Congress consequently did not insist on a tax increase nor did it carefully prune nondefense spending. As the demand for credit accelerated, the Federal Reserve sharply augmented credit supplies, in the apparent but, in my opinion, mistaken belief that the rising trend in interest rates and declining free reserves meant monetary policy was becoming tighter. In fact, monetary policy became more expansive as the growth in total bank reserves, total bank credit and the money supply accelerated.

Several unfortunate consequences followed largely as a result of increased policy stimulus. Current GNP began to rise at a faster rate. Since resources were in tight supply, inflation became a serious problem for the first time during this economic expansion. For example, consumer prices rose 2.9% in 1966 while wholesale prices increased 3.3% compared to only 1.3% and 0.4% annual rate of increase from 1960 to mid-1965. As inflation anticipations accelerated and sales and order trends developed strength, there was increased impetus to borrow, and money and credit demands surged ahead. Despite the rapid infusion of reserves and new money, interest rates rose rapidly. The easy money policy in the year ending April 1966 engendered a tight money market by increasing inflationary fears and thereby stimulating credit demands. Although a change toward an easier monetary policy does in the short run tend to lower interest rates by increasing the supply of money relative to demand, a continued easy money policy tends to stimulate demand relative to supply, particularly when inflation develops. Therefore, an easier monetary policy resulted in higher rates. The truth of this concept is borne out not only by our recent history but also by modern history of most European countries which have had high rates of monetary growth accompanied by inflation and high and rising interest rates.

In early May of last year monetary policy abruptly changed gears and the money supply declined at a 1.7% annual rate for the following seven months. Not only was the long-run impact of an easy money policy continuing to stimulate demand for money, but the sharp shift toward a tighter policy in the short run compounded pressure toward higher interest rates which peaked in August.

Furthermore, during the spring and early summer anticipatory borrowing began to develop as private borrowers became concerned that if they delayed making loan arrangements, credit might not be available. Federal Reserve officials accelerated this trend by refusing to raise CD ceiling rates in line with rising market rates as had become the custom. In fact, the rate that commercial banks were allowed to pay on consumer-type deposits was cut from 5½% to 5%. Therefore, banks were threatened with deposit liquidation and the necessity to severely reduce asset expansion. To compound the difficulties Federal Reserve officials made clear that they regarded bank loans to business as the major inflationary culprit. It was repeatedly stressed by Federal Reserve officials that banks must restrict loans to business or run the danger of not being able to borrow at the discount window. The move by Federal Reserve officials to blame excessive bank loans to business as the cause of inflation was analagous to the tendency of the Council of Economic Advisers to blame labor and business leaders for the same difficulty as they broke the economically unsound wage-price guidelines. Both actions reflected increasing tendencies to substitute Administrative actions for market forces under the apparent but, in my opinion, mistaken conviction that the free market would not protect the public welfare. Although it is always tempting to blame nebulous private markets, excessively expansionary monetary-fiscal policies were clearly the cause of recent inflationary pressures.

Considering the unprecedented pressures placed on the money market last summer, brought about mainly by activist and inept financial policies, it should not be surprising that a near monetary crisis developed. It is a tribute to the efficiency of a hobbled money market that it was avoided.

Following the near monetary crisis in August interest rates receded significantly. Just as an excessively easy money policy stimulates the economy and the demand for funds, a policy of monetary restraint eventually has the opposite effect. Demand for credit began to abate by fall 1966 and finally in December the money supply rose slightly. In late December the Federal Reserve rescinded the September letter which requested banks to restrict business loans. Although free reserves continue to improve as interest rates decline, there has been little monetary expansion even up to the present despite the obvious weakness in the economy. (See Chart II) To compound the difficulty, on September 8, 1966 the President asked Congress to suspend until January 1, 1968 the 7%