

if it seriously destabilizes interest rates. The important role that interest rates play in the capital account of the balance of payments gives the interest rate target an edge in the international area.

Frequency of Conflict Cases

This edge depends to an important extent on the combination of internal and external policy objectives a country is pursuing. Its objectives may be compatible, for example, the reduction of domestic inflation and of a simultaneous balance of payments deficit. A reduction in aggregate demand will simultaneously redress both disequilibria. The objectives may diverge, for example, ending a domestic recession accompanied by a balance of payments disequilibrium. A single instrument cannot cope with this situation.

In the absence of a conflict of objectives, a case can be made for either an interest or a money supply target. Monetary tightening, measured by interest rates or by money supply, will reduce aggregate demand and thus reduce domestic inflation and improve the current account in the balance of payments. Emphasis on high interest rates, indeed, would mean to emphasize improvement of the capital account as well, which, in conditions of domestic inflation, is not the most convenient means of coping with a payments deficit.

When a conflict is present, the interest rate strategy gains in attraction relative to the money supply strategy. As has been shown theoretically, and seems to be confirmed also by contemporary central bank practice, the proper allocation of instruments to targets is to assign fiscal policy to the achievement of domestic equilibrium and monetary policy to payments balance.²⁰ The reason is, of course, that monetary action works simultaneously on the current and on the capital account. To maximize effectiveness on the capital account, an interest strategy is clearly appropriate.

To differentiate still further the conditions that call for an interest rate strategy, one must distinguish between policy conflicts associated with domestic inflation and recession. Inflation combined with payments surplus could be corrected by simultaneous fiscal tightening and low interest rates. But the goal of payments equilibrium may not seem very important to a country under these conditions, particularly when it can be attained only by pushing out capital instead

²⁰ Robert A. Mundell, "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability," *IMF Staff Papers*, March 1962, pp. 70-77.