A Note on "Real" and "Monetary" Effects of an Exogenous Change in Interest Rates

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The interesting article by D. Rodney Thom (Economic and Social Review, January 1974) seems to contain a misleading assertion which makes his statistical results difficult to interpret. Thom's main thesis is that, in the Irish situation, the result of a change in the (exogenously determined) level of interest rates can be decomposed into "monetary" and "real" effects working in opposite directions, for example, an expansionary "monetary" and a contractionary "real" effect following a rise in interest rates.

While it is true that, given several assumptions not fully explicit in Thom's paper, it can be proved that the interest rate in a small open economy will be determined exogenously, it also follows that, under such circumstances, the quantity of real balances in the economy will adjust (through, say, price changes or capital flows) to reduce the (absolute size of the) excess demand for real balances, so that an equilibrium quantity of real balances corresponding to the interest rate will be reached. Moreover, the argument which ensures that the time-path of Irish interest rates will not noticeably diverge from that of London rates also clearly guarantees adjustment to the equilibrium quantity of real balances in Ireland with a negligible time lag. This means that a persistent excess demand or supply of funds with repercussions on real output cannot arise through a "monetary"

1. Somewhat analogous to what Leijonhufvud calls the "Keynes effect".
2. As Thom does not really make divergent movements in different interest rates a part of his analysis, neither will I.
4. This is the endogeneity of monetary aggregates mentioned in Thom’s first paragraph.
effect. In fact, the alternative view seems to be the precise point to which Thom takes exception in Hoare’s analysis.\(^5\)

Thom’s line of argument crucially ignores the horizontal supply of money schedule implicit in the maintained assumption of an exogenously determined interest rate.\(^6\) This is why, in reference to the possibility of London rates being above “equilibrium” Irish rates, he has to resort to a somewhat shaky argument to ensure the “right” sign in the change in money stock. Besides, his conclusion that the money stock will grow in response to an increase in interest rates, relies on a suspect balance-sheet argument in any case. Because the domestic component in the supply of credit has expanded, it is claimed that the money stock, which forms a large part of the liabilities of the principle lenders, must also increase. But this is a *non sequitur*: the stock of money in Irish hands is determined by the intersection of the demand schedule in Ireland with a horizontal supply schedule. Only if there were a positively sloped demand schedule over the relevant range would the money stock increase. This Thom specifically excludes in his equation (1). So, even in a less doctrinaire and more acceptable description of a small open economy than presented by Thom, with a gradual adjustment to the London interest rate, “monetary” and “real” effects would tend to be mutually reinforcing, with the domestic interest rates rising just as the stock of money declined in response to a growing awareness of interest opportunities abroad.

In short, Thom has failed to demonstrate the existence of a “monetary” effect working against the “real” effect, and his conclusions are to that extent vitiated.

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\(^6\) See figures 11b and 11b in Thom’s paper where a horizontal supply of credit is acknowledged. Cf. R. A. Mundell, *op. cit.* , esp. p. 479.