

MONEY AND WEALTH: A THEORETICAL NOTE*

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The purpose of this short paper is to offer some comments on the relationship of money to wealth. The first part of the paper gives a summary of the role of the real balance effect in macro-economic theory. Then the argument that money is a part of net wealth is examined. Finally some theoretical implications of the money-is-wealth argument are discussed.

I. The Real Balance Effect in Macro-economics

The classical system purports to describe an economy where there exist market forces which tend to automatically counteract the initial disturbances, and bring the economy back to full employment equilibrium. Keynes' General Theory shook the classical foundations by showing that even with perfect flexibility in money wages and prices, the competitive system may end up with underemployment equilibrium, thus destroying the classical automaticity. This may happen when there is a liquidity trap; when the investment schedule is completely inelastic with respect to changes in interest rate; and when the saving and investment schedules are such that saving at full employment is higher than investment at all positive interest rates.¹ Under these circumstances, there are, according to Keynes, no market forces which will push the economy to full employment. This alleged lack of automaticity in the economic system is highly disturbing both on theoretical and practical grounds. Theoretically, the lack of consistency points to the inadequacy of the model; practically, in terms of policy purposes, the implication is that monetary policy is impotent.

* This paper was written in 1968 and hence recent developments in the literature have not been consulted. The author wishes to thank professor Elmus Wicker of the Department of Economics, Indiana University, for his many valuable comments. Any remaining errors are the author's.

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¹ Boris P. Peseck, Thomas R. Saving, *Money, Wealth Economic Theory*, Macmillan, New York, 1967, p. 10.

In response to the Keynesian attack, Pigou and Scitovsky² introduced another variable as a new argument in the excess demand equation for the commodity market, assuming that consumption is a function not only of income and interest rate but also of the value of real cash balance. Patinkin, Gurley and Shaw make use of this new variable in their models. Based upon the premise that all money is an asset of the holder, and a debt of the issuer, the real balance effect will or will not work depending on the assumption made with regard to the response of the economic units to the change in their own real indebtedness. If the money is of the "outside" type, i.e., issued by the agency exogenous to the economic system, the usual assumption is that such agency, e.g., the government, does not respond to the change in their real indebtedness. If the money, however, is "inside" money issued by the private banking system, the assumption is that when the price level changes, the banking system will respond to the change in their real indebtedness. For both types of money, the fall in the price level will benefit the holders of money and will affect the issuers; but in the outside money case the issuers, to whom money is a debt, are assumed to act as if they are not affected while in the case of inside money, this assumption allegedly does not hold-leaving a zero net wealth effect. To repeat, in the outside money case, the change in the price level produces net wealth effects, not because money is said to be a part of net wealth, but because of the assumption concerning the behavior of the issues of money.³

Money is a Part of Net Wealth

In their provocative book, *Pesek and Saving* argue that all money is a part of net wealth and is not a debt of anybody. If this is so, the distinction between outside and inside money is irrelevant: the change in the price level will produce net wealth effects. Different assumptions as to the money issuers' response to the change in real debt are no longer necessary; indeed they are imaginary since there is no debt to respond to in the first place.

² Lloyd A. Metzler, "Wealth, Saving, and the Rate of Interest," *Journal of Political Economy*, Vol. 59 (April 1951), reprinted in Richard S. Thorn, *Monetary Theory & Policy*, Random House New York, 1966, p. 324.

³ Don Patinkin, *Money, Interest & Prices*, 2nd edition, Harper & Row, New York, 1965, p. 288

Crucial to the Pesek and Saving's argument is the unique "technical property" of money⁴ that the flow of services of money is dependent upon its own price and hence upon the general price level, because the price of money is the reciprocal of the general price level. Non-monetary commodities do not have this property. To the contrary, the flow of services from these commodities is independent of their own prices. Thus the flow of services of non-monetary capital goods cannot be increased or decreased by changing the general price level, while that of money can. In other words, when the price level declines, the holders of money are better off because a unit of money will buy a greater number of other things, but the non-holders of money will be completely unaffected because the resources needed to be given up in exchange for a unit of other non-monetary goods will remain the same. It is true that the new purchaser of money will have to give up more resources in order to obtain the same number of units of money, but to effect a given transaction, a proportionately smaller amount of money is required, hence the same amount of non-monetary resources will be sufficient for the given transaction. The crucial argument then rests upon the position of the producers of money.

In order to examine Pesek and Saving's argument more carefully, the author will follow their presentation of the types of money in their order of complexity—commodity money, fiat money and bank money.

So far as the producers of commodity money are concerned, all sales are final. Once the money has been sold, the money producers are in the same position as any other non-holders of money assuming that they have no commodity money left on hand's and hence are completely unaffected. In this case, Pesek and Saving rightly argue that the decline in the price level, i.e., the rise in the value or price of money leads to a net gain for the society as a whole because it leaves some body better off without making anybody worse off.⁵ The argument will also hold in the case of fiat money. Here Pesek and Saving argue that since the physical substance of a unit of money does not affect its performance as a medium of exchange or store of value, that money is just like a commodity money in this respect. Therefore the conclusions regarding commodity money being net wealth must apply in the case of fiat money as well.⁶

⁴ Pesek and Saving, *op. cit.*, pp. 60-61.

⁵ *Ibid.*, p. 60

⁶ *Ibid.*, pp. 72-74

To discuss the effect of the change in the price level on the position of the issuers of money in the case of bank money, we have to introduce a necessary limitation, i.e., the "repurchase clause," making the banks pay on demand the dominant money for bank money. Under this limitation, the money producers will have to hold a certain amount of dominant money in reserve to meet the repurchase clause agreement. Net wealth is the total sales of bank money less the value of dominant money held in reserve. The latter is viewed as a cost of producing money, measured in terms of the income foregone which the banks would have otherwise enjoyed had it not been necessary for them to hold dominant money in reserves. Pesek and Saving argue that the decline (or rise) in the general price level will affect the money producers only to the extent that it affects the quantity of reserves held.⁷ They assume that the change in the price level (hence the price of all money) does not affect the relative desirability of bank and dominant money, and hence the same level of reserves held before the money producers will again be unaffected.

It appears to the author that, Pesek and Saving's argument that money is a part of net wealth is persuasive. In the case of commodity money the author believes all would agree that it is a part of net wealth. Also it is difficult to imagine how the fiat money is a debt. If it is a debt, the holders of it must be able to ask for a repayment; but in actuality it is never paid back and it has "no maturity date." In the case of bank money, the argument that depositors can have a claim on the bank, and thus deposit is a debt of the bank, seems on the surface a little bit more plausible. But here, even if one still believes that deposit is a debt of the banking system, one can still be led to believe that the change in the price level will lead to a net change in wealth, if one will only look at the behavior of the banks. The net gain will be zero, only if the banks behave in such a way that all the deposits will be withdrawn at any given instant. But this clearly is not the way the banking system operates, witness the fractional reserves they hold. Thus those who believe that bank money is a "debt" and that the price change will produce on net wealth affect must also believe that the banks think all the money they have issued will be withdrawn at any instant of time. In such a case, the reserve will have to be a hundred percent, and the net

⁷ *Ibid.*, p. 89. Here Pesek & Saving argue in the case of privately produced money, but they assume the conclusions here to hold also in the case of bank money, see p. 95.

wealth will be zero, regardless of whether the price level changes or not. Thus if one cannot discard the view that bank money is a debt of the banking system, one should treat it as a "debt" only the amount of reserves held; and the response of the banking system to their real indebtedness should be thought to be confined to this part, and not to cover the total of the deposits they create. This, however, would be very strange in so far as reserves are actually treated as assets of the banks. Pesek and Saving view these reserves differently, and the author believes more plausibly in economic terms. They treat the money held in reserves as the cost of producing bank money, and not as a debt, because there is no debt. Note that these reserves are held independently of the law; their existence does not in anyway depend on the law. They exist because it is part and parcel of the process of producing bank money.

Some Implications of the Money is Net Wealth Argument

If we accept Pesek and Saving's argument, as the author thinks we must, that money is a part of the community's net wealth, we also have to accept the argument's implications. Here only some of the theoretical implications will be brought out.

First, the refutation of the argument that money is a debt is also a refutation of the relevance of the inside-outside money distinction. For now, all money is the same, whether originated from the outside or inside agencies-it is a part of net wealth. The increase in the quantity of money will produce initial "wealth and portfolio effects", and if the price of money changes in response to these initial effects, the changing flow of services of money will produce the "real balance" effect.⁸ Second, there is no need to make what Pesek and Saving call a symmetrical assumptions regarding the behavior of economic units. In other words, the "economically relevant wealth equation" and the "net wealth equation" will now be identical. Third, since now the real balance variable appears in the excess demand equations for all markets, the dichotomy that interest rate or "real variable" is determined in the real sector, while absolute prices are determined in the monetary sector, will be no longer valid.

There are some other implications of the argument which are relevant for policy purposes, but these are beyond the scope of this short note.

⁸ *Ibid.*, p. 65.