

Third, rapidly rising demands by Government for defense needs and by business for capital investment programs preempted a large share of our physical and financial resources. Homebuilding was elbowed to the rear of the line; residential construction activity was reduced far below the levels needed to meet our long-term housing needs.

No country can long sustain economic progress if wages and prices keep leapfrogging each other, if it continues to lose ground in international commerce, or if it permits serious imbalance in the composition of output. The task of stabilization policy last year was to strike at the root cause of these distortions and imbalances—an overrapid pace of expansion of aggregate demand.

The need for moderating expansion became evident even before 1966 began, as acceleration in defense outlays was added to the stimulus to private spending provided by earlier monetary expansion and the tax reductions of 1964 and early 1965. In the final months of 1965, economic activity spurted—but so did prices. The rate of increase in the GNP deflator—which measures the extent to which the dollar growth in GNP is a result of rising prices rather than rising output—doubled in the fourth quarter of 1965.

Moreover, increasing evidence was becoming available to suggest that demand pressures would intensify further. Restraint was needed and needed promptly. As the current report of the President's economic advisers puts it, "All in all, the economy exceeded reasonable speed limits in the period from mid-1965 through the first quarter of 1966."

In response to inflationary pressures, Federal Reserve policy moved toward greater restraint. This was signaled by the announcement in December of an increase in the discount rate from 4 to 4½ percent. To prevent an abrupt constriction in the flow of credit, the maximum rate banks could pay for time deposits was raised, and reserves were provided generously through open market operations over the subsequent year-end period, weeks usually marked by turbulence and crosscurrents in financial markets.

Net reserve availability was reduced gradually in early 1966, and increasingly, banks were forced to turn to the discount window to obtain additional reserves. Their borrowings from the Federal Reserve rose from an average of about \$400 million in January to about \$700 million by June.

At certain critical times, however, such as around the March-April tax period and again around the midyear tax period, nonborrowed reserves were supplied to banks in substantial volume to help moderate the temporary but intense money market pressures being generated by enlarged corporate needs for funds to meet accelerated taxpayments. With business loan demand strong, failure to provide additional reserves to banks at these times would have prompted more rapid liquidation of bank holdings of securities; the consequent rise in interest rates would have accelerated the outflow of funds from thrift institutions to financial markets. It would also have prompted even more widespread and aggressive efforts by banks to attract consumer savings into time deposits. Such efforts would have intensified the developing shortage of mortgage money at a time when financial supervisory agencies lacked the flexible authority—granted by Con-