Draft - Confidential

A briefing for the President on how the Fed's actions have helped & [H.S. hurt the inflation. 2/15/69] Contains a threat to the Fed's independence

MEMORANDUM FOR THE PRESIDENT

The Federal Reserve Problem

Achievement of the Administration's objective of steady non-inflationary growth will depend heavily upon the policy of the Federal Reserve. There is now much disagreement among qualified people about whether the approach to monetary policy taken by the Federal Reserve has contributed to economic stability in the past and is likely to do so in the future. The Administration should have a view of this matter and use its influence vigorously to bring about the monetary policy most appropriate to the Administration's objectives.

The Federal Reserve will take into account the Administration's views as expressed by you in your meetings with the Quadriad, as expressed by the Council of Economic Advisers in its frequent meetings with the Board of Governors, and as expressed judiciously in public statements. The Federal Reserve will give especial attention to the Administration's views now because of the state of its relationship with the Congress. The Federal Reserve knows that its "independence", which it values above all else, depends on the support of the Congress. There ~~have~~ has always been some criticism of the Federal Reserve in the Congress. Until recently the critics could be dismissed as a small extreme populist fringe. Most of the Congress was uninterested and uninformed. As long as the Federal Reserve had the support of the financial community, the academic ~~[illegible]~~ experts, and the Administration, the Federal Reserve did not have to worry about ~~[illegible]~~ intervention by the Congress. However, in recent years expert opinion has swung increasingly away from the views and policies of the Federal Reserve, skepticism is growing in the financial community and lack of confidence is spreading in the Congress. Accordingly the Federal Reserve will be sensitive to the danger of finding itself far out of line with the Administration.

a threat

Issues of the Past

Although the criticism of the Federal Reserve has a basis in long-standing issues of economic analysis it has been intensified by recent experience. We have had a large, undesirable and undesired inflation. Unless everything that modern economics says about the possibility of stabilizing the economy, at least roughly, by fiscal and monetary policy is mistaken, there must have been an error of policy somewhere.

The Federal Reserve's position is that the error was not theirs, on the whole, although they may admit some slips of forecasting and timing. They say that in general they did follow an anti-inflationary monetary policy, as evidenced by the height of interest rates. However, fiscal policy was not cooperative. The generation of a large budget deficit was directly inflationary. Moreover, the large budget deficit prevented the Federal Reserve from pursuing an even more restrictive policy, because to have done so in the face of a large deficit would have caused intolerable interest rates and credit stringency.

The opposing view is that the Federal Reserve was largely responsible for the inflation and that its errors were not accidental but were due to basic and continuing misconceptions about policy. The Federal Reserve's contribution to the inflation was the rapid and uneven rate of growth of the money supply. The high interest rates were not a sign of monetary restraint but the consequences of lack of restraint which caused actual inflation and the anticipation of inflation. ~~thus making~~ Because of the anticipation of inflation lenders demanded, and borrowers were willing to pay, high interest rates for loans which would be repaid in depreciated dollars. The continuing reasons for the Federal Reserve's errors are these:

1. Giving too little weight to ~~changes~~ the rate of growth of the money supply as evidence of monetary ease or restraint and giving too much weight

to interest rates.

2. Overestimating the speed with which restrictive fiscal action would be taken.

3. Overestimating the speed and size of the effects of fiscal action once it ~~is~~ was taken.

Although the true picture is undoubtedly mixed, we believe that there is much validity in this criticism.

Issues of 1969

At present we face the danger that monetary policy in 1969 will be either too expansive or too restrictive. ← Dul.

The Federal Reserve has estimated the rate of growth of the money supply in 1969 that would result from its intended policies. If this rate of growth of the money supply actually occurred it would probably be too inflationary.

On the other hand, the Federal Reserve does not manage its policies so as to bring about any chosen rate of growth of the money supply. What happens to the money supply is, by their lights, an accidental and unimportant by-product of action based on other signals. Thus there is a possibility that the behavior of the money supply will turn out to be quite different from their present expectations. In fact, the money supply in early February was a little below the December average. The period is too short to show clearly what is happening, but if this continued the result would be much too restrictive.

As the Federal Reserve has operated in the past the tendency will be to accentuate whichever of these errors occurs for a while before it is corrected. If growth is too rapid interest rates will rise, the Federal Reserve will think it is being too tight and its policy will become even more expansive. On the other hand, if growth is too slow interest rates will sag, the Federal Reserve will think it is not being tight enough and it will tighten further. In time the behavior of the economy will become clear enough to force a reversal of policy which, if it follows past patterns, may go too far.

We do not regard this ~~frightening~~ prospect as at all certain. However, we think it prudent to recognize the possibility. We shall be discussing these matters with the Federal Reserve. If we do not obtain more reassurance than we now have we will advise you further.