CHAPTER 3

Breaking Up Is Hard to Do: Splitting from the Treasury in Adolescence and Maturing More—September 1935–January 1970

Governor Laurence Meyer gave a talk in 1998 describing a Treasury lunch at the Board at which the question arose as to what the four letters FOMC meant. To quote him, "My concern about the public awareness of the FOMC was heightened recently during one of the weekly luncheons Governors host for a small group comprised of the staffs at the Board and the Treasury. A very senior member of the Treasury staff, during our luncheon conversion, asked me if I knew what 'FOMC' stood for. A strange question, I thought, coming from so knowledgeable a person. I replied that I thought I did, but, just to be sure, what did he believe it stood for? He replied 'Fruit of the Month Club.'"[1] I'll add just two comments regarding that story. First, FOMC is an acronym that in truth always stands for the Federal Open Market Committee. Second, I actually attended that lunch, and I remember vividly what Meyer described and who cracked the joke. It was none other than Timothy F. Geithner, later himself president of the Federal Reserve Bank of New York and vice chairman of the aforementioned FOMC before becoming Secretary of the Treasury.

Now we can return to the Great Depression. In November 1934, President Roosevelt appointed Marriner S. Eccles, a believer in the efficacy of fiscal policy before being a Keynesian was cool, to head the Fed's Board. Eccles persuaded the president to allow him to draft major legislation reforming the Federal Reserve. His draft bill, after some judicious compromises with by-then Senator Carter Glass, in August became the Banking Act of 1935. It reconstituted the FOMC, originally created by the Banking Act of 1933, into the modern structure of today. Eccles's bill would have lasting effects, including the book in your hands.

Founding the Modern Federal Open Market Committee and Pegging Interest Rates

The new legislation gave the Board of Governors in Washington a majority on the FOMC with seven votes, while the 12 Reserve banks were allotted only five votes at

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a time to be determined on a rotating basis. The head of each Reserve bank was to be called president rather than governor, a term to be reserved for the Board members, the head of which was renamed chairman (see Table 3.1). The Secretary of the Treasury and the Comptroller of the Currency were removed from the Board, with the remaining seven members serving staggered 14-year terms. Terms would expire on January 31 of each even-numbered year. The wording of the legislation also softened the emphasis on the real bills doctrine.

The new law required the FOMC to maintain records of its policymaking actions, and of the reasons they were taken, and to publish the records in its annual report to the Congress. Section 10, paragraph 10 of the Federal Reserve Act stated:

> The Board of Governors of the Federal Reserve System shall keep a complete record of the action taken by the Board and by the Federal Open Market Committee upon all questions of policy relating to open-market operations and shall record therein the votes taken in connection with the determination of open-market policies and the reasons underlying the action of the Board and the Committee in each instance. The Board shall . . . include in its annual report to the Congress . . . a copy of the records required to be kept under the provisions of this paragraph.

To comply with the act, the Board published in its *Annual Report* the Record of Policy Actions (or "Policy Record"). The Policy Record summarized each FOMC meeting. It was quite brief at first, comprising only a paragraph or two of the background or reasoning behind each Committee action, though it would grow over time. Figure 3.1 presents the timeline of past and present nomenclature regarding these records.[2]

Eccles had begun to issue a press release after each meeting. It announced the FOMC's decision, if any, and the main issues discussed.[3] Starting with its first meeting, the new FOMC additionally produced the "Minutes" that included initially in very summary form the comments of individual members. The FOMC, however, kept those records entirely internal. Apparently, the issue of retaining files of stenographic transcriptions of FOMC meetings was raised in the autumn of 1935.[4]

The wording of the legislation also softened the emphasis on the real bills doctrine. In his review of the first volume, Michael Bordo noted that "Meltzer (p. 575) points out the irony that once the Banking Act of 1935 made the Federal Reserve a full-fledged central bank with power centralized in Washington, conferring independence within the government, the Fed lost effective control to the Treasury for the next 16 years."[5] And this was the act that had removed the two Treasury officials, including its Secretary, from the Board! As Meltzer put it,

Table 3.1 Chairmen of the Board of Governors, August 23, 1935, through January 31, 1970

Chairman	*Date of Term*
Marriner S. Eccles	August 23, 1935–January 31, 1948
Thomas B. McCabe	April 15, 1948–March 31, 1951
William McChesney Martin	April 2, 1951–January 31, 1970

Source: Board of Governors of the Federal Reserve System, "Membership of the Board of Governors of the Federal Reserve System, 1913–Present." Retrieved from http://www.federalreserve.gov/aboutthefed/bios/board/boardmembership.htm.

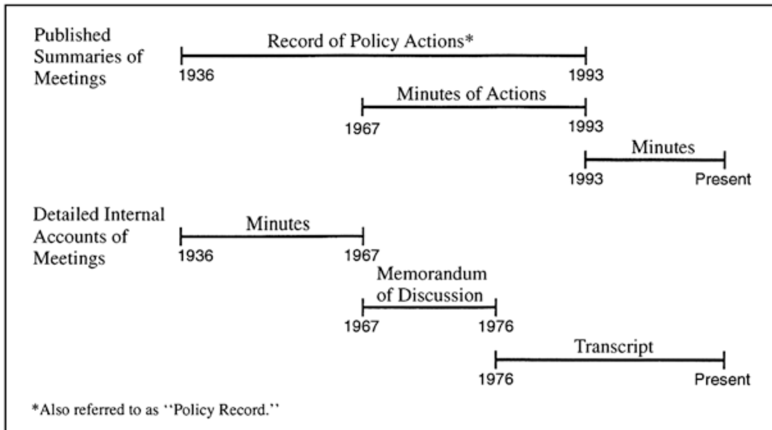

Figure 3.1 Reports from FOMC Meetings: Past and Present Nomenclature

Source: Deborah J. Danker and Matthew M. Luecke, "Background on FOMC Meeting Minutes," *The Federal Reserve Bulletin* 91, no. 2, Spring 2005, p. 176.

> The New Deal had a lasting effect on the organization of the Federal Reserve. The Banking Act of 1935 changed the locus of power in the Federal Reserve System by strengthening the role and powers of the (renamed) Board of Governors in Washington. Without ever reaching an explicit, collective judgment, Congress and the Roosevelt administration appear to have concluded that the policies pursued by the reserve banks, particularly New York, had encouraged speculation, leading to the stock market collapse, bank failures, and depression. Centralization of responsibility and authority in the Board, and measures to prevent security market speculation, were the chosen solutions.
>
> Subservience to the Treasury during the recovery, and in the war that followed, limited the effect of the legislation for a time. The Treasury took control of international economic policy. Both New York and the Board had a limited role. The Board gained nominal control of open market operations and the power to approve appointment of reserve bank presidents. The new powers changed the system's internal organization and operations in the 1930s. Major effects on policy had to wait for the post-war years.[6]

The Board did exert enough independence from the Treasury during the economic recovery later in the 1930s to take actions that the Roosevelt administration and Friedman and Schwartz both considered a serious policy blunder that helped spawn a renewed economic downturn.[7] In 1936–37 the Board exercised another power granted in the Banking Act of 1935 to double all the required reserve ratios on deposits in three steps. It had become concerned that the quite elevated levels of excess reserves were "superfluous" and potentially inflationary.

The first increase became effective in mid-August 1936. Secretary of the Treasury Henry Morgenthau was furious that he hadn't been informed of the action in advance. The second step, which occurred in early March 1937 and coincided with the start of a prolonged backup in the bond market, again infuriated Morgenthau.

The third step took effect in early May of that year. Despite the legislation passed by the Congress prior to that time to guard against recessionary forces, a very steep recession began in June 1937 on top of the already weak economy and lasted for a year.[8] Amity Shlaes offered this description:

> August had seen the worst drop in industrial production ever recorded. The Dow Jones Industrial Average dropped from its 190 level in August down to 114 on November 24 . . . In the period from September 15 to December 15, the jobs started to disappear, with unemployment moving back to 1931 levels. The Wall Street shock was spreading to Main Street.[9]

She recounted certain opinions within the Roosevelt administration on subsequent pages, "Eccles was in the doghouse, blamed for the new downturn, [Lauchlin] Curry later remembered."[10]

But Treasury bill rates already had started to ebb by the time of the third hike. Recent research has vindicated the Board by focusing on the much higher voluntary amounts of total reserves that banks wanted to hold as a precaution brought about by the uncertainties of the depression.[11] The hikes in required reserve ratios mainly just sopped up truly surplus excess reserves without binding banks at all by the higher requirements. The research has attributed renewed recession instead to the Treasury's sterilization of gold inflows from late 1936 to early 1938, enlarged federal taxes, starting with the undistributed profits tax in 1935, and reduced federal outlays.

During and after a tepid economic recovery in the late 1930s and early 1940s, the Fed kept interest rates low to aid the government's debt financing. The economic recovery strengthened after the Japanese raid on Pearl Harbor on December 7, 1941, that brought the United States into World War II as a combatant. Even so, Shlaes could pose the issue this way: "The big question about the American depression is not whether the war with Germany and Japan ended it. It is why the Depression lasted until that war." She goes on to provide a decidedly unconventional answer: "From 1929 to 1940, from Hoover to Roosevelt, government intervention helped to make the Depression Great."[12]

After the war began, as noted previously, the Fed fell completely under the thumb of the Treasury. The following April, the Fed established the "peg" of market yields on government securities in which the 90-day bill rate was set at 0.375 percent and that on the 25-year bond at 2.5 percent, with yields on intermediate maturity instruments in between. After the war ended in mid-August 1945, the Fed had considerable difficulty freeing itself from Treasury control. President Truman refused to reappoint Marriner Eccles as chairman when his third chairmanship expired in early February 1948, preferring the more compliant Thomas B. McCabe. Eccles remained on the Board, and later played an important role in resisting underhanded administration efforts to retain the Treasury's domination. After a meeting in the White House between President Truman and the FOMC on January 31, 1951, the administration falsely asserted in a press release and subsequent letter that the Committee had committed to support the current low bond rate. Eccles alone was exasperated enough to release a statement along with the Minutes of the meeting that clearly refuted the administration's claim.[13]

The Fed and the Treasury Reaching an Accord and the Unfolding of the Martin Era

Allan Sproul, president of the New York Reserve Bank, earlier had pushed internally for Fed independence. An external voice, Senator Paul H. Douglas (Democrat, Illinois) also had been supportive of the Fed's autonomy. Furthermore, the outbreak of the Korean War had raised the specter of inflation, which a central bank having independent power would be better able to address. In March 1951 the Federal Reserve and the Treasury finally signed an accord giving the Fed its formal independence, though it took a couple of years to establish it fully in practice.

After the accord, the Fed served as a counterweight for more than a decade to the expansionist Keynesian vision by maintaining a lonely vigil in interpreting the ambiguous phrase "maximum . . . purchasing power" in the Employment Act of 1946 to mean stable prices. William McChesney Martin Jr. (1906–1998), who replaced McCabe and served as Board chairman from April 1951 to January 1970, had an instinctive distaste for inflation. He always believed that, if anything, high inflation over time *caused* higher unemployment. He had been the president of the New York Stock Exchange and chairman of the Export-Import Bank before his tour of duty with the Treasury Department, where he was its main negotiator in the talks leading up to the accord.

He was a prototype of the genus that Keynes referred to above of "practical men." "When he was in a particularly self-deprecatory mood, he would describe himself as 'just a bond man,' referring to his thirteen years on Wall Street."[14] He abjured economic analysis, instead soliciting anecdotal evidence and coining colorful metaphors. For example, he said that the purpose of Fed policy "is to lean against the winds of deflation or inflation, whichever way they are blowing"[15] and to "take away the punchbowl just as the party got going."[16]

Under his chairmanship, FOMC meetings were marked by a short-term focus and the absence of a specific analytic framework. He claimed "central banking remains an art rather than a science."[17] In 1966 he thus decried the appointment of a fourth economist to the Federal Reserve Board, opposing the choice of Andrew Brimmer as governor for this reason.[18] Indeed, Martin's attitude was reminiscent of Edmund Burke's when contemplating the invasion by the mob of Marie Antoinette's bedchamber during the French Revolution: "[T]he age of chivalry is gone. That of sophisters, economists, and calculators has succeeded; and the glory of Europe is extinguished forever."[19] Martin was deeply suspicious of economists' inclination to rely on the measurement of economic forces that he thought only sound judgment after detailed observation could assess, and he doubted the validity of their sweeping policy recommendations grounded on dubious theoretical or statistical reasoning. "Martin often began a conversation by saying: 'I am not an economist.'"[20] Given the disastrous influence that adopting the flawed advice of economists would prove to have on monetary policy to come, this comment might seem to represent the height of hubris. But actually he was a modest man, so that clearly was not his motivation.

> His observation about Fed independence was justifiably memorable: The Fed, then under chairman William McChesney Martin Jr., told Congress in 1957, "should be independent—not independent of government, but independent within the structure

> of government." That meant, he said, having the freedom necessary to decide how best to meet the goals of national economic policy.[21]

He typically did not try to impose his own views on the Committee. Stephen Axilrod, a 34-year employee of the Board who ended up the staff director for monetary and financial policy, described his approach:

> From my observations at FOMC and Board meetings, he never appeared to alienate his colleagues. It was something of a joke that at FOMC meetings, after everyone had expressed their views in the preliminary discussion of policy, he would always say, "Well, we are not far apart," no matter how far apart the participants in fact were. But the "joke" of course had a point. It conveyed that each counted as much as anyone else; and even if you were in fact far apart from the rest, the distance could not be too far because you really were a thoughtful and well meaning-member of the group.
>
> Perhaps I am reading too much into Martin's use of the phrase, but I have come to believe that he deliberately, not just habitually, employed it to help the group feel close together and thus as responsive to each other as possible. It looked as if he strove for something like the cohesiveness required in the crew of a large sailboat if the helmsman's efforts were to have the best chance of succeeding.[22]

Under Chairman Martin, the central bank continued to pursue an anti-inflationary policy during the first half of the 1960s before accommodating President Johnson's guns and butter policy in the second half of the decade. Chairman Martin's approach kept the average rate of inflation down, although both inflation and economic activity exhibited some variability.[23] In the presidential campaign of 1960, Senator John F. Kennedy argued that the restrictive monetary as well as fiscal policy had prompted three recessions in eight years and thus had kept average unemployment too high and the economy too often below its potential. He specifically criticized Martin's leadership of a "tight money" Fed.[24] He promised "to get the country moving again," which, especially given the prevailing woes of the third recession, proved to be a compelling message to the electorate. In March of that election year Arthur Burns had warned Richard Nixon about the impending economic downturn, but Nixon's efforts to get the Eisenhower administration to encourage more stimulation were in vain. As historian Wyatt Wells put it in his biography of Burns, "The defeated candidate would not forget the recession, which he blamed for his defeat, nor would he forget Burns."[25]

Walter Heller, a liberal economist, became the chairman of President Kennedy's Council of Economic Advisers. In 1961 Heller proposed renaming the committee composed of the president and the Treasury secretary, the chairmen of the Council of Economic Advisers and the Fed, and the director of the Bureau of the Budget as the "Quadriad." It would have confined the Fed's independence if Martin had not resisted. As Bremner reported, "Heller and the CEA were often frustrated that they could not force Martin to actively support the CEA's plan to raise short-term interest rates (to discourage the outflow of short-term funds) and simultaneously lower long-term interest rates (to promote economic growth)."[26] This policy became known as "operation nudge" internally or operation twist externally, after a Chubby Checker song. Although questions have been raised about whether Treasury debt management didn't work at cross-purposes, research has suggested that long rates were affected by at most 15 basis points (that is, 0.15 percentage point).[27]

Heller touted the "New Economics," according to which the business cycle could be conquered through the application of the fundamental principles of macroeconomic science that already were familiar to college freshman. Heller did much to publicize that point of view, as did the other members of the CEA, James Tobin and Arthur Okun. Paul Samuelson and Robert Solow already had written an influential article providing intellectual support. It asserted that governmental policy could exploit a long-run tradeoff between unemployment and inflation in which more of one meant less of the other. They claimed that a "nonperfectionist's goal" for unemployment was 3 percent, which was unprecedented in peacetime.[28] Although they noted some caveats, their views certainly were taken to mean that lower unemployment could be attained permanently at the minor cost of somewhat higher, though not ever-rising, inflation. Under the macroeconomic policies implied by the Keynesian approach, unemployment was driven lower all right. Indeed, a business expansion began in 1961 that lasted for the rest of the decade, though those developments were increasingly marred in the second half by what proved to be the doctrine's Achilles heel—ever mounting inflation.

Lyndon Johnson assumed control of the executive branch after President Kennedy's assassination in November 1963. He was an old-fashioned populist with a congenital hatred of high interest rates. His Democratic colleagues in the Congress shared that sentiment, including Wright Patman. John William Wright Patman (1893–1976) was the son of a poor sharecropper in rural Northeast Texas. After graduating from high school as valedictorian in 1912, he earned a law degree at Cumberland University in Lebanon, Tennessee in one year without any other college credits, again graduating first in his class. He was elected to the House of Representatives as a Democrat from Texas in 1928, where his work was all consuming. He went to the office seven days a week for ten hours a day. In his biography, historian Nancy Beck Young wrote:

> Patman combined two different political traditions—populism and liberalism . . . Patman's liberalism was a liberalism of the past and often centered on criticism of the Federal Reserve, which Patman blamed for the credit problems of the South and the West. Specifically he believed that the Fed operated in collusion with Wall Street bankers to charge artificially high interest rates to the rest of American consumers. Sam Rayburn told a new member of Congress that Patman was "a smart man, but if he got shipwrecked on a lonely island with Liz Taylor, Liz in the nude, he'd say, 'Ms. Taylor, do you know the workings of the Federal Reserve Board?'"[29]

Although the House Committee on Banking and Currency remained dormant in the 1950s and early 1960s, things changed after Patman became its chairman in 1963. In the next year he held hearings on his broad-based anti-Fed draft legislation. As the initial hearings wore on into their fifth month, Martin finally had to get President Johnson to intervene to help stop them.[30] Patman next introduced a series of bills in the mid-1960s "to direct interest rate policy, but these efforts did not galvanize attention as economic policy was largely perceived to be in the domain of fiscal actions."[31]

Patman's battles with Martin became the stuff of legend. Their tiffs occasionally were animated; Representative Henry Reuss once heard, "'You're unconstitutional,' Patman was shouting, a familiar charge based on his belief that Congress, not the

Fed, had the constitutional power to 'coin money, regulate the value thereof.'"[32] But their dialogue never became personal, since both Patman and Martin always remained cordial. Patman did deeply resent the activities of Reserve bank directors in lobbying to defeat his proposed legislation. For example, he blamed such pressure for subverting his efforts to have the government own the Fed, or impose Congressional appropriations to deprive the Fed of its independent source of funding, or have the Fed audited by the General Accounting Office (now Government Accountability Office) (GAO).

But his own actions bore some responsibility for alienating Democrats as well as Republicans on the Banking Committee, as he ran that committee like a personal fiefdom. Also, some of Patman's colleagues were turned off by his demagogic rhetoric. In particular, he never relented in his verbal attacks on the Fed. For example, in April 1968 Patman derided "Old Doc Martin's handy dandy elixir for all complaints known to man or beast: A raise in the discount rate." He then contemplated impeachment proceedings against Martin.[33]

The ambiguity of the FOMC's operating intentions, which were never very explicit, irritated Patman, judging by his responses. A part of the Policy Record all along had transmitted the Committee's instructions; in the 1950s the recipient came to be the Federal Reserve Bank of New York. In March 1953, the Policy Record used the phrase "directive," as opposed to "direction," to describe the primary monetary policy decision voted on by the Committee. The phrase stuck, and has been used ever since. The last paragraph of the directive, called the "operational paragraph," gave the FOMC's operating objectives for open market operations to be conducted by the Trading Desk at the New York Fed.

In its operating instructions, the FOMC had made a transition from the "color, tone, and feel of the money market" for short-term financial instruments in the 1950s to "money market conditions" as the 1960s progressed. Those conditions were thought of mainly, but not exclusively, as some combination of the federal funds rate, the 3-month Treasury bill rate, and net borrowed reserves, which are equal to the reserves borrowed by commercial banks from Reserve banks less excess reserves. The FOMC inserted a "proviso" in the operational paragraph of the directive to the Trading Desk in the Policy Record in April 1966 to give some scope for the behavior of a total bank deposits proxy for bank credit to affect money market conditions between its meetings. But the proviso had very little practical effect.

Despite the evolution toward more specificity about the Committee's intentions in the Policy Records in the 1960s, the FOMC continued to refrain from simply aiming at the federal funds rate. Instead, it referred publicly to more or less "firming," "restraint," or "easing" in money market conditions. The Fed's vague operating procedures engendered increasing criticism from populist, liberal, and monetarist economists in the 1960s, which spilled over into the political sphere. The lack of specificity about the operating target generated not only external criticism but also reoccurring internal complaints about the Committee's lack of explicit directions to the Trading Desk. Internally, it still importantly indexed its stance by an operating objective for free reserves, that is, the negative of net borrowed reserves or excess reserves less borrowed reserves. In Karl Brunner and Allan Meltzer's phrase of 1964, the Fed exhibited an "attachment" to the concept of free reserves.[34] Meltzer well put the Fed's dominant motivations: "Tradition or history is one reason for relying mainly on free reserves or borrowing as a policy target instead of an interest rate. No

less important was concern that an interest rate target invited pressure from Congressional populists, especially Congressman Wright Patman, to keep interest rates low."[35] To me as well, the ambiguity that Chairman Martin fostered about the Fed's operating procedures must have stemmed in large part from his desire to portray a vague picture to the public about its specific techniques, thereby forestalling criticism and hence political pressure.[36]

In addition to the Fed's ambiguity, Congressman Patman also strenuously opposed its secrecy. The internal Minutes of FOMC meetings, which gave a comprehensive record of the attendance, discussions, and decisions at every FOMC meeting, became increasingly detailed over the years, notably during the 1960s. They were not meant to be released to the public, in contrast to the Policy Record, and thus were kept internal until 1964. This policy occasioned its share of criticism, particularly from Patman. In July 1961 his promise on behalf of the Joint Economic Committee to keep the FOMC's Minutes for 1960 confidential induced the Board to grant him access to them.[37] The Board regretted that decision in August when extracts of a summary of the Minutes that the JEC had prepared appeared in the *New York Times*. That leak surely left a bad taste in its mouth that influenced future Board decisions about disclosure.

Although the FOMC in general had kept the Minutes confidential, maintaining them for internal use alone, in 1964, the FOMC in effect decided to make the historical Minutes available to the public by transferring those for 1936 to 1960 to the National Archives. It announced that it had done so as part of the celebration of the 50-year anniversary of the founding of the Federal Reserve. But the agitation surrounding the publication in the previous year of *A Monetary History of the United States: 1867–1960* by Milton Friedman and Anna Schwartz no doubt contributed. The coauthors, who complained bitterly that the Fed had denied them access to the confidential Minutes, portrayed the institution as extremely secretive and its limited public statements as self-serving and misleading. This characterization only magnified the heavy pressure from Representative Patman, who had just become chairman of the House Banking Committee, for the Fed to disclose all its records promptly. Furthermore, the FOMC's subsequent actions suggest that the members considered the Friedman and Schwartz portrayal of the historical record to have been unduly critical and believed that the release of the actual Minutes would help to set the record straight. After transmitting the 1961 and 1962–1965 Minutes to the National Archives in 1967 and 1970, respectively, the Board decided to release future versions on a regular schedule after about five years.

The Policy Record by then had come to contain a summary of the economic situation as perceived by the Fed at the time of each FOMC meeting and of the highpoints of the discussion of the meeting itself, though without mentioning any names. By the mid-1960s these records had expanded to an average of about five pages per meeting. For decades, though representing the official statement of policymaking, the Policy Record continued to be published only once a year.

The enactment of the Freedom of Information Act in 1966 brought the issue of information release to a head. The FOMC insisted that any change in the release of information must preserve the effectiveness of the policy discussions and the operations implementing monetary policy. Even so, the Committee in June 1967 concluded that it could release the Policy Record in a more timely fashion, specifically,

after a lapse of only 90 days. It also began to be published in *The Federal Reserve Bulletin*, issued monthly. At the same time, as was shown earlier in Figure 3.1, the FOMC decided to prepare a separate document, called the "Minutes of Actions." It could be released to the public in response to FOIA requests—and also was made available in the Board's Freedom of Information Office—on the same schedule as the Policy Record was released to the public. The Minutes of Actions included summaries of all actions (both policy actions and non-policy actions, such as procedural or organizational votes) together with the list of attendees. The document did not state the reasoning behind the actions or give any indication of the discussion at the meeting, which instead was the province of the Policy Record as well as of another newly named document, the Memorandum of Discussion.

The content of the previous, now discontinued, Minutes was divided between the Minutes of Actions and the Memorandum of Discussion. Much like the previous Minutes, the detailed Memorandum of Discussion represented a narrative account of every point made by each speaker, who was identified by name. It was a thorough synopsis, despite being heavily edited and written in the third person. The FOMC's intent in creating the Memorandum of Discussion evidently was to avoid making the expansive version in the Minutes publicly available before five years had elapsed (even then with appropriate deletions, called redactions, of extremely sensitive material dealing with identifiable individuals, corporations, and foreign governments or central banks). The accuracy of the Memorandum of Discussion was ensured by careful note taking. When all the earlier Minutes had been the distributed to the public after five years, the Memoranda of Discussion also came to be released to the public after five years.

Returning to the conduct of monetary policy, from the start President Johnson aggressively pursued economic stimulus. In late February 1964 he signed into law the tax cut that Kennedy had advocated. A year later the administration started to propose expanding domestic spending with the Great Society legislation. The president also escalated US involvement in Vietnam but kept its true cost hidden even from his advisers. The unemployment rate dropped to 4 percent by late 1965 and was fated to stay at or below that rate for another four years. The change in December-to-December CPI prices rose to nearly 2 percent. Little did anyone know at the time, but that figure was headed higher and would not be improved on for another 20 years.

When the Board was contemplating a discount rate increase to counter the emerging inflationary pressures in late 1965, Gardner Ackley, then the Chairman of the Council of Economic Advisers, suggested to President Johnson in a memo dated November 29 that a not particularly sympathetic Board member named Dewey Daane could be lobbied to vote no, which would defeat the initiative.[38] That unusual effort was tried but failed, and the Board raised the discount rate by 1/2 percentage point on December 3. Through Ackley and Henry "Joe" Fowler, his Treasury secretary, "Johnson had advised Martin to delay the increase," as Martin biographer Robert P. Bremner wrote,

> and his instructions had been rejected. Few people ignored Lyndon Johnson instructions, and he was furious when he heard of the Fed's move. He had growled at Fowler over the telephone: "Those marble tower boys. Joe, you find a tough guy to head the Reserve. If Martin resigns, it won't wreck the country."[39]

President Johnson summoned Chairman Martin to his Texas ranch to complain in no uncertain terms. In "the Fed's finest hour," Martin resisted that pressure and refused to rescind the increase in the discount rate. But the pressure had its effect; in the words of Board member Sherman Maisel, the episode surrounding the discount rate action, although "one of the more dramatic incidents in Federal Reserve history," more importantly "marked a true watershed: It was the end of the age of innocence; the Fed would not be the same again."[40]

The Fed exercised more restraint in 1966 to resist rising inflation, leading to a "credit crunch," partly brought on by ceilings on the deposit interest rates that commercial banks and thrift institutions could offer. The diversion of funds from deposits into the open market meant that those depository institutions could not grant mortgages, so housing was especially impaired by the monetary stringency, which became politically rancorous. Economic growth softened considerably in the "mini-recession" of 1967. In response, Fed policy turned more expansionary again. The experience of deposit rate ceilings in concentrating the impact of monetary restraint on housing and thus lessening the possibility that monetary policy could be restrictive enough to retard inflation would resound in the years to come.

The FOMC's overly simulative policy stance over the rest of the decade was to become more obvious as time passed. The Fed unfortunately continued its "coordination" with the administration, which in practice meant considerable pressure on the Fed to keep the funds rate down. The Fed also retained its practice—known as "even keel"—of keeping market interest rates stable for more than a week before and after the Treasury's issuance of longer-term securities. But the increasing federal deficits meant Fed-tightening opportunities were reduced still further and made interest rates even more inertial. So did Chairman Martin's management style, with its emphasis on finding consensus among FOMC members before policy could be altered.[41] President Johnson's appointments to the Board in any event did not always see eye to eye with the chairman, who lost further influence over time. For all these reasons Fed policy would not be restrictive enough in the next few years and inflation would continue to build as unemployment fell further.

President Johnson belatedly called for a tax surcharge in his State of the Union address in early 1967. But the political stars were not yet aligned favorably; during much of the second half of the year Martin adopted the risky strategy of refusing to push to tighten monetary policy in order to strengthen the case for fiscal restraint instead, thereby allowing inflation to gain a firmer foothold.[42] Even so, the tax surcharge was not enacted until June 1968, when it was combined with slightly larger spending cuts than the administration had advocated.

Out of concern about "fiscal overkill," the Committee staff projected an economic slowdown absent Fed ease. Consistent with its virtual commitment to the administration but apparently to its subsequent chagrin given a policy reversal, the Board eased in late August through a cut of 1/4 percentage point in the discount rate. Nonetheless, as monetarists had predicted, the impact of temporary fiscal restraint was miniscule and the economy lurched forward. Unemployment dropped below a 3-1/2 percent rate, and annual average consumer inflation reached 4-1/4 percent that year. Martin admitted the policy mistake when he testified, "In retrospect, I believe that the Federal Reserve was overly hasty last summer in expecting an immediate impact from fiscal restraint."[43]

In December the Board reversed the earlier discount rate reduction, after Richard Nixon already had won the election of 1968 amid the unrest that was an outgrowth of the Vietnam War and the flowering of the counter culture. The president-elect met with Chairman Martin that month in New York City to offer him the position as Secretary of the Treasury, so Nixon could make Arthur Burns the Board's chairman upon assuming the presidency in January 1969. Martin respectfully declined, expressing his intention to serve out his term as governor, which did not expire until the end of January 1970. Former Governor Brimmer characterized his decision as a move to "defend the integrity of the System against encroachment from the White House."[44]

In reaction to the upsurge of inflation, the Fed tightened its policy a lot more in the first half of 1969. The Board further hiked the discount rate in April from 5.5 to 6 percent. The nominal funds rate increased by about 3 percentage points to the area around 9 percent by mid-year, where funds traded for the rest of Martin's tenure. The rise in inflation, though, muted the increase in the real, inflation-adjusted, federal funds rate, which still more than doubled over that interval to around 4 percent from a start below 2 percent. (The real federal funds rate is measured by subtracting the percent change in the GNP deflator from four quarters earlier from the nominal funds rate.) Although some dissenting Keynesian members of the FOMC as well as the Committee's staff counseled a relenting of monetary restriction during the second half of the year, Martin held a majority together favoring continued restraint. Private spending responded to the stringency, as a peak in the business cycle occurred in December 1969. Although the economy entered a recession just at the conclusion of Martin's chairmanship in January 1970, by then consumer inflation had escalated to more than 6 percent over the last 12 months of his term.

Powerful inflationary forces thus had emerged as Martin's years as chairman drew to a close, despite his instinctive distaste for inflation. This juxtaposition surely must rank among the paradoxes of history. Although Martin evidently had regrets, the "New Economics" certainly finished the decade in tatters, done in by an inflation that in its wake brought the policy resistance that caused recession. The inflationary pressures stemmed in part from political forces, which made restraining aggregate demand through firmer interest rates and higher taxes and/or lower spending hard. But bad economics also contributed, as public policy had been encouraged by Keynesian ideas to keep monetary and fiscal policies overly simulative in order to push the unemployment rate much too low, which had created the acceleration of prices in the first place. In the 1930s depression had proven very fertile for the Keynesian vision to spread and for a time to prosper. But in another irony of history, it was the very fears of even temporary economic weakness impressed upon policymakers' minds by the experience of the Great Depression that became *too* influential. Also indelibly impressed was the very success of expansionary fiscal and monetary policies in stimulating economic activity in the 1960s that led to the inflation that spelled the end of Keynesianism, at least for a while.

The next chapter will regale the reader with a synopsis of the developments after Chairman Arthur Burns took control of the policy reins in early 1970. The atmosphere of ascendant inflation worsened appreciably in the 1970s, in part because incipient policy firmness again aroused political resistance before it could reach fruition. Inflation attained crisis proportions late in the decade under Chairman G.

William Miller. Such an environment became hospitable to the monetarist vision, partly because of the consequences of its previous dismissal. As we shall see, "practical monetarism" finally triumphed as the intellectual foundation for a forceful policy for three years starting late in the decade under Chairman Paul Volcker. But as the next chapter also will recount, history didn't stop there; rather, it inexorably moved on. After the FOMC adopted a new approach to designing and implementing its policy in 1982, a quarter century of conquered inflation ensued, mostly overseen by Chairman Greenspan. The Fed attained price stability and moderated business fluctuations. But then a housing bubble set in under the radar. Its bursting caused the worst financial disaster since the Great Depression and the steepest economic downturn in post-war American history. Keynesian thinking was revived by President Obama before a concern about fiscal rectitude reemerged. Chairman Ben Bernanke's FOMCs adopted unusual policies toward lending and open market operations. The Fed completed its first century by playing major new roles in all these dramas.