

"Our contributors do not discuss the question of money supply. . . . The contributors make no special mention of credit policy to remedy actual depressions. . . . Inflation . . . might be fought more effectively by raising interest rates. . . . But . . . other anti-inflationary measures . . . are preferable" [6 pp. 23-24]. *A Survey of Contemporary Economics*, edited by Howard Ellis and published in 1948, was an "official" attempt to codify the state of economic thought of the time. In his contribution, Arthur Smithies wrote, "In the field of compensatory action, I believe fiscal policy must shoulder most of the load. Its chief rival, monetary policy, seems to be disqualified on institutional grounds. This country appears to be committed to something like the present low level of interest rates on a long-term basis" [1, p. 208].

These quotations suggest the flavor of professional thought some two decades ago. If you wish to go further in this humbling inquiry, I recommend that you compare the sections on money—when you can find them—in the *Principles* texts of the early postwar years, with the lengthy sections in the current crop even, or especially, when the early and recent *Principles* are different editions of the same work.

The pendulum has swung far since then, if not all the way to the position of the late 1920s, at least much closer to that position than to the position of 1945. There are of course many differences between then and now, less in the potency attributed to monetary policy than in the roles assigned to it and the criteria by which the profession believes monetary policy should be guided. Then, the chief roles assigned monetary policy were to promote price stability and to preserve the gold standard; the chief criteria of monetary policy were the state of the "money market," the extent of "speculation" and the movement of gold. Today, primacy is assigned to the promotion of full employment, with the prevention of inflation a continuing but definitely secondary objective. And there is major disagreement about criteria of policy, varying from emphasis on money market conditions, interest rates, and the quantity of money to the belief that the state of employment itself should be the proximate criterion of policy.

I stress nonetheless the similarity between the views that prevailed in the late 'twenties and those that prevail today because I fear that, now as then, the pendulum may well have swung too far, that, now as then, we are in danger of assigning to monetary policy a larger role than it can perform, in danger of asking it to accomplish tasks that it cannot achieve, and, as a result, in danger of preventing it from making the contribution that it is capable of making.

Unaccustomed as I am to denigrating the importance of money, I therefore shall, as my first task, stress what monetary policy cannot do. I shall then try to outline what it can do and how it can best make its contribution, in the present state of our knowledge—or ignorance.

I. WHAT MONETARY POLICY CANNOT DO

From the infinite world of negation, I have selected two limitations of monetary policy to discuss: (1) It cannot peg interest rates for more than very limited periods; (2) It cannot peg the rate of unemployment for more than very limited periods. I select these because the contrary has been or is widely believed, because they correspond to the two main unattainable tasks that are at all likely to be assigned to monetary policy, and because essentially the same theoretical analysis covers both.

Pegging of Interest Rates

History has already persuaded many of you about the first limitation. As noted earlier, the failure of cheap money policies was a major source of the reaction against simple-minded Keynesianism. In the United States, this reaction involved widespread recognition that the wartime and postwar pegging of bond prices was a mistake, that the abandonment of this policy was a desirable and inevitable step, and that it had none of the disturbing and disastrous consequences that were so freely predicted at the time.

The limitation derives from a much misunderstood feature of the relation between money and interest rates. Let the Fed set out to keep interest rates down. How will it try to do so? By buying securities. This raises their prices and lowers their yields. In the process, it also increases the quantity of reserves available to banks, hence the amount of bank credit, and, ultimately the total quantity of money. That is why central bankers in particular, and the financial community more broadly, generally believe that an increase in the quantity of money tends