restrict its own freedom of choice in some situations. Consider again the case in which the Congress provides for a large increase in expenditure with no increase in tax rates, so that a large deficit develops. If the Federal Reserve is prohibited from increasing the money stock at a rate greater than 6 percent a year, say via a congressional rule, then a large share of the deficit would have to be financed by the sale of Treasury securities to the private sector, thus driving interest rates very high, and not completely preventing inflation either—an undesirable situation. Notice that, if the Federal Reserve is required to keep the money stock from growing faster than 6 percent a year, and if the Congress increases expenditures greatly, then the Congress has only the following choices open: to endure high interest rates and some inflation, or to increase tax rates, or some combination of these two.

The basic alternatives among which the Nation must choose may be seen more clearly if looked at from another angle. There are three important ways in which the Treasury's expenditures may be financed: (1) by taxation, (2) by increasing the stock of money, and (3) by increasing the amount of Government debt in private hands (that is, by borrowing from the private sector). By choosing the level of Government expenditure and the level of taxes, the Congress determines the amount of the Government budget deficit, or surplus. Let's suppose there is a deficit. Then, it must be financed by some combination of increasing the stock of money, and increasing the amount of Government debt in private hands. The most important function of the Federal Reserve is to control how this deficit financing is to be divided between increasing the stock of money and increasing the amount of privately-held Government debt. This the Federal Reserve does chiefly by deciding what amount of Treasury securities to buy and hold (thus increasing the money stock), and what amount—that is offered by the Treasury—not to buy, thus requiring private holdings of the Government debt to increase.

I have been speaking of a deficit, but if there is a budget surplus the opposite choice is open to the Federal Reserve, decrease either the money stock or the private holdings of Government debt.

Just as the Congress has the authority to fix Government expenditures and taxes, and thus to fix the budget deficit, so the Congress has the authority to decide how much of the deficit should be financed by increasing the money stock, and how much of it should be financed by borrowing from the private sector.

I have suggested that the Federal Reserve ought to make the stock of money grow at a rate between 2 and 6 percent a year. But the foregoing discussion makes it clear that such a policy will not work well unless the Congress keeps the budget deficit or surplus within suitably narrow limits, so that the amounts of Government securities dumped on the private market by a budget deficit are not too large, and conversely so that the amounts of Government securities taken out of private hands by a budget surplus are not too large.

When I say the budget deficit or surplus should be kept within suitable limits, I mean a range something like a deficit of from 15 to 17 billion on the one hand to a surplus of 10 or 12 billion on the other hand.

In this sense, fiscal policy, which determines the size of the budget deficit, and monetary policy, which determines the stock of money,