

Macroeconomics Discussion Session Exercise #8

1. Outline the direct real balance (or Pigou) effect and indirect real balance (or interest rate or Keynes) effect.

Direct RBE or Pigou effect:

$AS > AD \rightarrow P \text{ falls} \rightarrow \text{increase in real value of } \$ \rightarrow (C + I) \text{ increases} \rightarrow \text{multiplier effects} \rightarrow Y \text{ increases...} Y_f$

Indirect RBE or interest rate or Keynes effect:

$AS > AD \rightarrow P \text{ falls} \rightarrow \text{increase in real value of } \$ \rightarrow \text{amount of } \$ \text{ necessary to satisfy transactions demand for } \$ \text{ falls} \rightarrow \text{amount of } \$ \text{ available for speculative demand increases} \rightarrow \text{demand for securities increases} \rightarrow \text{bond prices rise} \rightarrow \text{interest rates fall} \rightarrow (C + I) \text{ increases} \rightarrow \text{multiplier effects} \rightarrow Y \text{ increases...} Y_f$

2. What are the counter-arguments to the real balance effects stories?
 1. what happens to real value of non-cash assets when there is deflation? (re-valued downward)
 2. what happens to real value of debt when there is deflation? (goes up)
 3. consideration of expectations complicates RBE stories: if consumers and investors wait to buy and borrow to buy until they think prices and interest rates have hit rock bottom, then RBE will be sluggish or non-existent
 4. falling prices a dis-incentive to sellers?
 5. reintroduces the mechanistic relation between interest rates and investment
Keynes criticized
 6. historical/empirical
 - a) Great Depression – deflation but no RBE
 - b) Post –WWII – unemployment but no deflation (until very recently)

3. Derive a downward-sloping aggregate demand (AD) curve (as a function of the price level) by introducing real balance effects into the Keynesian cross diagram.

4. What are the three functions of money?

- 1) Unit of account – measures the comparable worth of goods; standard of value; measure of value; all price is money price
- 2) Medium of exchange
 - a) **means of purchase** – money exchanges directly for goods and services
 - b) **means of payment** – money can be used to settle debt
- 3) store of value – store of wealth; money as an end-in-itself; means of accumulating wealth

5. What are the three characteristics of a fractional reserve banking system? Between which two characteristics is there a tension, and why?

- 1) banks are private, profit-seeking enterprises – in business to earn profits
- 2) banks engage in money creation – through processes of lending, spending, and redepositing, banks in a frb system can affect the money supply
- 3) banks are susceptible to runs – it can and has happened that everyone does come down and demand their money all at the same time, and despite insurance, banks in a frb system cannot meet such demands

tension between #1 and #3 – because banks are profit-seeking, they want to lend out as much as they can; because they are susceptible to runs, they don't want to lend out too much