

Even if the proposition that monetary policy can prevent money itself from being a major source of economic disturbance were a wholly negative proposition, it would be none the less important for that. As it happens, however, it is not a wholly negative proposition. The monetary machine has gotten out of order even when there has been no central authority with anything like the power now possessed by the Fed. In the United States, the 1907 episode and earlier banking panics are examples of how the monetary machine can get out of order largely on its own. There is therefore a positive and important task for the monetary authority—to suggest improvements in the machine that will reduce the chances that it will get out of order, and to use its own powers so as to keep the machine in good working order.

A second thing monetary policy can do is provide a stable background for the economy—keep the machine well oiled, to continue Mill's analogy. Accomplishing the first task will contribute to this objective, but there is more to it than that. Our economic system will work best when producers and consumers, employers and employees, can proceed with full confidence that the average level of prices will behave in a known way in the future—preferably that it will be highly stable. Under any conceivable institutional arrangements, and certainly under those that now prevail in the United States, there is only a limited amount of flexibility in prices and wages. We need to conserve this flexibility to achieve changes in relative prices and wages that are required to adjust to dynamic changes in tastes and technology. We should not dissipate it simply to achieve changes in the absolute level of prices that serve no economic function.

In an earlier era, the gold standard was relied on to provide confidence in future monetary stability. In its heyday it served that function reasonably well. It clearly no longer does, since there is scarcely a country in the world that is prepared to let the gold standard reign unchecked—and there are persuasive reasons why countries should not do so. The monetary authority could operate as a surrogate for the gold standard, if it pegged exchange rates and did so exclusively by altering the quantity of money in response to balance of payment flows without “sterilizing” surpluses or deficits and without resorting to open or concealed exchange control or to changes in tariffs and quotas. But again, though many central bankers talk this way, few are in fact willing to follow this course—and again there are persuasive reasons why they should not do so. Such a policy would submit each country to the vagaries not of an impersonal and automatic gold standard but of the policies—deliberate or accidental—of other monetary authorities.

In today's world, if monetary policy is to provide a stable background for the economy it must do so by deliberately employing its powers to that end. I shall come later to how it can do so.

Finally, monetary policy can contribute to offsetting major disturbances in the economic system arising from other sources. If there is an independent secular exhilaration—as the postwar expansion was described by the proponents of secular stagnation—monetary policy can in principle help to hold it in check by a slower rate of monetary growth than would otherwise be desirable. If, as now, an explosive federal budget threatens unprecedented deficits, monetary policy can hold any inflationary dangers in check by a slower rate of monetary growth than would otherwise be desirable. This will temporarily mean higher interest rates than would otherwise prevail—to enable the government to borrow the sums needed to finance the deficit—but by preventing the speeding up of inflation, it may well mean both lower prices and lower nominal interest rates for the long pull. If the end of a substantial war offers the country an opportunity to shift resources from wartime to peace time production, monetary policy can ease the transition by a higher rate of monetary growth than would otherwise be desirable—though experience is not very encouraging that it can do so without going too far.

I have put this point last, and stated it in qualified terms—as referring to major disturbances—because I believe that the potentiality of monetary policy in offsetting other forces making for instability is far more limited than is commonly believed. We simply do not know enough to be able to recognize minor disturbance when they occur or to be able to predict either what their effects will be with any precision or what monetary policy is required to offset their effects. We do not know enough to be able to achieve stated objectives by delicate, or even fairly coarse, changes in the mix of monetary and fiscal policy. In this area particularly the best is likely to be the enemy of the good. Experience suggests that the path of wisdom is to use monetary policy explicitly to offset other disturbances only when they offer a “clear and present danger.”