

I suspect as a matter of realism, if we introduced this rule, it would last just as long as the next crisis. Suppose that crisis were one of heavy unemployment; then the Fed should be grinding out money rapidly—instead, it grinds out money peacefully at 4 percent a year. I think the Congress would not stand for it, economists would not stand for it, the Federal Reserve itself would not stand for it. As soon as the rule produces a crisis, the rule almost inevitably is going to be abandoned in order to get out of the crisis. I would regard that as a fortunate development.

Thank you.

(The prepared statement of Professor Wallich follows:)

PREPARED STATEMENT OF HENRY C. WALLICH

STANDARDS FOR GUIDING MONETARY ACTION

Among the numerous standards of monetary policy that have been suggested, such as money supply, credit, interest rates, and bank reserves, one has attracted particular attention: a rule for a stable increase in the money supply. This proposal, associated principally with the name of Professor Milton Friedman of the University of Chicago, is embodied in recommendations made by this Committee. It was supported, as early as 1930, by Carl Snyder of the Federal Reserve Bank of New York. A detailed specification has been offered by Representative Henry Reuss, in this Committee's Report on the February 1968 Economic Report. My comments will be principally concerned with the fixed money growth rule.

RATIONALE OF THE RULE

The rule rests upon the theoretical and statistical finding, not universally accepted, that the *rate of growth* of money supply and the *level* of economic activity are closely related. A downturn in the rate of money growth, even when it does not lead to a positive shrinkage of the money supply, tends to be followed by a decline in the level, rather than the rate of growth, of economic activity. The same applies to troughs in the two series. It is argued that the behavior of money, because it precedes movements in the economy, causes the latter. The effect takes place with a long and variable lag, however. Hence, while those controlling the money supply have great power over the economy, the long and unstable lag makes it difficult to apply monetary policy on a discretionary basis for stabilization purposes. Monetary policy has so often been wrong that it seems preferable to deprive it of discretion and subject it to a fixed rule. It is not claimed that the fixed rule will produce perfect policy. But it will produce better policy than discretion is likely to do.

The main burden of my argument will be that this reasoning is fallacious. Before proceeding with the argument, I would like to point out, however, that while the rule at times is likely to have very bad results, it will probably have better results than alternative fixed rules that have sometimes been proposed. For instance, a rule that fixes the rate of growth of money supply is vastly superior to a rule fixing the interest rate. The fixed money growth rule may at times lead to wrong action. It may also have bad side effects through instability in the capital markets and in the balance of payments. But so long as the money supply is kept growing at a stable rate, roughly commensurate with the growth rate of the economy, cumulative instability is unlikely to develop. Short run fluctuations may be wider than under a competent discretionary policy. But in the long run money and income will move broadly hand in hand, with at most a moderate rate of inflation or deflation, and moderate changes in the foreign exchange value of the dollar.

A rule pegging the interest rate, on the other hand, for which some time ago there was widespread support, would be cumulatively destabilizing. If, for instance, interest rates were pegged below their equilibrium values, i.e. below the level consistent with stable prices or a stable rate of inflation, the open market purchases required to keep rates at the pegged level will sharply increase the money supply. Inflation would start or accelerate. This would raise the equilibrium rate of interest, which must be higher, in nominal terms, the faster the rate of inflation. This in turn would widen the gap between the equilibrium rate and