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THE ROLE OF MONETARY POLICY*

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There is wide agreement about the major goals of economic policy: high employment, stable prices, and rapid growth. There is less agreement that these goals are mutually compatible or, among those who regard them as incompatible, about the terms at which they can and should be substituted for one another. There is least agreement about the role that various instruments of policy can and should play in achieving the several goals.

My topic for tonight is the role of one such instrument—monetary policy. What can it contribute? And how should it be conducted to contribute the most? Opinion on these questions has fluctuated widely. In the first flush of enthusiasm about the newly created Federal Reserve System, many observers attributed the relative stability of the 1920s to the System's capacity for fine tuning—to apply an apt modern term. It came to be widely believed that a new era had arrived in which business cycles had been rendered obsolete by advances in monetary technology. This opinion was shared by economist and layman alike, though, of course, there were some dissonant voices. The Great Contraction destroyed this naive attitude. Opinion swung to the other extreme. Monetary policy was a string. You could pull on it to stop inflation but you could not push on it to halt recession. You could lead a horse to water but you could not make him drink. Such theory by aphorism was soon replaced by Keynes' rigorous and sophisticated analysis.

Keynes offered simultaneously an explanation for the presumed impotence of monetary policy to stem the depression, a nonmonetary interpretation of the depression, and an alternative to monetary policy

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Milton Friedman

Number 69 of a series of photographs of past presidents of the Association.

for meeting the depression and his offering was avidly accepted. If liquidity preference is absolute or nearly so—as Keynes believed likely in times of heavy unemployment—interest rates cannot be lowered by monetary measures. If investment and consumption are little affected by interest rates—as Hansen and many of Keynes' other American disciples came to believe—lower interest rates, even if they could be achieved, would do little good. Monetary policy is twice damned. The contraction, set in train, on this view, by a collapse of investment or by a shortage of investment opportunities or by stubborn thriftiness, could not, it was argued, have been stopped by monetary measures. But there was available an alternative—fiscal policy. Government spending could make up for insufficient private investment. Tax reductions could undermine stubborn thriftiness.

The wide acceptance of these views in the economics profession meant that for some two decades monetary policy was believed by all but a few reactionary souls to have been rendered obsolete by new economic knowledge. Money did not matter. Its only role was the minor one of keeping interest rates low, in order to hold down interest payments in the government budget, contribute to the "euthanasia of the rentier," and maybe, stimulate investment a bit to assist government spending in maintaining a high level of aggregate demand.

These views produced a widespread adoption of cheap money policies after the war. And they received a rude shock when these policies failed in country after country, when central bank after central bank was forced to give up the pretense that it could indefinitely keep "the" rate of interest at a low level. In this country, the public denouement came with the Federal Reserve-Treasury Accord in 1951, although the policy of pegging government bond prices was not formally abandoned until 1953. Inflation, stimulated by cheap money policies, not the widely heralded postwar depression, turned out to be the order of the day. The result was the beginning of a revival of belief in the potency of monetary policy.

This revival was strongly fostered among economists by the theoretical developments initiated by Haberler but named for Pigou that pointed out a channel—namely, changes in wealth—whereby changes in the real quantity of money can affect aggregate demand even if they do not alter interest rates. These theoretical developments did not undermine Keynes' argument against the potency of orthodox monetary measures when liquidity preference is absolute since under such circumstances the usual monetary operations involve simply substituting money for other assets without changing total wealth. But they did show how changes in the quantity of money produced in other ways could affect total spending even under such circumstances. And, more

fundamentally, they did undermine Keynes' key theoretical proposition, namely, that even in a world of flexible prices, a position of equilibrium at full employment might not exist. Henceforth, unemployment had again to be explained by rigidities or imperfections, not as the natural outcome of a fully operative market process.

The revival of belief in the potency of monetary policy was fostered also by a re-evaluation of the role money played from 1929 to 1933. Keynes and most other economists of the time believed that the Great Contraction in the United States occurred despite aggressive expansionary policies by the monetary authorities—that they did their best but their best was not good enough.[1] Recent studies have demonstrated that the facts are precisely the reverse: the U.S. monetary authorities followed highly deflationary policies. The quantity of money in the United States fell by one-third in the course of the contraction. And it fell not because there were no willing borrowers—not because the horse would not drink. It fell because the Federal Reserve System forced or permitted a sharp reduction in the monetary base, because it failed to exercise the responsibilities assigned to it in the Federal Reserve Act to provide liquidity to the banking system. The Great Contraction is tragic testimony to the power of monetary policy—not, as Keynes and so many of his contemporaries believed, evidence of its impotence.

In the United States the revival of belief in the potency of monetary policy was strengthened also by increasing disillusionment with fiscal policy, not so much with its potential to affect aggregate demand as with the practical and political feasibility of so using it. Expenditures turned out to respond sluggishly and with long lags to attempts to adjust them to the course of economic activity, so emphasis shifted to taxes. But here political factors entered with a vengeance to prevent prompt adjustment to presumed need, as has been so graphically illustrated in the months since I wrote the first draft of this talk. "Fine tuning" is a marvelously evocative phrase in this electronic age, but it has little resemblance to what is possible in practice—not, I might add, an unmixed evil.

It is hard to realize how radical has been the change in professional opinion on the role of money. Hardly an economist today accepts views that were the common coin some two decades ago. Let me cite a few examples.

In a talk published in 1945, E. A. Goldenweiser, then Director of the Research Division of the Federal Reserve Board, described the primary objective of monetary policy as being to "maintain the value of Government bonds. . . . This country" he wrote, "will have to adjust to

[1] In [2], I have argued that Henry Simons shared this view with Keynes, and that it accounts for the policy changes that he recommended.

a 2½ per cent interest rate as the return on safe, long-time money, because the time has come when returns on pioneering capital can no longer be unlimited as they were in the past" [4, p. 117].

In a book on *Financing American Prosperity,* edited by Paul Homan and Fritz Machlup and published in 1945, Alvin Hansen devotes nine pages of text to the "savings-investment problem" without finding any need to use the words "interest rate" or any close facsimile thereto [5, pp. 218-27]. In his contribution to this volume, Fritz Machlup wrote, "Questions regarding the rate of interest, in particular regarding its variation or its stability, may not be among the most vital problems of the postwar economy, but they are certainly among the perplexing ones" [5, p. 466]. In his contribution, John H. Williams—not only professor at Harvard but also a long-time adviser to the New York Federal Reserve Bank—wrote, "I can see no prospect of revival of a general monetary control in the postwar period" [5, p. 383].

Another of the volumes dealing with postwar policy that appeared at this time, *Planning and Paying for Full Employment,* was edited by Abba P. Lerner and Frank D. Graham [6] and had contributors of all shades of professional opinion—from Henry Simons and Frank Graham to Abba Lerner and Hans Neisser. Yet Albert Halasi, in his excellent summary of the papers, was able to say, "Our contributors do not discuss the question of money supply. . . . The contributors make no special mention of credit policy to remedy actual depressions. . . . Inflation . . . might be fought more effectively by raising interest rates. . . . But . . . other anti-inflationary measures . . . are preferable" [6, pp. 23-24]. *A Survey of Contemporary Economics,* edited by Howard Ellis and published in 1948, was an "official" attempt to codify the state of economic thought of the time. In his contribution, Arthur Smithies wrote, "In the field of compensatory action, I believe fiscal policy must shoulder most of the load. Its chief rival, monetary policy, seems to be disqualified on institutional grounds. This country appears to be committed to something like the present low level of interest rates on a long-term basis" [1, p. 208].

These quotations suggest the flavor of professional thought some two decades ago. If you wish to go further in this humbling inquiry, I recommend that you compare the sections on money—when you can find them—in the Principles texts of the early postwar years with the lengthy sections in the current crop even, or especially, when the early and recent Principles are different editions of the same work.

The pendulum has swung far since then, if not all the way to the position of the late 1920s, at least much closer to that position than to the position of 1945. There are of course many differences between then and now, less in the potency attributed to monetary policy than in the

roles assigned to it and the criteria by which the profession believes monetary policy should be guided. Then, the chief roles assigned monetary policy were to promote price stability and to preserve the gold standard; the chief criteria of monetary policy were the state of the "money market," the extent of "speculation" and the movement of gold. Today, primacy is assigned to the promotion of full employment, with the prevention of inflation a continuing but definitely secondary objective. And there is major disagreement about criteria of policy, varying from emphasis on money market conditions, interest rates, and the quantity of money to the belief that the state of employment itself should be the proximate criterion of policy.

I stress nonetheless the similarity between the views that prevailed in the late 'twenties and those that prevail today because I fear that, now as then, the pendulum may well have swung too far, that, now as then, we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making.

Unaccustomed as I am to denigrating the importance of money, I therefore shall, as my first task, stress what monetary policy cannot do. I shall then try to outline what it can do and how it can best make its contribution, in the present state of our knowledge—or ignorance.

I. *What Monetary Policy Cannot Do*

From the infinite world of negation, I have selected two limitations of monetary policy to discuss: (1) It cannot peg interest rates for more than very limited periods; (2) It cannot peg the rate of unemployment for more than very limited periods. I select these because the contrary has been or is widely believed, because they correspond to the two main unattainable tasks that are at all likely to be assigned to monetary policy, and because essentially the same theoretical analysis covers both.

Pegging of Interest Rates

History has already persuaded many of you about the first limitation. As noted earlier, the failure of cheap money policies was a major source of the reaction against simple-minded Keynesianism. In the United States, this reaction involved widespread recognition that the wartime and postwar pegging of bond prices was a mistake, that the abandonment of this policy was a desirable and inevitable step, and that it had none of the disturbing and disastrous consequences that were so freely predicted at the time.

The limitation derives from a much misunderstood feature of the relation between money and interest rates. Let the Fed set out to keep

interest rates down. How will it try to do so? By buying securities. This raises their prices and lowers their yields. In the process, it also increases the quantity of reserves available to banks, hence the amount of bank credit, and, ultimately the total quantity of money. That is why central bankers in particular, and the financial community more broadly, generally believe that an increase in the quantity of money tends to lower interest rates. Academic economists accept the same conclusion, but for different reasons. They see, in their mind's eye, a negatively sloping liquidity preference schedule. How can people be induced to hold a larger quantity of money? Only by bidding down interest rates.

Both are right, up to a point. The *initial* impact of increasing the quantity of money at a faster rate than it has been increasing is to make interest rates lower for a time than they would otherwise have been. But this is only the beginning of the process not the end. The more rapid rate of monetary growth will stimulate spending, both through the impact on investment of lower market interest rates and through the impact on other spending and thereby relative prices of higher cash balances than are desired. But one man's spending is another man's income. Rising income will raise the liquidity preference schedule and the demand for loans; it may also raise prices, which would reduce the real quantity of money. These three effects will reverse the initial downward pressure on interest rates fairly promptly, say, in something less than a year. Together they will tend, after a somewhat longer interval, say, a year or two, to return interest rates to the level they would otherwise have had. Indeed, given the tendency for the economy to overreact, they are highly likely to raise interest rates temporarily beyond that level, setting in motion a cyclical adjustment process.

A fourth effect, when and if it becomes operative, will go even farther, and definitely mean that a higher rate of monetary expansion will correspond to a higher, not lower, level of interest rates than would otherwise have prevailed. Let the higher rate of monetary growth produce rising prices, and let the public come to expect that prices will continue to rise. Borrowers will then be willing to pay and lenders will then demand higher interest rates—as Irving Fisher pointed out decades ago. This price expectation effect is slow to develop and also slow to disappear. Fisher estimated that it took several decades for a full adjustment and more recent work is consistent with his estimates.

These subsequent effects explain why every attempt to keep interest rates at a low level has forced the monetary authority to engage in successively larger and larger open market purchases. They explain why, historically, high and rising nominal interest rates have been associated

with rapid growth in the quantity of money, as in Brazil or Chile or in the United States in recent years, and why low and falling interest rates have been associated with slow growth in the quantity of money, as in Switzerland now or in the United States from 1929 to 1933. As an empirical matter, low interest rates are a sign that monetary policy *has been* tight—in the sense that the quantity of money has grown slowly; high interest rates are a sign that monetary policy *has been* easy—in the sense that the quantity of money has grown rapidly. The broadest facts of experience run in precisely the opposite direction from that which the financial community and academic economists have all generally taken for granted.

Paradoxically, the monetary authority could assure low nominal rates of interest—but to do so it would have to start out in what seems like the opposite direction, by engaging in a deflationary monetary policy. Similarly, it could assure high nominal interest rates by engaging in an inflationary policy and accepting a temporary movement in interest rates in the opposite direction.

These considerations not only explain why monetary policy cannot peg interest rates; they also explain why interest rates are such a misleading indicator of whether monetary policy is "tight" or "easy." For that, it is far better to look at the rate of change of the quantity of money.[2]

Employment as a Criterion of Policy

The second limitation I wish to discuss goes more against the grain of current thinking. Monetary growth, it is widely held, will tend to stimulate employment; monetary contraction, to retard employment. Why, then, cannot the monetary authority adopt a target for employment or unemployment—say, 3 per cent unemployment; be tight when unemployment is less than the target; be easy when unemployment is higher than the target; and in this way peg unemployment at, say, 3 per cent? The reason it cannot is precisely the same as for interest rates—the difference between the immediate and the delayed consequences of such a policy.

Thanks to Wicksell, we are all acquainted with the concept of a "natural" rate of interest and the possibility of a discrepancy between the "natural" and the "market" rate. The preceding analysis of interest rates can be translated fairly directly into Wicksellian terms. The monetary authority can make the market rate less than the natural rate

[2] This is partly an empirical not theoretical judgment. In principle, "tightness" or "ease" depends on the rate of change of the quantity of money supplied compared to the rate of change of the quantity demanded excluding effects on demand from monetary policy itself. However, empirically demand is highly stable, if we exclude the effect of monetary policy, so it is generally sufficient to look at supply alone.

only by inflation. It can make the market rate higher than the natural rate only by deflation. We have added only one wrinkle to Wicksell—the Irving Fisher distinction between the nominal and the real rate of interest. Let the monetary authority keep the nominal market rate for a time below the natural rate by inflation. That in turn will raise the nominal natural rate itself, once anticipations of inflation become widespread, thus requiring still more rapid inflation to hold down the market rate. Similarly, because of the Fisher effect, it will require not merely deflation but more and more rapid deflation to hold the market rate above the initial "natural" rate.

This analysis has its close counterpart in the employment market. At any moment of time, there is some level of unemployment which has the property that it is consistent with equilibrium in the structure of *real* wage rates. At that level of unemployment, real wage rates are tending on the average to rise at a "normal" secular rate, i.e., at a rate that can be indefinitely maintained so long as capital formation, technological improvements, etc., remain on their long-run trends. A lower level of unemployment is an indication that there is an excess demand for labor that will produce upward pressure on real wage rates. A higher level of unemployment is an indication that there is an excess supply of labor that will produce downward pressure on real wage rates. The "natural rate of unemployment," in other words, is the level that would be ground out by the Walrasian system of general equilibrium equations, provided there is imbedded in them the actual structural characteristics of the labor and commodity markets, including market imperfections, stochastic variability in demands and supplies, the cost of gathering information about job vacancies and labor availabilities, the costs of mobility, and so on.[3]

You will recognize the close similarity between this statement and the celebrated Phillips Curve. The similarity is not coincidental. Phillips' analysis of the relation between unemployment and wage change is deservedly celebrated as an important and original contribution. But, unfortunately, it contains a basic defect—the failure to distinguish between *nominal* wages and *real* wages—just as Wicksell's analysis failed to distinguish between *nominal* interest rates and *real* interest rates. Implicitly, Phillips wrote his article for a world in which everyone anticipated that nominal prices would be stable and in which that anticipation remained unshaken and immutable whatever happened to actual prices and wages. Suppose, by contrast, that everyone anticipates that prices will rise at a rate of more than 75 per cent a year—as, for exam-

[3] It is perhaps worth noting that this "natural" rate need not correspond to equality between the number unemployed and the number of job vacancies. For any given structure of the labor market, there will be some equilibrium relation between these two magnitudes, but there is no reason why it should be one of equality.

ple, Brazilians did a few years ago. Then wages must rise at that rate simply to keep real wages unchanged. An excess supply of labor will be reflected in a less rapid rise in nominal wages than in anticipated prices,[4] not in an absolute decline in wages. When Brazil embarked on a policy to bring down the rate of price rise, and succeeded in bringing the price rise down to about 45 per cent a year, there was a sharp initial rise in unemployment because under the influence of earlier anticipations, wages kept rising at a pace that was higher than the new rate of price rise, though lower than earlier. This is the result experienced, and to be expected, of all attempts to reduce the rate of inflation below that widely anticipated.[5]

To avoid misunderstanding, let me emphasize that by using the term "natural" rate of unemployment, I do not mean to suggest that it is immutable and unchangeable. On the contrary, many of the market characteristics that determine its level are man-made and policy-made. In the United States, for example, legal minimum wage rates, the Walsh-Healy and Davis-Bacon Acts, and the strength of labor unions all make the natural rate of unemployment higher than it would otherwise be. Improvements in employment exchanges, in availability of information about job vacancies and labor supply, and so on, would tend to lower the natural rate of unemployment. I use the term "natural" for the same reason Wicksell did—to try to separate the real forces from monetary forces.

Let us assume that the monetary authority tries to peg the "market" rate of unemployment at a level below the "natural" rate. For definiteness, suppose that it takes 3 per cent as the target rate and that the "natural" rate is higher than 3 per cent. Suppose also that we start out at a time when prices have been stable and when unemployment is higher than 3 per cent. Accordingly, the authority increases the rate of monetary growth. This will be expansionary. By making nominal cash

[4] Strictly speaking, the rise in nominal wages will be less rapid than the rise in anticipated nominal wages to make allowance for any secular changes in real wages.

[5] Stated in terms of the rate of change of nominal wages, the Phillips Curve can be expected to be reasonably stable and well defined for any period for which the *average* rate of change of prices, and hence the anticipated rate, has been relatively stable. For such periods, nominal wages and "real" wages move together. Curves computed for different periods or different countries for each of which this condition has been satisfied will differ in level, the level of the curve depending on what the average rate of price change was. The higher the average rate of price change, the higher will tend to be the level of the curve. For periods or countries for which the rate of change of prices varies considerably, the Phillips Curve will not be well defined. My impression is that these statements accord reasonably well with the experience of the economists who have explored empirical Phillips Curves.

Restate Phillips' analysis in terms of the rate of change of real wages—and even more precisely, anticipated real wages—and it all falls into place. That is why students of empirical Phillips Curves have found that it helps to include the rate of change of the price level as an independent variable.

balances higher than people desire, it will tend initially to lower interest rates and in this and other ways to stimulate spending. Income and spending will start to rise.

To begin with, much or most of the rise in income will take the form of an increase in output and employment rather than in prices. People have been expecting prices to be stable, and prices and wages have been set for some time in the future on that basis. It takes time for people to adjust to a new state of demand. Producers will tend to react to the initial expansion in aggregate demand by increasing output, employees by working longer hours, and the unemployed, by taking jobs now offered at former nominal wages. This much is pretty standard doctrine.

But it describes only the initial effects. Because selling prices of products typically respond to an unanticipated rise in nominal demand faster than prices of factors of production, real wages received have gone down—though real wages anticipated by employees went up, since employees implicitly evaluated the wages offered at the earlier price level. Indeed, the simultaneous fall *ex post* in real wages to employers and rise *ex ante* in real wages to employees is what enabled employment to increase. But the decline *ex post* in real wages will soon come to affect anticipations. Employees will start to reckon on rising prices of the things they buy and to demand higher nominal wages for the future. "Market" unemployment is below the "natural" level. There is an excess demand for labor so real wages will tend to rise toward their initial level.

Even though the higher rate of monetary growth continues, the rise in real wages will reverse the decline in unemployment, and then lead to a rise, which will tend to return unemployment to its former level. In order to keep unemployment at its target level of 3 per cent, the monetary authority would have to raise monetary growth still more. As in the interest rate case, the "market" rate can be kept below the "natural" rate only by inflation. And, as in the interest rate case, too, only by accelerating inflation. Conversely, let the monetary authority choose a target rate of unemployment that is above the natural rate, and they will be led to produce a deflation, and an accelerating deflation at that.

What if the monetary authority chose the "natural" rate—either of interest or unemployment—as its target? One problem is that it cannot know what the "natural" rate is. Unfortunately, we have as yet devised no method to estimate accurately and readily the natural rate of either interest or unemployment. And the "natural" rate will itself change from time to time. But the basic problem is that even if the monetary authority knew the "natural" rate, and attempted to peg the market rate at that level, it would not be led to a determinate policy. The "market" rate will vary from the natural rate for all sorts of reasons other than monetary policy. If the monetary authority responds to

these variations, it will set in train longer term effects that will make any monetary growth path it follows ultimately consistent with the rule of policy. The actual course of monetary growth will be analogous to a random walk, buffeted this way and that by the forces that produce temporary departures of the market rate from the natural rate.

To state this conclusion differently, there is always a temporary trade-off between inflation and unemployment; there is no permanent trade-off. The temporary trade-off comes not from inflation per se, but from unanticipated inflation, which generally means, from a rising rate of inflation. The widespread belief that there is a permanent trade-off is a sophisticated version of the confusion between "high" and "rising" that we all recognize in simpler forms. A rising rate of inflation may reduce unemployment, a high rate will not.

But how long, you will say, is "temporary"? For interest rates, we have some systematic evidence on how long each of the several effects takes to work itself out. For unemployment, we do not. I can at most venture a personal judgment, based on some examination of the historical evidence, that the initial effects of a higher and unanticipated rate of inflation last for something like two to five years; that this initial effect then begins to be reversed; and that a full adjustment to the new rate of inflation takes about as long for employment as for interest rates, say, a couple of decades. For both interest rates and employment, let me add a qualification. These estimates are for changes in the rate of inflation of the order of magnitude that has been experienced in the United States. For much more sizable changes, such as those experienced in South American countries, the whole adjustment process is greatly speeded up.

To state the general conclusion still differently, the monetary authority controls nominal quantities—directly, the quantity of its own liabilities. In principle, it can use this control to peg a nominal quantity—an exchange rate, the price level, the nominal level of national income, the quantity of money by one or another definition—or to peg the rate of change in a nominal quantity—the rate of inflation or deflation, the rate of growth or decline in nominal national income, the rate of growth of the quantity of money. It cannot use its control over nominal quantities to peg a real quantity—the real rate of interest, the rate of unemployment, the level of real national income, the real quantity of money, the rate of growth of real national income, or the rate of growth of the real quantity of money.

II. *What Monetary Policy Can Do*

Monetary policy cannot peg these real magnitudes at predetermined levels. But monetary policy can and does have important effects on these real magnitudes. The one is in no way inconsistent with the other.

My own studies of monetary history have made me extremely sympathetic to the oft-quoted, much reviled, and as widely misunderstood, comment by John Stuart Mill. "There cannot . . . ," he wrote, "be intrinsically a more insignificant thing, in the economy of society, than money; except in the character of a contrivance for sparing time and labour. It is a machine for doing quickly and commodiously, what would be done, though less quickly and commodiously, without it: and like many other kinds of machinery, it only exerts a distinct and independent influence of its own when it gets out of order" [7, p. 488].

True, money is only a machine, but it is an extraordinarily efficient machine. Without it, we could not have begun to attain the astounding growth in output and level of living we have experienced in the past two centuries—any more than we could have done so without those other marvelous machines that dot our countryside and enable us, for the most part, simply to do more efficiently what could be done without them at much greater cost in labor.

But money has one feature that these other machines do not share. Because it is so pervasive, when it gets out of order, it throws a monkey wrench into the operation of all the other machines. The Great Contraction is the most dramatic example but not the only one. Every other major contraction in this country has been either produced by monetary disorder or greatly exacerbated by monetary disorder. Every major inflation has been produced by monetary expansion—mostly to meet the overriding demands of war which have forced the creation of money to supplement explicit taxation.

The first and most important lesson that history teaches about what monetary policy can do—and it is a lesson of the most profound importance—is that monetary policy can prevent money itself from being a major source of economic disturbance. This sounds like a negative proposition: avoid major mistakes. In part it is. The Great Contraction might not have occurred at all, and if it had, it would have been far less severe, if the monetary authority had avoided mistakes, or if the monetary arrangements had been those of an earlier time when there was no central authority with the power to make the kinds of mistakes that the Federal Reserve System made. The past few years, to come closer to home, would have been steadier and more productive of economic well-being if the Federal Reserve had avoided drastic and erratic changes of direction, first expanding the money supply at an unduly rapid pace, then, in early 1966, stepping on the brake too hard, then, at the end of 1966, reversing itself and resuming expansion until at least November, 1967, at a more rapid pace than can long be maintained without appreciable inflation.

Even if the proposition that monetary policy can prevent money it-

self from being a major source of economic disturbance were a wholly negative proposition, it would be none the less important for that. As it happens, however, it is not a wholly negative proposition. The monetary machine has gotten out of order even when there has been no central authority with anything like the power now possessed by the Fed. In the United States, the 1907 episode and earlier banking panics are examples of how the monetary machine can get out of order largely on its own. There is therefore a positive and important task for the monetary authority—to suggest improvements in the machine that will reduce the chances that it will get out of order, and to use its own powers so as to keep the machine in good working order.

A second thing monetary policy can do is provide a stable background for the economy—keep the machine well oiled, to continue Mill's analogy. Accomplishing the first task will contribute to this objective, but there is more to it than that. Our economic system will work best when producers and consumers, employers and employees, can proceed with full confidence that the average level of prices will behave in a known way in the future—preferably that it will be highly stable. Under any conceivable institutional arrangements, and certainly under those that now prevail in the United States, there is only a limited amount of flexibility in prices and wages. We need to conserve this flexibility to achieve changes in relative prices and wages that are required to adjust to dynamic changes in tastes and technology. We should not dissipate it simply to achieve changes in the absolute level of prices that serve no economic function.

In an earlier era, the gold standard was relied on to provide confidence in future monetary stability. In its heyday it served that function reasonably well. It clearly no longer does, since there is scarce a country in the world that is prepared to let the gold standard reign unchecked—and there are persuasive reasons why countries should not do so. The monetary authority could operate as a surrogate for the gold standard, if it pegged exchange rates and did so exclusively by altering the quantity of money in response to balance of payment flows without "sterilizing" surpluses or deficits and without resorting to open or concealed exchange control or to changes in tariffs and quotas. But again, though many central bankers talk this way, few are in fact willing to follow this course—and again there are persuasive reasons why they should not do so. Such a policy would submit each country to the vagaries not of an impersonal and automatic gold standard but of the policies—deliberate or accidental—of other monetary authorities.

In today's world, if monetary policy is to provide a stable background for the economy it must do so by deliberately employing its powers to that end. I shall come later to how it can do so.

Finally, monetary policy can contribute to offsetting major disturbances in the economic system arising from other sources. If there is an independent secular exhilaration—as the postwar expansion was described by the proponents of secular stagnation—monetary policy can in principle help to hold it in check by a slower rate of monetary growth than would otherwise be desirable. If, as now, an explosive federal budget threatens unprecedented deficits, monetary policy can hold any inflationary dangers in check by a slower rate of monetary growth than would otherwise be desirable. This will temporarily mean higher interest rates than would otherwise prevail—to enable the government to borrow the sums needed to finance the deficit—but by preventing the speeding up of inflation, it may well mean both lower prices and lower nominal interest rates for the long pull. If the end of a substantial war offers the country an opportunity to shift resources from wartime to peacetime production, monetary policy can ease the transition by a higher rate of monetary growth than would otherwise be desirable—though experience is not very encouraging that it can do so without going too far.

I have put this point last, and stated it in qualified terms—as referring to major disturbances—because I believe that the potentiality of monetary policy in offsetting other forces making for instability is far more limited than is commonly believed. We simply do not know enough to be able to recognize minor disturbances when they occur or to be able to predict either what their effects will be with any precision or what monetary policy is required to offset their effects. We do not know enough to be able to achieve stated objectives by delicate, or even fairly coarse, changes in the mix of monetary and fiscal policy. In this area particularly the best is likely to be the enemy of the good. Experience suggests that the path of wisdom is to use monetary policy explicitly to offset other disturbances only when they offer a "clear and present danger."

III. *How Should Monetary Policy Be Conducted?*

How should monetary policy be conducted to make the contribution to our goals that it is capable of making? This is clearly not the occasion for presenting a detailed "Program for Monetary Stability"—to use the title of a book in which I tried to do so [3]. I shall restrict myself here to two major requirements for monetary policy that follow fairly directly from the preceding discussion.

The first requirement is that the monetary authority should guide itself by magnitudes that it can control, not by ones that it cannot control. If, as the authority has often done, it takes interest rates or the current unemployment percentage as the immediate criterion of policy,

it will be like a space vehicle that has taken a fix on the wrong star. No matter how sensitive and sophisticated its guiding apparatus, the space vehicle will go astray. And so will the monetary authority. Of the various alternative magnitudes that it can control, the most appealing guides for policy are exchange rates, the price level as defined by some index, and the quantity of a monetary total—currency plus adjusted demand deposits, or this total plus commercial bank time deposits, or a still broader total.

For the United States in particular, exchange rates are an undesirable guide. It might be worth requiring the bulk of the economy to adjust to the tiny percentage consisting of foreign trade if that would guarantee freedom from monetary irresponsibility—as it might under a real gold standard. But it is hardly worth doing so simply to adapt to the average of whatever policies monetary authorities in the rest of the world adopt. Far better to let the market, through floating exchange rates, adjust to world conditions the 5 per cent or so of our resources devoted to international trade while reserving monetary policy to promote the effective use of the 95 per cent.

Of the three guides listed, the price level is clearly the most important in its own right. Other things the same, it would be much the best of the alternatives—as so many distinguished economists have urged in the past. But other things are not the same. The link between the policy actions of the monetary authority and the price level, while unquestionably present, is more indirect than the link between the policy actions of the authority and any of the several monetary totals. Moreover, monetary action takes a longer time to affect the price level than to affect the monetary totals and both the time lag and the magnitude of effect vary with circumstances. As a result, we cannot predict at all accurately just what effect a particular monetary action will have on the price level and, equally important, just when it will have that effect. Attempting to control directly the price level is therefore likely to make monetary policy itself a source of economic disturbance because of false stops and starts. Perhaps, as our understanding of monetary phenomena advances, the situation will change. But at the present stage of our understanding, the long way around seems the surer way to our objective. Accordingly, I believe that a monetary total is the best currently available immediate guide or criterion for monetary policy—and I believe that it matters much less which particular total is chosen than that one be chosen.

A second requirement for monetary policy is that the monetary authority avoid sharp swings in policy. In the past, monetary authorities have on occasion moved in the wrong direction—as in the episode of the Great Contraction that I have stressed. More frequently, they have

moved in the right direction, albeit often too late, but have erred by moving too far. Too late and too much has been the general practice. For example, in early 1966, it was the right policy for the Federal Reserve to move in a less expansionary direction—though it should have done so at least a year earlier. But when it moved, it went too far, producing the sharpest change in the rate of monetary growth of the postwar era. Again, having gone too far, it was the right policy for the Fed to reverse course at the end of 1966. But again it went too far, not only restoring but exceeding the earlier excessive rate of monetary growth. And this episode is no exception. Time and again this has been the course followed—as in 1919 and 1920, in 1937 and 1938, in 1953 and 1954, in 1959 and 1960.

The reason for the propensity to overreact seems clear: the failure of monetary authorities to allow for the delay between their actions and the subsequent effects on the economy. They tend to determine their actions by today's conditions—but their actions will affect the economy only six or nine or twelve or fifteen months later. Hence they feel impelled to step on the brake, or the accelerator, as the case may be, too hard.

My own prescription is still that the monetary authority go all the way in avoiding such swings by adopting publicly the policy of achieving a steady rate of growth in a specified monetary total. The precise rate of growth, like the precise monetary total, is less important than the adoption of some stated and known rate. I myself have argued for a rate that would on the average achieve rough stability in the level of prices of final products, which I have estimated would call for something like a 3 to 5 per cent per year rate of growth in currency plus all commercial bank deposits or a slightly lower rate of growth in currency plus demand deposits only.[6] But it would be better to have a fixed rate that would on the average produce moderate inflation or moderate deflation, provided it was steady, than to suffer the wide and erratic perturbations we have experienced.

Short of the adoption of such a publicly stated policy of a steady rate of monetary growth, it would constitute a major improvement if the monetary authority followed the self-denying ordinance of avoiding wide swings. It is a matter of record that periods of relative stability in the rate of monetary growth have also been periods of relative stability in economic activity, both in the United States and other countries. Periods of wide swings in the rate of monetary growth have also been periods of wide swings in economic activity.

[6] In an as yet unpublished article on "The Optimum Quantity of Money," I conclude that a still lower rate of growth, something like 2 per cent for the broader definition, might be better yet in order to eliminate or reduce the difference between private and total costs of adding to real balances.

By setting itself a steady course and keeping to it, the monetary authority could make a major contribution to promoting economic stability. By making that course one of steady but moderate growth in the quantity of money, it would make a major contribution to avoidance of either inflation or deflation of prices. Other forces would still affect the economy, require change and adjustment, and disturb the even tenor of our ways. But steady monetary growth would provide a monetary climate favorable to the effective operation of those basic forces of enterprise, ingenuity, invention, hard work, and thrift that are the true springs of economic growth. That is the most that we can ask from monetary policy at our present stage of knowledge. But that much—and it is a great deal—is clearly within our reach.

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