

$R_{RW}/(R_{RW} + R_H)$ is close to unity, and their ability to influence their equilibrium money supply is accordingly small. Imperfect or totally lacking mobility of capital gives temporary power to affect the domestic money supply. Only a floating exchange rate system foregoing all use of international reserves validates the traditional domestic money multiplier.

The conclusion that a country can only temporarily determine its money supply offers a parallel to an analogous conclusion in another area of monetary theory: the view that monetary changes cannot alter the equilibrium values of real variables. National monetary policy finds its range of action limited in both dimensions. Neither limitation, however, is absolute. Monetary variables can affect real equilibrium values if the conditions for neutrality of money are not met. National monetary policy can permanently determine the domestic money supply under certain conditions—if it is prepared to increase the money supply of the entire world.

The degree to which even the world's richest country can afford the luxury of "raising the world's money supply" depends on its international reserves. Freedom of monetary policy thus is circumscribed by the lag with which heavy reserve drains may set in and by the willingness to lose reserves. The willingness of other countries to be drained of reserves sets limits of a less binding sort, in the inverse direction. Thus control of the balance of payments becomes an objective of monetary policy. Historically, this indeed has been the origin of monetary policy, the domestic impact being in the nature of an afterthought.

When the monetary authorities seek to influence the current account of the balance of payments, interest rate and money supply strategies both are adequate. Either works through aggregate demand. When the capital account is to be influenced, an interest rate strategy is clearly preferable. The proximate factor determining international capital flows is differential interest rates, not differential rates of money growth.

Even when no particular balance of payments effect is desired by the monetary authorities, the habit of international monetary cooperation requires them to watch their interest rates. If they did not, a large country particularly might inadvertently and needlessly destabilize the balance of payments and perhaps the domestic equilibrium of foreign countries. A money supply target pursued for purely domestic reasons may have awkward repercussions in the international sphere,