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Inflation Lifts Off, 1965–1969

All too soon, Vietnam blew the economy off course.
—Walter W. Heller[1]

The progress made during the first half of the 1960s suggested the possibility that the "new economics" had provided the knowledge to cure the economy of the old bane of the business cycle, just as medical science had recently eliminated the scourge of polio. The expansion that began in February 1961 at the start of the Kennedy administration continued until December 1969 in the first year of Nixon's presidency, a total of 106 months, or almost nine years, easily breaking the record for the longest span from trough to peak. But something happened on the way to the promised land of steady economic growth, full employment, and stable prices. In the late 1960s, inflation, which had been held in check since the end of the Korean War in 1951, broke out due to demand-pull pressure caused by the Vietnam War. In addition to the problem of inflation, the financial markets suffered bouts of tightness that bordered on crises and that introduced a new type of ailment with the label of disintermediation. These problems placed a heavy burden on monetary policy. We turn to an examination of inflation, credit squeezes, and the responses of the monetary authorities as they sought to improve their performance.

The Resurgence of Inflation

The war in Vietnam produced what is widely recognized as the greatest blunder in Government economic policy since World War II.
—Edwin L. Dale, Jr.[2]

The statement quoted was made in 1973 by a leading writer on economics of *The New York Times*. In July 1965 U.S. combat troops were sent in force to Vietnam just as the economy was nearing the full employment level, so that the additional spending on the war threatened to drive aggregate demand above the supply potential of the economy. The inflationary danger was well understood by the chairman of the Council of Economic Advisers,

Gardner Ackley, and other economists of the administration. Yet even though the danger was foreseen and there was ample time to prepare a policy to avoid it, the opportunity to do so was missed. What occurred instead has been called the Great Botch of 1966.[3] President Johnson blundered by rejecting the advice of his economic advisers to ask Congress for a tax increase early in 1966, thereby missing a "key block" that allowed inflation to gain momentum. A year later, in January 1967, the president did ask for a tax increase, and Congress finally enacted one in July 1968, two and a half years after the advice was originally given. As 1966 began, Johnson had domestic (Great Society) legislation pending in Congress which would have been put at risk by a recommendation for higher taxes. It was also possible then to hope that the war effort would be brief and not overly costly—wishful thinking, as events soon showed. Eventually Johnson realized that he was mainly to blame for the debacle.[4]

The inflation set in motion at the end of 1965 became a major issue in the last half of the 1960s. Since taxes were not raised until 1968, it fell to monetary policy to provide the primary brake on the booming economy. Consumer prices, which had risen by 1.9 percent during 1965, rose by 4.7 percent during 1968, a more rapid increase than in any year since the Korean War. In 1969 the increase was 6.1 percent, slightly higher than during the Korean War years.

Federal Reserve Policy—The Bucks Are Stopped Here

> The Federal Reserve probed, tested, and reacted. It shot in the dark in some instances. Yet the Board put on an outstanding performance in 1966, making wise judgments and, most of all, having the courage to act promptly and decisively on them. The objectives could not have been carried out if the Board had been frozen by timidity or hogtied by rigid rules about the growth of the money supply, the level of interest rates, or any other criterion of monetary policy.
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> —Arthur M. Okun[5]

Presidents can turn their thumbs down to the advice of their economists but not to the decisions of the Federal Reserve. The Board of Governors raised the discount rate from 4 to 4.5 percent on December 3, 1965, a "provocative" act that led to a direct confrontation with President Johnson and immediately resulted in congressional hearings with abundant media coverage.[6] The discount rate was raised because of war-induced pressure of excess demand and because the balance of payments was in continuing deficit. The board chose the discount rate increase at this time, after some internal debate, because of its announcement effect. The commercial banks had been

deterred from raising the prime lending rate by presidential pressure despite a heavy demand for credit at the existing rate. The board also raised the Regulation Q ceilings on time deposits by a percentage point, with the intention that they would then be too high to have an effect on the market. In this way the Fed acted in accordance with free market philosophy; the market would be able to determine how credit would be distributed, and the central bank would be concerned solely with the total amount of credit, not with its allocation among the sectors of the economy.[7] We shall soon see, however, that less than a year later the system found direct intervention to be expedient.

The Federal Reserve gradually increased monetary restraint during the first eight months of 1966 in a clearly overheated economy.[8] The M1 money stock was held constant from April until the year ended. Although the discount rate was kept constant at the level set in December 1965, market interest rates rose sharply to new post–World War II highs as intense competition developed in the credit markets. In response to an extremely heavy demand for borrowed funds, the credit flow shifted markedly toward business. The banks, anxious to meet the large demand of their customers for accommodation, scrambled for funds. They increased their borrowings from the Federal Reserve, but that of course was a limited source. Funds were attracted in the form of CDs until mid-year, when the rates paid on competing money market instruments became more attractive than the 5.5 percent ceiling under Regulation Q. As sales of large-denomination CDs fell, the banks pushed small-denomination CDs in an effort to attract consumer savings, but to a large extent all they did was draw down their own passbook savings accounts, an exercise not unlike climbing a greased pole. It was evident that liability management did not produce an ever flowing stream of funds. With CDs running off as market rates rose, banks turned to quite costly sources by borrowing federal funds and Eurodollars (dollar-denominated deposits against banks located outside the United States). They also sold U.S. government and municipal securities at sacrifice prices. By late summer, as the credit squeeze turned into (in the jargon of the day) crunch, and with interest rates at levels not seen for four decades, signs of disorderly market conditions appeared: the climax was at hand. "With no apparent end to the demand for funds and the upsurge in interest rates, conditions in the financial markets seriously deteriorated in August and some observers even saw the threat of a financial panic."[9] In other words there was apprehension that those seeking liquidity by selling bonds would fail to find buyers at more than disastrously low prices, a feeling remotely akin to that felt by a sky diver uncertain about his parachute. At this critical juncture the central bankers, deeply concerned about both the dicey conditions in the securities market and with the growth in business loans, decided to resort to "moral suasion," that is, to give some fatherly advice to the banking community. A

letter was sent on September 1, 1966, by each Federal Reserve Bank president to all of the member banks in his district pointing out that the national interest required them to (a) moderate the rate of expansion of business loans, and (b) reduce their liquidation of securities. The banks were very politely given to understand that the discounting privilege was not to be used for further expansion of business loans. Predictably, the response of the commercial bankers was that the Fed would cripple the economy with such quantitative controls, but a calming effect was felt in the security markets, and interest rates soon began to subside. Other steps were taken that contributed to stabilizing market conditions, such as presidential action to reduce nondefense spending and to suspend both the tax credits on machinery and equipment and the accelerated depreciation allowances on new buildings. By October it became clear that the pace of economic activity was moderating, and the Federal Reserve relaxed the degree of restraint on the banks somewhat. Near the end of the year the Federal Reserve signaled that it considered the storm to be over by announcing that the letter of September 1 no longer applied.

Monetary policy during 1966 curtailed the total demand for goods and services, but its impact upon different sectors was distressingly uneven. Housing, small business, and local government were leading victims of tight money—by October housing starts fell by 50 percent compared with the previous December. The financial institutions closely associated with the housing industry, the thrifts, suffered severe problems as the flow of funds, like a diverted river, changed direction. Funds were withdrawn from the financial intermediaries, a malfunction soon known as disintermediation. The hardest hit, the savings and loan associations, experienced net outflows during four months. Without an inflow of funds, and with the possibility of massive withdrawals, their ability to finance the residential construction industry was severely impaired.

A closer look at the problem of the savings and loan institutions begins with the point that rising interest rates subjected them to competition from the money and bond markets. Since savings and loans lent long on mortgages, the slow turnover of their assets kept them from competing for deposits when interest rates rose. When the Fed raised the Regulation Q ceiling to 5.5 percent in December 1965, it made commercial banks more competitive vis-à-vis the savings and loans. As noted earlier, the big banks were able to attract funds to lend to their major corporate borrowers for inflationary capital goods spending, while simultaneously building construction was depressed. As the squeeze worsened, the several types of thrift institutions pressed for a return of the interest rate ceiling to its pre-December level, but the system rejected a rollback on the grounds that money would not flow to the thrifts from the banks but from both of them to the market. In a climate of grave uncertainty concerning the viability of the thrifts, the

Board of Governors authorized the Federal Reserve Banks to make emergency loans to nonmember depository institutions if that should become necessary—the "lender of last resort" was prepared to come to the rescue. In September, after months of intense lobbying and debate, Congress passed the Interest Rate Adjustment Act of 1966, which authorized the Fed to set differential interest rate ceilings by deposit size. The board immediately reduced the ceilings on time deposits of less than $100,000 from 5.5 percent to 5 percent, while leaving unchanged the 5.5 percent rate on the large CDs. The new law also extended deposit rate ceilings to the thrifts for the first time, but the ceilings set for them were higher than for the banks, providing an advantage over commercial banks in attracting deposits and easing the pressure on the beleaguered thrifts.

After slowing down in 1967, the economy surged upward during the first half of 1968 as GNP expanded at an annual rate of 10 percent and unemployment dropped to 3.5 percent. With serious inflation and a run by foreign governments on the nation's gold reserves recognized as imminent dangers by the business community, Congress finally agreed to Johnson's urgings and passed a 10 percent income tax surcharge in June 1968. At this time, as the long-delayed tax increase began to bite, the big question for the Federal Reserve was the extent to which spending would be depressed. Unfortunately its forecast (and others) exaggerated the braking power of the tighter fiscal policy.[10] Instead of the fiscal "overkill" that was expected by many, inflationary psychology asserted itself in the summer and fall, and the economy maintained a fast second half despite the fiscal restraint. Opinion within the Federal Open Market Committee gradually shifted from October to December toward restraint, until by mid–December the system turned decisively toward restraint. While many economic forecasts for 1968 were not very accurate, the monetarists' were quite good. This is a matter of some significance, for the monetarists were working their way toward greater acceptance during the 1960s; their record in 1968 added to their credibility and contributed to their rise to prominence in policy-making, a point soon to be elaborated.[11]

A reading of the annual reports of the Federal Reserve Bank of New York for the late 1960s reveals the year-by-year struggle to slow down inflation without precipitating a recession or financial collapse. The year 1966 was described as one of "difficult problems and decisions," and 1967 was called "a trying year." The report for 1968 thought that the combination of monetary and fiscal restraint in effect at the end of the year should bring the economy under control in 1969, but it was far from confident.[12] As it turned out, 1969 was (without overstatement) "a difficult year."

Throughout 1969 the Federal Reserve System maintained a policy of intensive restraint as inflationary forces remained strong. The discount rate was raised to its highest level in forty years, reserve requirements were raised,

and system open-market operations kept pressure on bank reserve positions. In large measure 1969 was a replay of 1966. The growth of the M1 money stock for the second half of 1969 was at a rate of only 1.5 percent per annum. As in 1966, disintermediation hurt the housing market and threatened the solvency of many thrift institutions; as short-term market interest rates rose well above the Regulation Q interest rate ceilings, deposit balances set off in hot pursuit. The highest inflation rate since the Korean War went hand-in-hand with high interest rates. The large banks saw a massive runoff of negotiable CDs—a $12 billion net outflow—and responded by trying every tactic they could think of to escape from the Fed's regulations in order to maintain their earning assets. They drew in nondeposit funds via Eurodollars, repurchase agreements, and sales of commercial paper by bank subsidiaries and affiliates. The banks were nimble in finding nondeposit gaps in the Fed's regulations, and the Fed responded with more complex regulations. The large corporations were able to bypass the banking system and go directly to the open market to obtain funds. At last, as 1969 came to a close, the long period of excessive aggregate demand that began in 1965 ended, as did the expansion of the economy that began in early 1961. December 1969 marked the topping out of the cycle.

The year 1966 also saw the emergence of the one-bank holding company concept, previously used as a device to control small banks, as a means by which large banks could elude Regulation Q ceilings on negotiable CDs. By the legal device of forming a holding company, a bank could in effect borrow money free of an interest rate limitation. A teenager unable to buy liquor at the club can imbibe if his dad buys it for him. In this case the bank legally creates its own holding company "dad" which is able to tap the money market by issuing CDs or otherwise borrowing free from Federal Reserve regulation. It took a few years before the Federal Reserve could get Congress to amend the Bank Holding Company Act, but in 1970 the Federal Reserve was given power to regulate one-bank holding companies. The banks had been like sturgeon in spawning one-bank holding companies in the late 1960s, and these continue as a prominent feature of the American banking scene.

Questioning the Adequacy of Federal Reserve Operating Procedures

> I call the pre–1966 period the age of innocence because it was possible at that time to think of monetary policy in very simple terms.
> —Sherman J. Maisel[13]

The Federal Reserve operating targets from 1951 until 1970 were linked to

money market conditions—a money market strategy. In this post-accord era, high priority was given to maintaining stability in financial markets. It was considered vital that interest rates and securities prices should change gradually, for financial institutions held large amounts of government securities and were vulnerable to a rapid rise in interest rates that would seriously depress government securities prices. The prevailing view was that investment spending was insensitive to interest rate changes, so that an interest rate change large enough to have an effect on aggregate demand would cause turmoil in financial markets. Keynesian theory relied on fiscal policy to deal with the business cycle; monetary policy was needed to expand the money stock as the economy grew and to be "on call" to prevent incipient financial crises from derailing the real economy. Acting within this structure of ideas, the Federal Reserve System used interest rates as its operating target and as its intermediate target as well. These targeted objectives of course were transmission mechanisms connecting the money supply with the ultimate goals of real output and stable prices. Interest rate targets are effective in meeting a disturbance in financial markets or a money supply disturbance, but when spending disturbances predominate, then interest rate targets can be perverse, leading to procyclical price and output movements. Federal Reserve operating procedures came under fire by outside critics in the early 1960s. The inflationary pressures that began in 1965 forced the issue, and the Federal Open Market Committee began to modify its targeting procedures.[14]

When Sherman Maisel became a governor of the Federal Reserve System in 1965 he was disappointed to find that no description of how monetary policy was made or how it operated existed. Apparently it was all considered self-evident. Chairman Martin described monetary policy as leaning against the winds of inflation and deflation with equal vigor. If inflation was a problem, then the Fed should supply only part of the money that the public demanded, but if recession was imminent then the Fed should supply more money than was demanded. Looking back on his tenure on the Board of Governors, Maisel concluded that semantic confusion was not uncommon: "Frequently, members of the FOMC argued over the merits of a policy without ever having arrived at a meeting of the minds as to what monetary policy was and how it worked."[15]

Here is how the Federal Reserve's money market strategy used money market conditions as a target. The manager of the Open Market Desk would buy and sell securities so that the banks would have a net reserve position as set by the Federal Open Market Committee at each meeting. For example, the target might be net free reserves of $100 million or perhaps net borrowed reserves of $200 million.[16] As the commercial banks make loans or buy securities, they create deposits and so determine the reserves they require. If the Fed does not on its own initiative create additional reserves to match the pace of bank expansion, the banks must borrow at the discount window, so

if the banks create deposits faster than the Fed pumps out reserves to them, the result is an increase in net borrowed reserves. The manager of the open-market account in the Federal Reserve Bank of New York has the information to carry out his instructions effectively—he is well able to control net borrowed reserves on a weekly basis. Next, the link between the level of net borrowed reserves and the federal funds rate is quite consistent,[17] so that control over net borrowed reserves gives control over the federal funds rate. So far so good, but while this procedure allows the Fed to control the level of net free or net borrowed reserves, *the Fed does not have control over the total amount of reserves and therefore of the money supply.* As a result of lending and creating deposits, the banks require more reserves, so they borrow more from the Fed. It follows that to keep to the net reserve target, the manager of the open-market account must create additional reserves. Furthermore the money market strategy considered the level of net reserves to serve as a measure of monetary policy. When the Fed wanted to tighten monetary policy it did so by firming money market conditions: the banks had to borrow more. Then the Fed could jack up the discount rate above market rates or require the banks to reduce their deposits as a condition of loan renewal. Over time, interest rates would rise until credit expansion stopped.

In 1966 adherence to the money market strategy led to serious trouble. The root of the problem was that monetary policy was measured solely by money market conditions. As inflationary pressure mounted, it was obvious that a restrictive monetary policy was needed. The discount rate was raised and market interest rates rose but no real restraint was exercised. How could this be? It was profitable for the banks to lend money and then run to the discount window for borrowed reserves. The manager of the open-market account was constrained to hold net borrowed reserves at the level specified in the FOMC directive, which required him to purchase securities in increasingly larger amounts, thereby increasing the level of total reserves. To a considerable extent the Fed was deceiving itself by adhering to a policy of tightening that did not tighten.

> To those who adhered to the traditional doctrine and saw money market conditions tightening, the Fed was doing its part to fight inflation. But to those of us who saw the fast growth of the monetary aggregates and the rapid creation of money and credit, it seemed that the Fed, far from combatting inflationary forces, might even be adding to the inflation.[18]

During the spring of 1966 one group within the FOMC wanted to adopt monetary aggregates and reserves as a measure of policy in addition to the level of net borrowed reserves. After much discussion, in June a compromise was adopted under which the committee instructed the manager as usual in

terms of money market conditions, but a secondary set of targets was added based on reserves (or, later, on the growth in bank deposits at member banks—the "bank credit proxy"). If the secondary targets were not being hit, then the manager was to switch to a different set of money market conditions. Thus if reserves (or bank deposits) rose faster or slower than the rate specified, the target for net borrowed reserves would be changed. The FOMC introduced a special clause directing that certain action should be taken "provided that" something else happened. For example, a target of net borrowed reserves of $200 million might be specified provided that if required reserves or bank deposits increased faster than expected then the net borrowed reserves target would be raised to $300 million, forcing the banks to borrow more and causing the federal funds rate to rise. Adoption of the proviso seemed at the time to be a significant change in operating procedure, but as it was interpreted it had little effect. Yet it presaged changes that were to come a few years later—the "real significance of the proviso lay in the fact that a majority of the FOMC had agreed that some improvements in operating procedures were necessary."[19]

In September 1968 another type of change in Federal Reserve operating procedures was adopted. Prior to the change, banks were required to hold reserves on a "contemporaneous" basis under which the amount of required reserves in a given banking week was based on average deposits in that same week. Under the new "lagged" basis, the banks' required reserves were determined by the weekly average of deposits two weeks earlier. The change, generally pleasing to the banking community, was quite controversial. It was looked upon with strong disfavor by economists who emphasized control of the money stock on the grounds that it resulted in greater fluctuations in the money stock than did contemporaneous reserve accounting.[20] The system eventually agreed with the critics of the lagged system and reverted to a version of the contemporaneous reserve accounting system in 1984.