

Reply to the Comment by Charles Goodhart on “The Design of a ‘Two Pillar’ Monetary Policy Strategy”

by Meixing Dai

Thanks for your comment.

I recognize the duality between official interest rates and the monetary base. This duality is the main obstacle to giving a role for money in the monetary policy strategy under the inflation targeting regime.

To bypass the obstacle, I consider that the central bank rations or limits the access of commercial banks to the central liquidity. This is stated in the sentence “They (money growth rules) can be implemented thanks to a kind of rationing or limitation of access to the central liquidity by the commercial banks and complements the interest rate rule in the ‘two-pillar’ monetary policy strategy” (page 25). It seems that, during the periods before the current financial crisis, it is quite frequent that ECB does not totally satisfy the demand of central liquidity expressed by the commercial banks in its auctions.

The idea is that at given repo rate, commercial banks are rationed on the reserve market (central liquidity) if their demand excess what the central bank would like to supply under a money growth rule. On the monetary market (internal money plus central liquidity), the control of central liquidity implies a modification of future expected inflation, leading to the dynamics of inflation expectations. The interest rate on the money market will be nearly equal to the repo rate if the monetary control is not too restrictive and unanticipated. The direction of change of money growth gives guidance to market operators for revising their expectations concerning the future.

I agree that the distinction between the demand and supply of money is observationally and empirically unhelpful when the duality between official interest rates and the monetary base is verified, i.e. the demand for liquidity of the commercial banks is always 100 % satisfied at given official interest rates.

This distinction makes a sense in the theoretical framework where a control is exercised over the money growth through rationing of the central liquidity.

When we consider money and financial markets, we may need more than one supplementary instrument in order to stabilise the financial markets and the economy. Consequently, I agree with the idea that the macroeconomic prudential measure is necessary. However, financial institutions may rapidly innovate to find ways of circumventing these regulations. Under these conditions, the control of money growth is useful and can be more rapidly adapted to the quickly changing economic environment.