

Part of it was because the administration clearly underestimated inflationary potentials as did many other people. They underestimated the defense needs by a sizable margin and as the chairman has pointed out on numerous occasions recently. Consequently, Congress did not insist on a tax increase, nor did they insist on a pruning of total expenditures.

The demand for credit rose and interest rates began to rise. And of course the Federal Reserve responded by adding additional credit to the system under what I think was the unfortunate assumption that monetary policy was tightening because interest rates were going up. This was due primarily to a rise in demand for money, and in fact monetary policy was easing.

There were several unfortunate consequences that followed this increased stimulus. GNP began to rise faster, and of course a larger component became inflation. Consumer prices in 1966 rose nearly 3 percent, and wholesale prices were up a little over 3 percent. Sales and order trends rose rapidly. There was discounting of inflation. The easy money policy in my opinion contributed to tight money, and it is very important to distinguish between the two.

The easy money policy which accelerated total spending, and demands for credit, certainly tended to increase the upward pressure on interest rates, and of course the Federal Reserve accommodated during much of this period by adding credit at a rapid pace.

In May of 1966, monetary policy abruptly changed gears, shifting from a 6-percent annual rate of expansion in the money supply to a rate of decline of about 1.7 percent rate for the following 7 months. In the short run this impact did mean higher interest rates. But there were several other compounding difficulties.

Private borrowers began to anticipate their needs. They feared that credit would not be available. You may remember the Federal Reserve refused to raise CD rates in line with the rising market trend. This meant that bankers were faced with sharp increases in demand for credit, and at the same time threatened with the liquidation of their liabilities and fewer assets.

Furthermore, numerous speeches by Federal Reserve officials placed the blame on banks for making too many loans to business; that this was the culprit causing the inflation. In fact, I think a near panic was caused by the activists and inept policies pursued in 1966, and it is a real tribute to a hobbled money market that one was avoided.

Since August, interest rates have receded. Monetary policy restraint of course, which in the short run tended to make for higher interest rates, ultimately brought easier money, because the demand for money is now declining.

The Federal Reserve rescinded its letter in December. Free reserves have improved and interest rates have declined, but the money supply has not increased, as you will note from the second chart in my prepared text.

The difficulties have been compounded in my opinion by a withdrawal of the investment credit. Of all the fiscal tools available, this one, in my opinion, was the most cumbersome for slowing up the economy, because it works with a considerable lag.

There is now talk about renewing it, and of course if we talk a long time about it, this will compound the difficulties. Already some prob-