

III. THE THEORY OF MONETARY CONTROL

Tastes differ with respect to the extent to which economists desire or believe it necessary to spell out the detailed process through which they visualize monetary policy as influencing aggregate spending and the level of income. By and large, quantity theorists seem to confine themselves to explanations in terms of a stable demand for cash balances that is primarily a function of income, often expressed as a stable velocity. Beyond that, the particular categories of spending affected by monetary policy are rarely specified. Keynesians (if one may use that term to cover a wide variety of views when it comes to the subject of monetary policy) analyze the process more in terms of the interest elasticity of the demand for idle balances and the interest elasticity of particular sectors of investment and consumer spending. The quantity theory implies a low interest elasticity of demand for idle balances, that is, an insensitivity of hoarding to monetary expansion (no liquidity trap) and an insensitivity of dishoarding to monetary contraction (no substantial release of idle balances to augment active balances in periods of tight money). It also implies a substantial interest elasticity of investment or consumer spending.

The explanations in the various editions of *Purposes and Functions* of the mechanism through which monetary policy is seen as influencing aggregate spending cannot be placed squarely into either camp. In terms of the method of approach—not the conclusions—perhaps the first two editions are more inclined toward a quantity-theory orientation and the last two toward a Keynesian approach. But this is an inadequate charac-

terization, for the first two editions continuously stress that while the Reserve "can create credit when demand, can encourage the demand by making funds abundant and can create deposits by open purchases of securities, they cannot create a demand for credit or cause existing deposits to be actively used" (p. 86). And while the broad outlines of the Keynesian framework are discernible in the last two editions, the analysis contains unique contributions of its own. In Tobin's words, in commenting on Federal Reserve testimony during the Patman Hearings, which is essentially reproduced in the 1954 edition, this "third school sets forth a new theory of monetary control which claims that both of the old schools are asking the wrong questions. According to this theory, monetary controls work much more through restricting the availability of credit than through increasing its cost, much more through restraints on lenders than through reactions of borrowers."¹²

The various editions of *Purposes and Functions* differ greatly in the attention they devote to the theory of monetary control. In 1939, discussion was limited to the assertion that the effects of monetary policy "extend to all forms of economic activity and are felt indirectly by everyone" (1939, p. 11). However, the only causal process mentioned was that through its control over bank reserves the central bank influenced both the availability and the cost of bank credit

¹² James Tobin, "Monetary Policy and Management of the Public Debt," *Review of Economics and Statistics*, XXXV, No. 2 (May, 1953), 118-27. Tobin concludes: "Only the future will tell whether this kind of monetary policy will do the job to the satisfaction of the monetary authorities themselves, or whether in the end they will conclude that monetary control can only be successful through the more pronounced changes in interest rates on which central banks traditionally relied in the past."