial investments. Friedman (1970) pointed out that cash assets are risk-free and generate no income, but bonds include hazards like default and market rate risk. Market risk is the chance that, in an environment of rising yields, bondholders who sell their bonds before they mature might lose their principal. Because not all money is invested right away, Uchenna (2017) contended that interest rates do not always strike a balance between saving and investment. According to Ogwuma (2018), the money market uses the interplay between money supply and demand to set interest rates.

Baumol's Proposition

As demonstrated by Baumol's (1952) study, money balances serve as a ready supply of bargaining power that may be used for a variety of economical operations' immediate needs. On the other hand, earning assets are thought of as a substitute for cash balances, serving as a short-term holding location for money in between income receipt and outlays. Keynes's (1936) theory that higher interest rates increase the velocity of money is supported by Ogbodeku (2017), who noted that the inventory model of cash management indicates a negative correlation between the yield on other kinds of assets and the amount of cash held for transactions, highlighting the sensitivity of interest rates. According to Anyanwu (2017), balancing the advantages of keeping cash in interest-bearing assets against the expenses of transferring funds is necessary to determine the best way to divide funds between cash and other assets.

Tokunbo (2018) contended that the inventory model (Ogbodeku, 2017) suggests that, in addition to the interest-sensitive demand for transaction balances, the velocity of money tends to increase with growing income due to economies of scale in transaction management. The optimal quantity of money retained for transactions increases less than proportionately to planned spending as expenses rise, making it less practical to retain a sizable percentage of working capital in interest-earning assets (Jhingan, 2006). Pandey (2006) pointed out that the aim of Baumol's certainty-based approach is to minimise the total costs of retaining cash and turning marketable securities into cash by comparing inventory management and cash management. The model relies on a number of assumptions, including the following: (i) the company can forecast its cash needs with accuracy; (ii) cash payments are made consistently over time; (iii) the opportunity cost of keeping cash is known and constant; and (iv) there is a set transaction cost associated with turning securities into cash.

Tokumbo (2017) highlighted that cash balances operate as a reserve of purchasing power for paying bills and characterised Baumol's model as concentrating on the ideal money supply for public transactions. According to Akpanta (2017), a company's cash balance may be thought of as an inventory of money that is available to be spent on hiring staff, buying supplies, and covering other expenses. Parker (2017) noted that when transaction volume rises, so does the need for cash holdings. According to Baumol (1952), there is neither a linear nor a proportional relationship between the demand for transaction balances and income since fluctuations in income cause the demand for transaction balances to fluctuate less than proportionately. In summarising Baumol's theory, Okpara (2017) pointed out that people receive income on a periodic basis (e.g., monthly) and spend it gradually; cash balances are kept on hand because income and expenses don't always line up exactly, and keeping cash on hand can be expensive, so it makes sense to invest idle cash in bonds or other securities. As a tactic to reduce expenses over time, people typically retain bigger balances at lower interest rates and smaller transaction balances at higher rates.

Tobin's Proposition

The portfolio balance method developed by Tobin in 1956 examines the distribution of money and other liquid assets in an economy, with a focus on interest rates and how changes in the money supply affect money demand. This approach departs from the idea that securities and non-monetary assets are perfect substitutes, but it is consistent with the liquidity preference theory. Rather, Tobin contended that the interest rates on earning assets vary and are not perfectly correlated (Ankintoye, 2016). In accordance with Uchendu (2017), portfolio balance is a theory of asset selection in which people allocate their holdings among a variety of assets on both the community and individual level. In accordance with this theory, the implicit interest rate of each asset is directly correlated with the demand for it relative to the entire portfolio, and the interest rates of alternative assets are correlated inversely. According to Tobin's theory, the structure of interest rates can be altered by changes in the money supply or other unique assets, though the precise nature of these changes may have different effects on the economy.

Eudouma (2018) finds that the typical investor's risk aversion helps explain the negative link between money demand and interest rates. Orsota (2017) reminds us that Tobin's theory tackles a fundamental deficiency in Keynesian liquidity preference theory, which assumed the inelasticity of future interest rate expectations. Orsota contends that Tobin's theory accepts an inverse link between interest rates and speculative money demand. Tobin also claimed that humans are naturally risk-averse and may want to avoid dangers completely. Parker (2017) adds that Tobin's thesis fixed fundamental errors in Keynesian theory by proving that individuals often keep diverse portfolios, containing both bonds and cash, rather than only owning one form of asset. Tobin (1954) suggested that interest rates are inversely connected to the demand for money. Imo (2016) divided investors according to Tobin's theory into three types: (i) risk-averse investors, who avoid the danger of bond losses; (ii) risk-neutral investors, who tolerate risk for possibly better returns; and (iii) risk-loving investors, who prefer to put all their capital in bonds.

Ikeora (2017) emphasises that investors are prepared to take on risk only to the degree that the marginal utility of returns matches the marginal disutility of risk. Both Baumol's and Tobin's theories, based on rational behavior about cash use affected by interest rates, originate from the Keynesian economic model. Baumol emphasized money as the basis for transactions, whereas Tobin concentrated on interest rates. The differences in their views on liquidity preference have had a significant impact on the development of their distinct models. Since both theories derive from the Keynesian framework, they must handle both the inverse connection between aggregate demand and yield changes, as well as the demand for individual assets.

CONCLUSION AND RECOMMENDATIONS

The study concludes that investors should carefully consider the best options available to them, given the common basis of Baumol and Tobin's ideas within Keynesian principles. Although Tobin focuses on portfolio investments and Baumol focuses on transaction balances, Keynes' liquidity preference theory serves as the foundation for both theories. As a result, prudent investors are advised to base their choices on the best available investment options. Money is a key component of both models, but the study emphasises how important it is to comprehend not just why cash is still in demand despite having a lower yield than other assets, but also how the total demand for cash and different yield levels are inversely related. The study also suggests that policymakers and monetary authorities endorse Baumol's concept, which sees money balances as a buying power reserve that can be used to fund investments as needed. The transactional, speculative, and precautionary incentives that fuel the demand for money should be carefully managed by investors and stakeholders in order to produce optimum economic outcomes.

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