M.A ECONOMICS PROGRAMME

SEM. II - COURSE CODE -CC8

E-CONTENT DEVELOPED BY PROF.RAJ LUXMI, HOD ECONOMICS, PATNA UNIVERSITY--CONTACT NO. 9835063742

Topic:-Patinkin's monetary model-Real Balance Effect

Don Patinkin presented his monetary model in his monumental work "Money ,interest and prices".

Patinkin criticized Cambridge economists for the homogeneity postulate and dichotomization of goods and money markets and then reconciles the two markets through the real balance effect.

Criticism of neo-classical assumptions

The homogeneity postulate states that the demand and supply of goods are affected only by relative prices which means that if money prices doubles it will have no effect on demand and supply of goods. Mathematically, the demand and supply functions for goods are homogeneous of degree zero in prices alone. The homogeneity postulate precludes the price level from affecting the goods market as well as the money market. Patinkin criticizes this postulate for its failure to have any determinate theory of money and prices.

The dichotomization of goods and money markets means that the relative price level is determined by the demand and supply of goods, whereas absolute price level is determined by the demand and supply of money. This implies that the price level has absolutely no effect on the monetary sector of the economy, and the level of monetary prices has no effect on the real sector of the economy.

The Real Balance Effect

Patinkin integrates the money market and the goods market of the economy which depend not only on relative prices but also on Real balances.

Real balances mean the real purchasing power of the stock of cash holdings of the people. When the price level changes, it affects the purchasing power of people's cash holdings which ,in turn, affects the demand and supply of goods. This is the Real balance effect.

Patinkin introduces the stock of real balances(M/P) held by community as an influence on their demand for goods. Thus the demand for a commodity depends upon real balance as well as relative prices. Now if the price level rises , this will reduce the real balances (purchasing power) of the people who will spend less than before. This implies a fall in the demand for goods and the consequent fall in prices and wages. The price decline increases the value of money balances held by the people which, in turn, increases the demand for goods directly.

The initial decrease in commodity demand creates a state of involuntary unemployment. The unemployment will not last indefinitely because as wages and prices fall, the real balance effect tends to increase commodity demand directly and indirectly through the interest rate. With sufficiently large fall in wages and prices, the full employment level of output and income will be restored. Finally, even if there is the “Liquidity Trap”, the expansion of the money supply will increase money balances, and full employment can be restored through the operation of the real balance effect.

According to Patinkin “The dynamic grouping of the absolute price-level towards its equilibrium value will----through the real balance effect-----react on the commodity markets and hence on relative prices”.Thus absolute prices play a crucial role not only in the money market but also in the real sector of the economy.

Patinkin further says “once the real, and monetary data of an economy with outside money are specified, the equilibrium values of relative prices, the rate of interest and the absolute price level are simultaneously determined by all the markets of the economy”. Thus Patinkin also introduces the real balance effect in the general equilibrium analysis.

Patinkin also validates the quantity theory conclusion .He says, the real balance effect implies that people do not suffer from “money illusion” .They are interested only in the real value of their cash holdings. This means doubling of the quantity of money will lead to a doubling of the price level, but relative prices and the real balance will remain constant and the equilibrium of the economy will not be changed.

DIAGRAMMIC REPRESENTATION

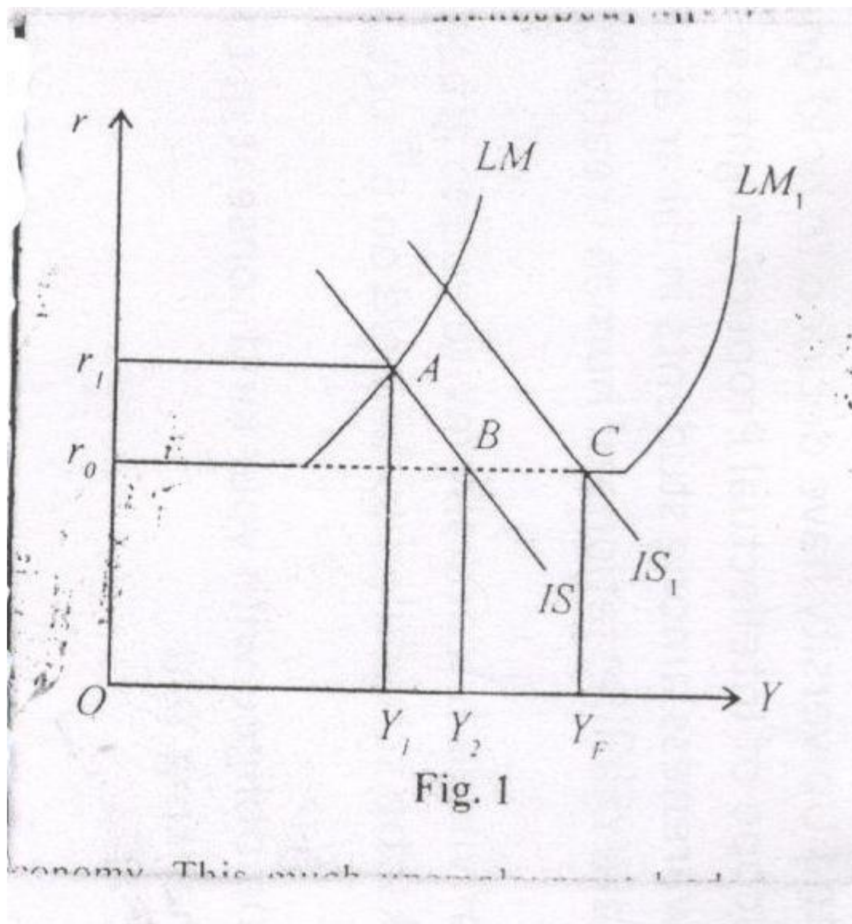

Fig. 1

The real balance effect is diagrammatically represented by using the IS and LM technique. The IS curve represents the goods market and the LM curve the money market. The economy is in equilibrium at OY1 level of income where IS and LM curves intersect at point A and the interest rate is Or1. Assuming OYf to be full employment level, the pressure of unemployment is measured by Y1-Yf, which causes wages and prices to fall simultaneously. It results into an increase in the real value of people's money holdings which shifts the LM curve to the right. The new LM1 Curve intersects IS curve at point B with OY2 income level and interest rate falls to Oro which stimulates investment, discourages savings and increases consumption. Even when the interest rate falls to its minimum level of Oro, the level of demand in the commodity market as represented by the IS curve is not high enough to lead the economy to the full employment level OYf. Unemployment remains and is measured by Y2-Yf. This much unemployment further reduces wages and prices, and increases the

demand for consumption goods and IS curve shifts to the right as new IS1 curve. It intersects LM1 at point C at the full employment level of OYf.

Thus the real balance effect ultimately leads the economy to the full employment level, even in the “liquidity trap” situation as shown above when investment is interest inelastic .

CONCLUSION

1 This model eliminates the classical dichotomy between value and monetary theory .

2 It validates the conclusions of the quantity theory that in equilibrium, money is neutral and the interest rate is independent of the quantity of money through the real balance effect.

3 The wage-price flexibility leads to full employment in the long-run and that the Keynesian underemployment equilibrium is a disequilibrium situation.

CRITICISM

1. Not applicable in equilibrium situation—Johnson says that real balance is needed only to ensure the stability of the price level and not to determine the real equilibrium of the system.
2. Conceptually inadequate –Archibald and Lipsey said that Patinkin traces the real balance analysis as a short-run phenomenon and does not work it out through the Long-run.
3. Price stability without real balance effect—Cliff Lloyd said that , by assuming that money is available in fixed quantity and people want to hold it, will bring price stability, but, “money illusion” will not be absent.
4. Failure to explain increase in monetary wealth--- Shaw criticized that Patinkin simply assumes a doubling of money balances and analyses only the resultant effects. In practice money stock does not change in this manner.

QUESTIONS

1. Critically evaluate Patinkin’s monetary model of Real balance effect.-10 marks
2. Write a short note on Real balance effect.