Monetary Policy Instruments in China — A Comparison Between the Money Supply and the Interest Rate

Yi Ding[1]

Abstract

Unlike the policy makers in advanced economies, who use the interest rate as the primary to conduct monetary policy, the People's Bank of China (PBoC) has used both the interest rate and the money supply as monetary policy instruments during recent decades. In this paper, I seek to identify interest rate and money supply rules for China and evaluate the efficiency of these two monetary policy rules using a dynamic stochastic general equilibrium (DSGE) model. The DSGE framework in this paper is the same as that of Iacoviello (2005). The empirical results show that the interest rate rule responds more aggressively to inflation than to output and the money supply rule responds more aggressively to output than to inflation. Results from the DSGE model indicate the interest rate rule results in a smaller welfare loss in response to a technology shock and an inflation shock, relative to the money supply rule. On the other hand, the money supply rule results in a smaller welfare loss when there are spillovers from the housing market to the consumption market. In sum, whether the PBoC should choose an interest rate or a money supply rule depends on the source of the shocks.

Keywords: Money Supply, Interest Rate, DSGE

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[1] University of New South Wales, Australia, yi.ding3@unsw.edu.au