A Note on "Real" and "Monetary" Effects of an Exongenous Change in Interest Rates—A Rejoinder

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HONOHAN seems to be treating my model as being both analytically and operationally equivalent to the standard Mundell open economy model. This I believe to be a misconception.

The Mundell model was constructed to examine the consequences of monetary policy under alternative exchange rate systems. Thus, with fixed exchange rates, a divergence between domestic and foreign interest rates, which is engineered by the monetary authorities, can only be maintained if the central bank is prepared to undertake the appropriate sterilisation operations. In the limiting case of perfect capital mobility such operations will be self-defeating and the interest differential will be rapidly closed.

In my model, however, the monetary authorities do not alter the nominal money stock from that level which is consistent with the equilibrium rate of interest.[1] Rather it is the latter which moves from one equilibrium level to another under the pressure of external forces and with a negligible time lag. In the Irish case it does not necessarily follow that the domestic money stock will automatically do likewise. Sterilisation operations, which do not affect the domestic (Irish) rate of interest, create disequilibrium in the money market rather than in the foreign exchange market.

In Ireland such sterilisation operations have been traditionally undertaken by the commercial banks who have consistently offset the internal monetary consequences of overall payments deficits by substituting domestic assets (i.e., by increasing their private sector lending) for foreign assets. Operations of this type, which are aimed at maintaining bank domestic liabilities rather than interest rate

1. In the Irish case the equilibrium, or market-clearing rate, is totally determined by the UK rate.

differentials, may have the effect of creating an excess supply (demand) of both nominal and real balances of the new rate of interest imposed externally. In terms of the simple monetarist model this excess supply (demand) will have expansionary (contractionary) effects on the level of economic activity.

Furthermore, given higher rates of interest, there will be a fall in the total (domestic plus foreign) liabilities of the non-bank sector. Rising interest rates, however, generate increases in the flow of domestic resources towards home based financial institutions including commercial banks. Consequently, a greater proportion of domestic credit can be financed from domestic sources; i.e., domestic liabilities of banking sector are increased.

The above argument is not at issue with the, now fashionable, Humean analysis of the adjustment of the *real* money stock to the demand for *real* balances in an open economy. Rather, it suggests that in a country such as Ireland interest rates may adjust to their equilibrium levels much more rapidly than the real quantity of money adjusts to the level consistent with given rates of interest.

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