

Real balance effects (RBE)

Begins with different adjustment mechanism:

Keynes: $AS > AD \rightarrow Y$ falls

Neoclassical: $AS > AD \rightarrow P$ falls

Direct RBE (Pigou Effect):

$AS > AD \rightarrow P$ falls \rightarrow increase in real value of \$ \rightarrow C and I increase \rightarrow Y increase \rightarrow multiplier effects $\rightarrow Y_f$

Indirect RBE (Keynes or interest rate effect):

$AS > AD \rightarrow P$ falls \rightarrow increase in real value of \$ \rightarrow decrease in amount of \$ necessary to satisfy transactions demand for cash \rightarrow increase in \$ available for speculative demand for cash \rightarrow demand for securities increases \rightarrow bond prices increase \rightarrow interest rates fall \rightarrow C and I increase \rightarrow Y increase \rightarrow multiplier effects $\rightarrow Y_f$

Counter arguments to RBE stories:

1. what about the value of non-cash assets when P falls?
2. what about the real value of debt when P falls?
3. consideration of expectations complicates RBE stories (consumers and investors want to wait until prices and interest rates hit rock bottom until they begin spending and borrowing, but prices and interest rates continue to fall until spending and borrowing results in Y_f !)
4. falling prices can be a dis-incentive to sellers
5. (only applies to indirect RBE): re-introduces the mechanistic relation between interest rates and investment that Keynes criticized!
6. empirical/historical:
 - a) Great depression: prices and interest rates fell but no RBE
 - b) Post-WWII: many periods of unemployment, but no deflation (as opposed to slowing of inflation, which is not sufficient for RBE) to speak of in industrial countries (until recently)