

"finely tune" the economy will almost certainly lead to serious errors, particularly when the margin for error is small.

III. THE RECORD—1960 TO MID-1965

It is my view that both monetary and fiscal policies were unprecedentedly beneficial from 1961 through mid-1965 partly because the margin for error was great. Monetary-fiscal stimulus was provided and was clearly in order from 1960 through mid-1965 when substantial amounts of capital and labor resources were underutilized. There was considerable room for error for increased stimulation was unlikely to bring inflation but would hasten the employment of idle resources. Furthermore, monetary policy was quite stable from 1960 through mid-1965. During that period the money supply, the measure of monetary policy I prefer because of demonstrable empirical relations to spending, increased at a fairly stable 3% annual rate. (See Chart I). The only exception occurred during the first nine months of 1962 when monetary growth dropped sharply. Although the rate of rise in the economy was remarkably stable during most of the early expansion years, the economy faltered in late 1962 and threatened to go into a recession. Following the resumption in monetary growth in late 1962 the economy resumed its upward thrust.

Another additional major but, in my opinion, incorrect postulate of the new economics is that fiscal policy can be used in large measure as a substitute for monetary policy. Although fiscal policy received most of the plaudits for the 1961-1965 economic expansion, it should be noted that economic performance can be better explained by trends in monetary growth. Despite the fact that the 1964 tax lagged the initial proposal over one and one-half years, the economy continued to record favorable growth records in response to an expansive monetary policy following the 1962 slowup. Furthermore, there was no demonstrable acceleration in the economy subsequent to the tax cut. Rather than looking on monetary-fiscal policies as substitutes, the evidence suggests they are more nearly complements with monetary policy providing the major spending motive force while the tax system establishes the structural incentives to encourage production, employment, saving, investment and growth. As pointed out later, the predominant influence of monetary policy as a spending inhibitor was again vividly illustrated during the past few months.

IV. DESTABILIZATION SINCE MID-1965

One could have dared hope that as the economy approached full employment of resources near mid-1965 a "flexible" monetary-fiscal policy would provide less stimulus. But alas, the stimulus increased! The Administration seriously underestimated the rising cost of the Vietnam War so that increased spending on defense and Great Society programs shifted the cash budget from a small surplus in the second quarter of 1965 to a sizable deficit. And, in fact, the cash budget probably underestimated the changing fiscal impact since the surge in Government orders, which initiated hiring and production, occurred well in advance of cash payments.

To compound the difficulty, monetary policy also became more expansive. In contrast to the approximate 3% annual growth in the money supply from 1960 to April 1965, monetary growth doubled to 6.1% from April 1965 to April 1966. Furthermore, measures of bank reserves and total bank credit reflected similar tendencies. In December 1965 when the Fed raised the discount rate amid great objections by the Administration, who argued that a tighter monetary policy was inappropriate, the money supply actually increased nearly 1%, the largest monthly gain in 19 years. As late as March 17, 1966, the majority report of this Committee condemned the discount rate increase because of lack of coordination with fiscal policy and also because it was apparently the Committee's view that a tighter monetary policy was inappropriate for the existing needs of the economy.² Even though interest rates were tending upward due to sharp increases in demands for funds, monetary policy continued to fuel the flames of inflation by sharply augmenting the money supply.

We can properly ask why policies became more expansive just as the economy approached full employment of resources and inflation became a threat. The Administration clearly underestimated the inflation potential. To a considerable extent this was due to the sizable underestimation of Government spending

² Report of the Joint Economic Committee, Congress of the United States on the January 1966 Economic Report of the President, March 17, 1966, pp. 6-10.