

objective leads to outflows on current or capital account. In time the outflows will exhaust exchange reserves. Thereafter, unless payments controls are introduced, the dollar would be on a floating exchange rate. If the money growth rule continues to be overly expansive, this would result, not in a deficit, but in a continuously declining exchange rate for the dollar. Academic discussions of a money growth rule generally recognize that floating exchange rates are its logical and necessary counterpart. This has not been the case, so far as I know, in congressional discussions. If a flexible exchange rate is not acceptable, then the money growth rule will have to be modified from time to time to prevent reserves from being exhausted. Related considerations apply to the case where a fixed money growth rule would produce a continuing balance of payments surplus. To avoid draining the world of its reserves, the dollar would have to be allowed to appreciate, or the fixed rule would have to be abandoned.

3. *Balance-of-Payments Objectives*

If an internationally stable dollar and an equilibrated balance of payments are desired, any money supply target, whether based on a rule or on discretion, is inferior to a monetary policy using interest rates as a target. An important part of the balance of payments is determined by flows of short and long term capital, so long as these are not subject to controls. These flows reflect interest rate differentials between the United States and abroad. They can best be controlled, therefore, by a monetary policy using an interest rate target.

That an interest rate target, pursued without regard to domestic equilibrium, can be much more disruptive than a money supply target, whether based on rule or discretion, has already been pointed out. Nevertheless, monetary policy, in one form or another, is the appropriate weapon for balance of payments management. It is superior, in this regard, to fiscal policy. If the objectives of domestic and external stability should conflict, as they sometimes do, it is best to pursue domestic stability by means of fiscal policy, balance of payments equilibrium by means of monetary policy. The reason for this is that while both fiscal and monetary policy affect domestic activity and thereby also the level of imports, monetary policy additionally affects the balance of payments via capital movements. Thus, monetary policy has a "comparative advantage" in dealing with the balance of payments. To implement this advantage, an interest rate target is superior to a money supply target or rule.

4. *Stable Money Growth—Unstable Interest Rates*

If the volume of money were rigidly fixed from day to day, interest rates probably would jump about within a wide range. The exact amount of money demanded by the economy varies from day to day. It depends on the payments that firms and households have to make, subject to weekly, monthly, quarterly and annual "seasonals", and also to purely random fluctuations. The normal policy of central banks is to stabilize interest rates in the short run by allowing bank reserves and the money supply to vary. The Federal Reserve's policy of maintaining "net free reserves" roughly constant over short periods has the same effect. Any change in the economy's demand for money is thus validated by a change in the supply of reserves and of money. Without this flexibility in the money supply, those in need of money would have to sell short term securities, thereby unsettling interest rates.

A fixed money growth rule would put an end to this accommodating central bank behavior. The ensuing instability of interest rates would probably be moderated, in the course of time, by the market itself. Speculators and arbitrageurs would buy short term securities when they seemed depressed by transitory factors and sell them when they have risen because of temporary excess liquidity. This smoothing activity of the market would not be perfect, however, nor costless.

Unstable interest rates are not an intolerable calamity. They are painful mainly to participants in the financial markets. They would damage the real sector of the economy only if instability was transmitted to it, or if uncertainty in financial markets leads to a reduction in the flow and an increase in the cost of capital for investment. Some cost increase probably would result, since market participants would have to protect themselves against interest instability by charging higher risk premia.

Unstable interest rates might destabilize international capital flows. It is true that these international flows would help to limit the amplitude of domestic interest rate fluctuations. They would also, however, destabilize foreign capital and exchange markets. Foreign countries might reasonably complain about an American monetary policy that interfered with their own stability.