Appendix: THE REAL BALANCE EFFECT

This claim that the real balance effect is at the heart of the transmission mechanism from money to the real economy is controversial. Patinkin regarded the real balance effect as a kind of wealth effect. It was pointed out that, as the banking system's assets and liabilities must be equal, that part of the quantity of money represented by banks' deposit liabilities (so-called 'inside money', from a distinction proposed by Gurley and Shaw in their 1960 *Theory of Finance*) could not represent a nation's net wealth. A logical implication was that the real balance effect related only to 'outside money', often taken to be equivalent to monetary base assets issued by the central bank. It was then shown that, since the monetary base is modest compared with other elements in a nation's wealth, the real balance effect is small and cannot have a powerful influence on macroeconomic outcomes.[1]

The emphasis in macroeconomic theory moved away from the real balance effect towards 'the Keynes effect', to be understood as the effect of changes in the quantity of money on interest rates and so on investment. An argument can be made, however, that the only concept of money relevant to the real balance effect is an all-inclusive measure, since agents can eliminate excesses or deficiencies of smaller, less-than-inclusive measures by transfers

1 See, in particular, Thomas Mayer, 'The empirical significance of the real balance effect', *Quarterly Journal of Economics* (vol. 73, no. 2, 1959), pp. 275–91.

between money balances (i.e. they can switch between sight and time deposits, or between notes and sight deposits). Such 'money transfers' plainly have no effect on aggregate demand or asset dispositions. By implication, if the real balance effect is indeed the *sine qua non* of monetary theory, it must relate to inside money and cannot be exclusively a wealth effect.[2]

Laidler has also used the phrase 'the real balance effect' to mean something more than just a wealth effect and claimed that, in the US economy for the years 1954–78, 'the adjustment of real balances towards the desired long-run values has a pervasive and systematic influence on the macroeconomy'.[3]

Note also that the claim that outside money, i.e. the central bank's liabilities, constitutes net wealth to the private sector of the economy is debatable. It would obviously be invalid if the central bank's assets were all claims on the private sector. But even if government securities were all of the central bank's assets and – in accordance with Barro's doctrine of Ricardian equivalence – government debt were judged not to be net wealth to the private sector, then

a) outside money also cannot be net wealth to the private sector; and
b) the private sector's net wealth cannot be increased when the central bank expands its balance sheet.

Yet virtually all macroeconomists accept that something

2 See Tim Congdon, 'Broad money vs. narrow money', *The Review of Policy Issues* (Sheffield: Policy Research Centre, 1995), vol. 1, no. 5, pp. 13–27, for further discussion.

3 David Laidler, *Money and Macroeconomics* (Cheltenham: Edward Elgar, 1997), p. 172.

important happens when the central bank shifts the position of the supply curve of the monetary base and changes short-term interest rates. If this effect is not a net wealth effect, how does it change anything and why does it matter? And, if it matters so much even though it is not a wealth effect, why is it that changes in inside money do not matter at all?