

all the other guides of monetary policies such as interest rates or free reserves or the rate of credit creation, all of which the Federal Reserve says they look at.

The multiplicity of objectives is suspicious, and I shall focus on the one objective that I believe is of interest to the committee, namely, a fixed money growth rule.

First, I am sorry to have to differ with some of the witnesses. I am not at all convinced that the Federal Reserve can make the money supply anything it pleases. There are a number of slips between cup and lip. A small one occurs at the level of the banks which can accumulate excess reserves. When the Federal Reserve pumps reserves in, they may not use them to expand.

The second occurs because the banks can borrow from the Fed when the Federal Reserve tries to tighten. This is a minor thing and will be overcome within a month.

Second, there is a flow into time deposits; when the Federal Reserve wants to increase demand deposits, it may turn out that the public converts these demand deposits into time deposits. We had an experience of that sort early in 1960.

But the most important leakage is the international one. We increase the money supply, thereby driving down interest rates. Money will flow abroad and that will counteract the rise in the money supply. In a large country like ours, the Federal Reserve probably can overcome this, but at great sacrifice in reserves. In a small country, if that is relevant here, it is quite impossible for the central bank to determine the money supply, and few central banks around the world in convertible countries would think of trying to set the money supply, because any excess money they create will simply flow abroad. It is a matter of pouring water into a glass that is already full. No more than a single Federal Reserve district in this country can fix the money supply in that district than can a central bank in a small country control its money supply.

There is a remedy to this, and Professor Friedman has always recognized it. We could go on a floating exchange rate. If then, excessive money supplies are generated, changing the relation of interest rates in this country to interest rates abroad, that differential would draw money out of the country. All that would happen, however, is that the dollar depreciates. That removes the need to pay out gold. Professor Friedman has always recognized that in strict thought, a flexible exchange rate is the necessary concomitant of a fixed rule. But that has not been, I think, what has been said to the committee, and I think we ought to be clear about it. If we want to go with a fixed money growth rate through thick and thin, we do need flexible exchange rates. Our gold supply will be exhausted if we set a high money growth rate that drives down the interest rate and money flows abroad.

Alternatively, if we set a low money growth rate that causes interest rates to rise in this country relative to rates abroad, we will be sucking in gold from the rest of the world, denuding them of reserves, and creating trouble internationally.

Third, if we take into account balance-of-payment objectives, assuming the balance of payments is a legitimate objective of policy, as I think, then it is not the money supply that ought to be our target, but interest rates. We ought to look at interest rates abroad and so conduct