

The Design of a ‘Two Pillar’ Monetary Policy Strategy
By Meixing Dai

Comment by Charles Goodhart

The problem with this paper is that it fails adequately to recognise the duality between official interest rates and the monetary base, and proposes a distinction between the demand and supply of money, which is observationally and empirically unhelpful. If a Central Bank sets and maintains an official short-term interest rate, (monetary base quantity) then it simply has to accept the monetary base (short term interest rate) that the commercial banking system wants (otherwise they will react in such a way as to change the previous base/interest rate pair).

Once the monetary base/interest dual pair is determined, then the development of the wider monetary aggregates, (M_1, M_2, \dots, M_n), depends on bank, private sector behaviour, over which the authorities have little influence, subject to two qualifications. First, when official interest rates hit the zero nominal bound, the authorities can use quantitative easing, QE, to adjust M up or down, so long as M is not kept so tight that it is only consistent with a positive, non-zero interest rate.

Second, the authorities could also use a second instrument, say a macro-prudential measure to tax or to subsidise bank intermediation, so that, consistent with the given interest rate/base dual pairing, there is a further way to influence bank intermediation, and hence monetary growth. Now many of us support the idea that the interest rate instrument be used to achieve the inflation target, but that a further, second (macro-prudential) instrument be used to constrain bank leverage and asset price inflation.

So Meixing Dai’s objectives are, on this view, laudable. The problem with this paper is the lack of appreciation that all this requires a second instrument, and some questionable analysis of the process of money stock determination, and the, somewhat unhelpful, assumption of a distinction between the demand and supply of money.

Finally, the paper was obviously written by someone for whom English was a foreign language, and would have benefited from some editorial polishing.

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