

The paper addresses a potentially interesting topic, as it tries to give a theoretical underpinning for the ECB's two-pillar strategy. The author argues that the monetary base and a short-term interest rate can (and should) be used as independent policy instruments. The author associates short-term interest rates with inflation targeting and the monetary base with monetary targeting. In this sense, a strategy of simultaneous monetary targeting and inflation targeting is desirable.

The main problem I had with the paper is that the exposition is extremely sloppy and confusing. In particular, the formal analysis is not sufficiently precise and the underlying model is unclear. In the following, I give a few examples.

1. On p. 14, the author describes the sequence of events. At the beginning of each period, workers form inflation expectations and agree on wages. Later, they are allowed to revise their inflation expectations. Does this mean that nominal wages are also revised? And do the expectations formed at the beginning of the period have any consequences, given that they can be re-adjusted later?

2. On p. 10, the author notes that inflation expectations are formed prior to t . At this point, it is unclear at which point they are formed and which information is used for expectation formation.

3. At the bottom of p. 13 (and elsewhere), the author stresses that money supply may differ from money demand in the model presented in the paper. However, this appears to be inconsistent with Equation (3) (money-market equilibrium).

4. In most models of monetary policy, the central bank can either choose a short-term interest rate (and then money is determined endogenously) or it can choose money (and thus the interest rate is determined endogenously). The present paper claims to present a model in which both variables can be chosen independently from each other. However, it is unclear why this should be possible. I strongly conjecture that the model would be overdetermined in general if the central bank chose both instruments simultaneously. The new ingredient to the model is (4). If a model with an optimizing central bank and equations (1)-(3) pins down i , y , m , p (and thus π), then the additional equation (4) simply determines b (base money). Hence b cannot be chosen freely by the central bank.

5. On p. 15, the author derives the optimal interest-rate policy for a given inflation rate and for given inflation expectations. However, because inflation expectations are re-adjusted later, one would have to take into account the effect that the choice of interest rate may have on inflation expectations. In addition, there may be an impact on the optimal future choice of b , which, in turn, might influence inflation. These effects are completely ignored.

6. Language should be polished. Substantial confusion is created due to the imprecise use of language. For example, the author notes in the middle of p. 3 that papers by Gerlach and Assenmacher-Wesche "try to justify" the ECB's two-pillar strategy. This suggests that these authors are supporters of the two-pillar strategy, which is incorrect.

7. The paper makes strong claims, which are not supported by rigid arguments. For example, at the top of p. 19, the author suggests that inflation targeting is one of the main reasons for the current financial crisis.

To sum up, although the paper's topic is interesting I could not identify a significant contribution to the literature on monetary policy. Moreover, the model is not specified sufficiently clearly to grant new insights.

If I may give an advise on how to rewrite the paper, I would recommend to focus on a much simpler model with just one period t . This model should be specified clearly and be solved properly by backward induction. Particular care should be given to modeling how policies like quantitative easing can affect the economy in addition to interest-rate policies (or in the case where interest-rate policies are ineffective). In the introduction, the author should separate more clearly the critique of inflation targeting and the critique of New Keynesian models.