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Discussion of

"Dual-track Interest Rates and the Conduct of Monetary Policy in China"

Discussion: Dual-track Interest Rates and the Conduct of Monetary Policy in China

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What does the paper do?

- Present a theoretical model to illustrate the effects of monetary policy in China
- Taking into account several distortions that make the Chinese case a special one.
- Then, presents empirical evidence on the relation between policy instruments and market-determined interest rates.

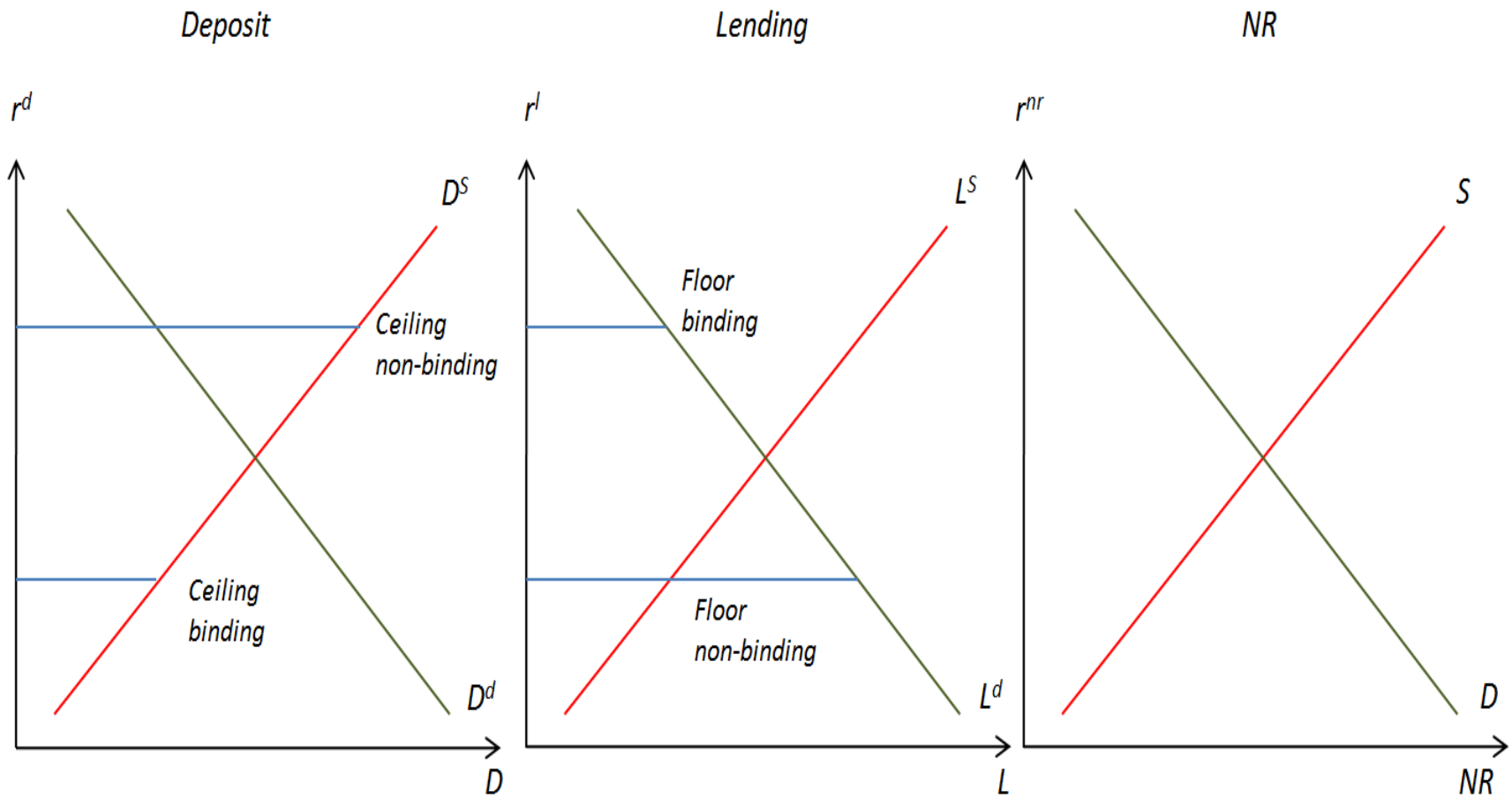
Model

- Banking model with deposit, lending and non-regulated markets.
- Banks capture deposits from the economy and lend money to investors (regulated operations).
- They also inject money in non-regulated markets (money market and bonds).
- $(1-\alpha)D = L + NR + B$, where α is reserve requirements.

Model

- Distortions present in the Chinese banking system analyzed:
  - A Deposit-Rate Ceiling.
  - A Lending-Rate Floor.
  - Quantitative target on banking lending
- These distortions are used as monetary-policy instruments (not the only ones).
- Effectiveness and effects of these instruments would depend on whether they are binding or not.
- Policy instruments have to be binding to have any effect (ceiling, floors, quotas and required reserves).

The simplified model graphically:



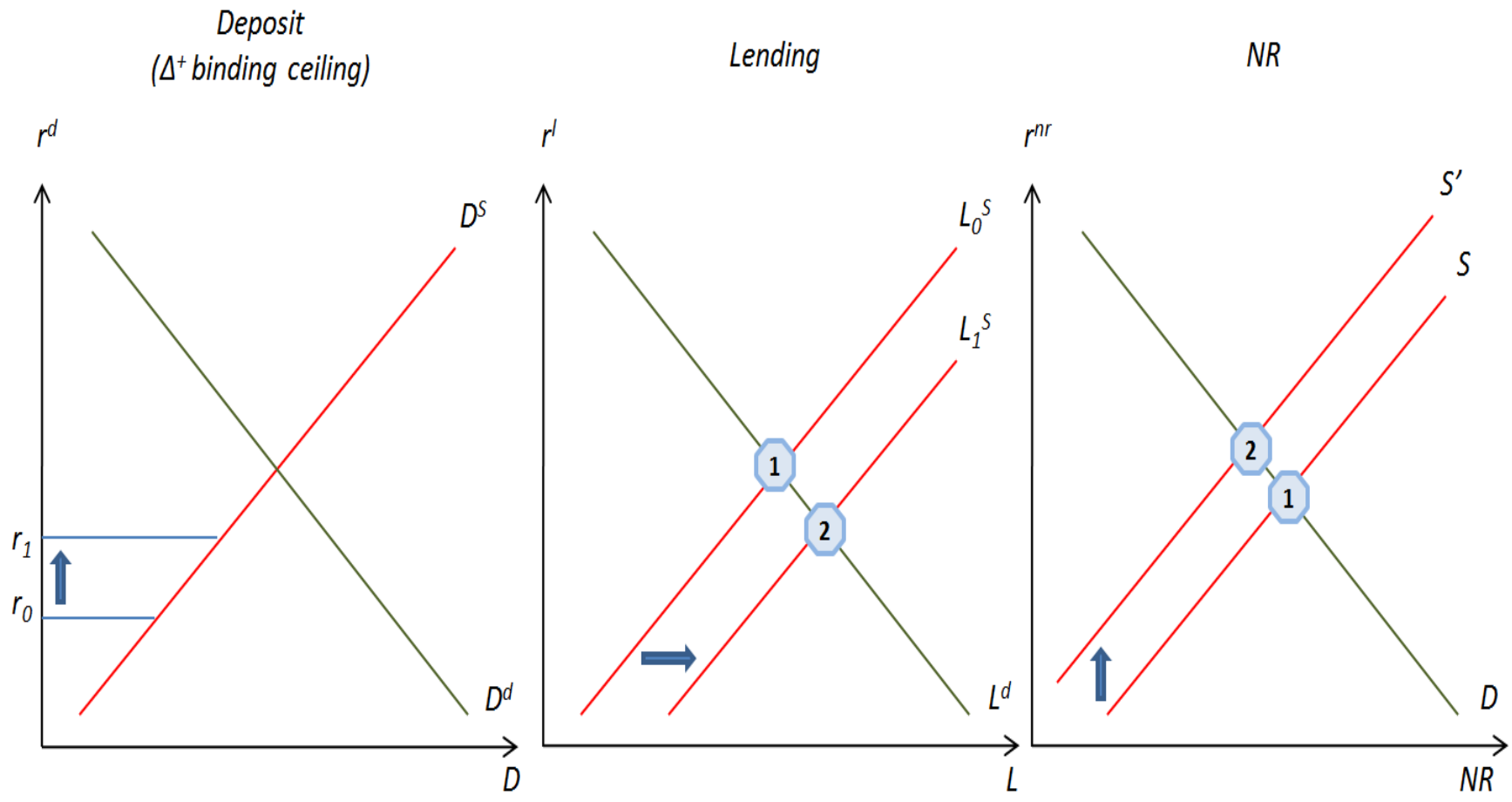
Policy-instrument effects with no distortions:

- Usual effects.
- An increase in α: reduces banks' funds available to lend and thus increases the interest rate. Also people and firms would turn to find funds in non-regulated market increasing the demand and the interest rate in that markets.
- Selling securities by central bank: reduces liquidity and increases interest rates.

Policy-instrument effects with binding deposit ceiling

- Increase in the deposit-ceiling rate:
  - Attracts more deposits to banks,
  - Which would reduce the supply of funds in non-regulated markets increasing the rate (there would be a second-round smaller positive effect in NR supply given higher loans derived form higher deposits).
  - If the lending floor is not binding, Would not be the case that banks' lending interest rate is reduced? (there is an increase in credit supply increase derived from the increase in deposits). Problem of assuming a functional form for the demand of bank credit not micro-funded.
- Changes in reserves requirements and central banks securities same effects as above.

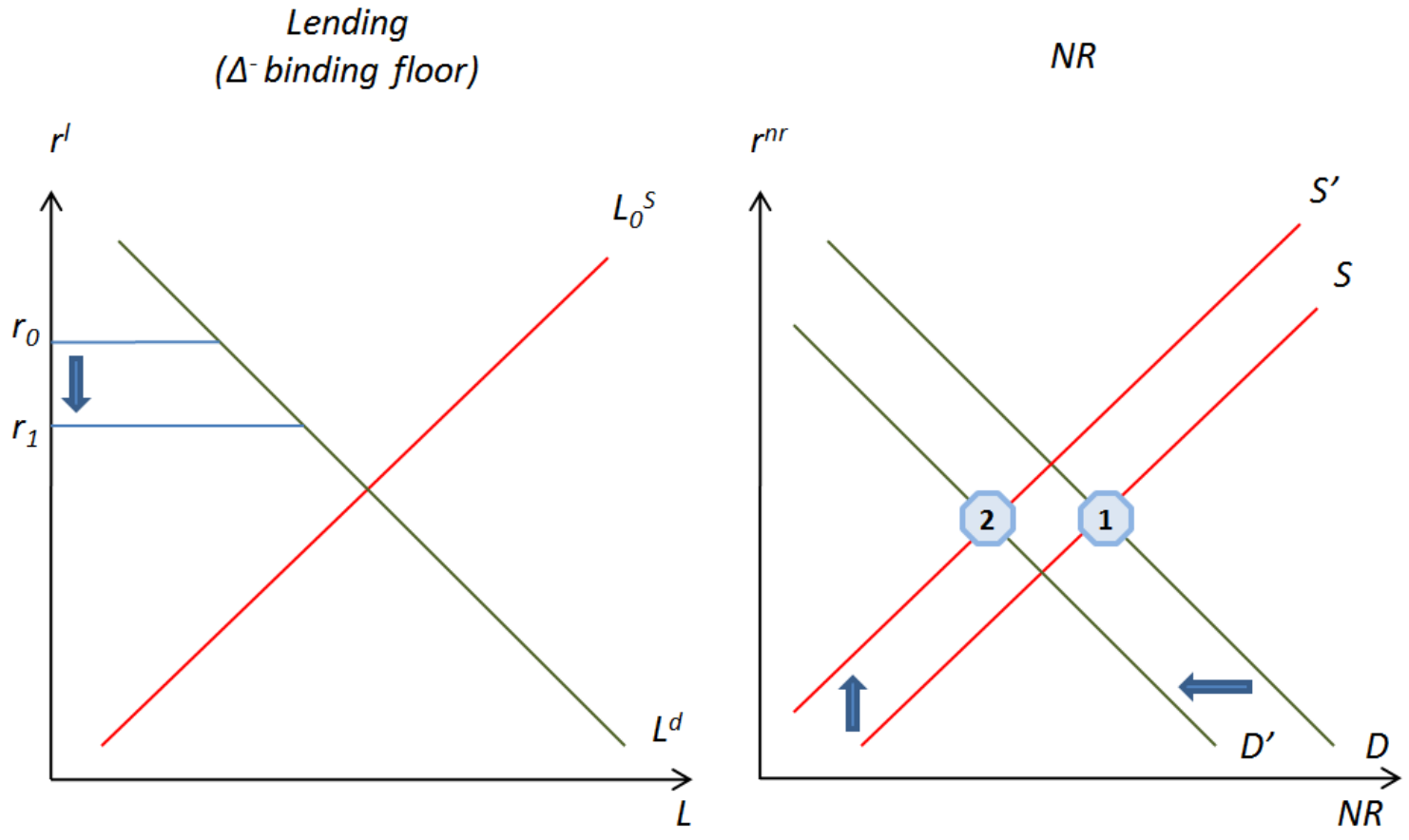
Graphically:



Policy-instrument effects with binding restrictions on credit

- The relevant restriction (floor or quota) is the more binding one.
- Loosening restrictions on credit (reduce floor or quota):
  - Ambiguous effect on non-regulated rates given by increase in bank lending.
  - On the one hand, more funds go to bank lending and the supply of NR markets is reduced (tends to increase NR rates).
  - On the other, demand for funds in NR markets is reduced (since a part is satisfied through higher bank credits).
  - In this case was assumed in the paper that the demand in NR market depends on the interest rate in the banking sector (differently from the assumption on credit markets above).

Graphically:



Empirical Results:

- Use Linear and GARCH models to study the effects of policy changes on short-term and long-term interest rates.
- Ranking of policy effects' strength:
  1. Benchmark deposit rate
  2. Required reserves
  3. Open market operations
- In all cases the effects are higher in short-term rates (which depend more on liquidity)

General Comments

- A very useful framework to think about monetary policy in an economy with distortions in asset markets.
- For an uninformed reader it would be good to have a deeper description of the importance of different markets in the financial sector in China to understand the relevance of the transmission channels. This is important in presence of many instruments in many regulated markets.
- This would be useful to understand transmission channels.
- How is monetary policy reflected in the aggregate demand in an economy like China? Are there other distortions that make the interest rate lack relevance? (e.g. managing of investment)

General Comments

- Are open market operations used to sterilize monetary expansion from FX interventions?If it were the case, then could be a reason why it does not affect interest rates.
- What is the intuition of these distortions? Could be: Financial repression (floor rates or quotas) needed to maintain at low levels Central Bank interest rates (used to sterilize?). In turn deposit ceiling is needed to maintain banks running.
- Are this inefficiencies a consequence of managing the exchange rate?