1965: The Year the Fed and LBJ Clashed

BY HELEN FESSENDEN

The storied showdown between Fed Chairman Bill Martin and President Lyndon Johnson wasn't just about personalities. It was a fundamental dispute over the Fed's policymaking role

Few challenges to the Federal Reserve's independence have ever matched the drama of Dec. 5, 1965. Fed Chairman William McChesney Martin Jr. had just convinced the Board of Governors to raise the discount rate amid signs that the economy was starting to overheat. Fiscal stimulus — increased spending on the Vietnam War, expanded domestic programs for President Lyndon Johnson's "Great Society," and a tax cut enacted in 1964 — had raised inflationary warning signals for Martin and, increasingly, a majority of the Federal Open Market Committee (FOMC). But Johnson was adamant that higher rates would slow down the economy and compromise his domestic agenda. Enraged, he called Martin and other top economic officials to his Texas ranch, where he was recovering from gallbladder surgery.

"You've got me in a position where you can run a rapier into me and you've done it," charged Johnson, as recounted by Robert Bremner in *Chairman of the Fed*. "You took advantage of me and I just want you to know that's a despicable thing to do."

President Lyndon Johnson and Fed Chairman William McChesney Martin Jr., in a more collegial moment, shake hands during a bill signing in September 1966.

Johnson was accustomed to getting his way — whether through bluntness or sweet-talking, as the occasion might require. But not this time.

"I've never implied that I'm right and you're wrong," Martin said. "But I do have a very strong conviction that the Federal Reserve Act placed the responsibility for interest rates with the Federal Reserve Board. This is one of those few occasions where the Federal Reserve Board decision has to be final."

Johnson finally relented, and Martin's refusal to back down is often considered one his strongest moments as Fed chairman. His relationship with the president was sometimes strained in the following years. But the 1965 showdown was seen as a tough lesson to Johnson that the Fed would flex its muscles when needed to push back against the inflationary pressures caused, in part, by his administration's own policies.

What is less often remembered in the popular mind is that the rate hike of 1965 did not, in fact, turn a corner on inflation. In the years that followed, fiscal stimulus was ample, war spending kept rising, and the deficit grew. But FOMC members were often divided, and their policy decisions reflected this ambivalence. Furthermore, while Martin saw monetary and fiscal policymakers as obligated to work together to promote price stability and growth, he discovered that dealing with this particular White House and Congress was often a one-way street. And even though the Fed was substantially upgrading its analytic capacity in the 1960s — hiring more Ph.D. economists, building up its research departments, and adopting forecasting — it didn't always translate into consistent monetary policymaking.

What this meant for the economy was that high inflation, so closely associated today with the 1970s, was already ticking upward in the 1960s. While it averaged only 1.5 percent a

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year from 1952 to 1965, it rose to an annual average of 4.5 percent starting in 1966. In 1969, it hit an 18-year high of 5.75 percent. In retrospect, many scholars now believe that the roots of the 1970s inflationary spiral can be found in the 1960s. The economic historian Allan Meltzer has described 1965 as a turning point on inflation. Robert Hetzel of the Richmond Fed, similarly, noted in his history of the Fed that "an explanation for the Great Inflation must deal with Martin's responsibility." Martin himself seemed to have grasped this, lamenting to his colleagues upon retirement in 1970, "I've failed."

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The Early Years

Martin's 19-year tenure saw historic changes at the Fed, and many scholars consider him one of the most influential Fed leaders ever. Named as chairman following the 1951 Treasury-Fed Accord — the deal that cemented the Fed's independence from the executive branch — he presided over a stretch of strong economic growth, interrupted by a few relatively short recessions, and low inflation for the next 14 years. During the administrations of Eisenhower and Kennedy, he generally had good relations with a White House that was mindful of the Fed's authority. His commitment to Fed independence and to a strong price-stability mandate was summed up in two of his most famous sayings: that the Fed's role is that of the chaperone who "has ordered the punch bowl removed just when the party was really warming up," and that monetary policy's mandate was to "lean against the winds" of either inflation or deflation.

Martin's background was not in economics but in finance. His father, William McChesney Martin Sr., had helped draft the 1913 Federal Reserve Act and later headed the St. Louis Fed. Martin Jr. started after college as a bank examiner for the St. Louis Fed and later moved to Wall Street. He got his first big professional break in 1938, when he was tapped as chairman of the New York Stock Exchange at the age of 31. Steeped in Fed history and culture, Martin Jr. was profoundly influenced by the failure of the Federal Reserve Banks to coordinate monetary policy effectively during the early years of the Depression, including the missed chance to prevent the 1929 crash from worsening into a recession in the first place. Martin also eschewed economic theory and preferred an "intuitive" approach to monetary policy, scouring the markets for clues on where interest rates, and the real economy, were heading. And until late in his tenure, he didn't see much value in economic forecasting.

Martin strongly believed that the Fed's core mission was price stability. But he also adhered to the view that the Fed and the other branches of government would work most effectively if they respected the interaction of their policy decisions. As part of this approach, he believed, the Fed had to communicate effectively with Treasury and Congress to achieve a common set of goals. Sometimes this meant that the burden of adjustment (i.e., tightening policy) was on the Fed, since Congress, as the democratically elected branch with the power of the purse, determined the course of fiscal policy, including whether to run deficits. "It is monetary policy that must adapt itself to the hard facts of the budget," is how Martin put it in a 1965 speech. "Not the other way around."

Priming the Pump

Martin's approach generally worked well during the administrations of both Eisenhower and Kennedy, even though Kennedy pledged to accelerate growth and lower unemployment and hired economists who were generally supportive of fiscal stimulus (for example, Walter Heller as chairman of the Council of Economic Advisers, or CEA). But Martin had to deal with a new administration in 1964. One of Johnson's first priorities was passing Kennedy's tax cut proposal, which Congress quickly cleared that spring. At the same time, Johnson sought to ramp up domestic spending. He also brought on a number of officials, including Gardner Ackley at the CEA and Henry Fowler to lead the Treasury Department, who he thought would support him in these efforts. This camp held that the Fed's primary role was keeping unemployment very low, around a target of 4 percent, and providing stimulus through low interest rates. Unlike Martin, they believed allowing a modest amount of inflation to reach low unemployment was not risky; as long as the economy had not reached full employment, it would have enough slack to keep wage pressures in check. And if inflation did emerge, they believed fiscal policy, rather than the Fed, was the most effective tool to manage it.

Martin was at odds not only with those officials in the executive branch, but also with some of his fellow FOMC colleagues. The appointments of George Mitchell (1961) and Sherman Maisel (1965) as governors effectively ensured a strong "dovish" plurality. Martin preferred to avoid tipping the scales during votes until he knew where a majority was heading, but as inflationary signs picked up, he increasingly tried to bring the Reserve Bank presidents — who generally were more independent — to his side.

By spring 1965, Martin became concerned that the stimulus of the past year was working its way through the economy, noting signs of rising demand for credit. Money market rates and bond yields were trending up. Meanwhile, the effective fed funds rate — what banks can charge each other for interbank loans — began to rise above the official discount rate — what the Fed charges member banks for loans from the Fed's discount window, as determined by the Board of Governors. (At the time, the Fed's preferred monetary policy tool was the discount rate; the fed funds rate didn't take on that function until the 1980s.)

To Martin, this indicated that the market was pushing short-term borrowing rates upward, and the Fed was behind the curve. Industrial wholesale prices were also rising after holding steady for four years, as was the money supply, which had expanded by an annualized rate of almost 6 percent by year-end. Martin typically did not focus on the money supply as an early indicator, but he was alarmed about the shift in market rates, and his public comments in the spring and summer began reflecting that. At the same time, he worried that he didn't have a majority of the Board behind him.

The Secret Surge

Another red flag to Martin was that Vietnam War spending began accelerating — and far more than the administration would let on. Johnson announced a massive troop increase in the summer of 1965 but withheld the actual, far higher, budget estimates from most of Congress as well as from the Fed. Johnson got some cover from Ackley, who said the economy could absorb the extra defense spending without risking inflation, but Martin had his doubts.

Through secret talks that autumn with Sen. Richard Russell, D-Ga., Martin learned that war spending was ballooning well above official numbers, by about 25 percent. At the same time, Johnson kept telling Martin that the Fed should hold off on any tightening until the White House released the next year's budget the following January. Martin was deeply reluctant to force a confrontation, but Johnson's dissembling in the matter made the Fed chairman skeptical that the budget would be accurate. (Indeed, when the White House released its budget, it asserted that Congress didn't need to raise taxes because the war would end in June 1967.)

Worried that the Fed would be acting too late if it waited until 1966, and that its independence might be compromised, Martin decided that early December was the time to act. On a 4-3 vote, the Board decided on Dec. 3 to lift the discount rate from 4 percent to 4.5 percent. That also allowed it to lift the ceiling on the prime lending rate that banks could charge to 5.5 percent (a limit known as Regulation Q, which the Fed gradually phased out starting in 1980). As Martin argued to his colleagues, and later to Johnson and to Congress, if the Fed had decided to keep short-term rates as low as 4 percent, it would have to flood banks with more reserves, increasing the risk of inflation.

The showdown at Johnson's ranch occurred two days later, and Martin held his ground. He also laid out his case in public statements after that meeting, emphasizing that the economy was in strong enough shape — with unemployment dropping close to 4 percent and labor costs holding steady — that it could weather the tightening well. He pointed out that it was a boost in credit demand, not rising wages, that was driving inflation, and he explained the Fed's decision as an adjustment to meet that demand.

The rate hike "is intended not to reduce the pace of the economy's expansion but to moderate mounting demands for bank credit that might jeopardize that pace by over-stimulating the economy," he said in a speech to an insurance conference in New York City shortly after the Texas trip. And given that the economy was close to full employment, he added, the risk was that "bottlenecks will develop in strategic areas so that large new injections of bank credit and money will serve to raise prices more than production."

The Tax Battle

But it wasn't enough. Martin and others on the FOMC soon became alarmed that inflation continued to rise despite the December 1965 hike. It reached 2.8 percent by March 1966, and the effective fed funds rate began to creep over the discount rate, by around a half a percentage point that summer. In July 1966, without the prospect of any action on taxes, the Board asked banks to ration credit rather than raising benchmark rates. This time, the move had broad support.

In the following months, Martin also made progress in another priority: getting high-level support to convince Johnson and Congress to raise taxes to pay for Johnson's programs. Higher taxes, Martin believed, would relieve the Fed of the need to tighten rates further to offset rising deficit financing. By fall 1966, both Ackley and Fowler began siding with Martin on this point, even though both were unhappy about the December rate hike. Still, Johnson continued to resist. Powerful fiscal conservatives in Congress wanted domestic spending cuts in return if they were going to raise taxes — and that was a bargain Johnson refused to consider.

The summer tightening of 1966 did dampen inflation temporarily but brought with it the side effect of a deep credit crunch. By spring 1967, Martin felt that inflation had slowed down enough to allow the Fed to dial the discount rate back to 4 percent — on the condition that Johnson would finally push his tax hike proposal in Congress. Again, the president resisted. It was not until spring 1968, when the Johnson administration and the Fed had to scramble to address a balance-of-payments crisis caused by destabilization in the gold market and a looming collapse of the British pound, that Johnson and Congress found the support to move the tax hike package. (It was also at this point that Johnson had decided against running for re-election.) But by then both interest rates and inflation were moving higher. In fact, starting in fall 1967, the Board had begun raising the discount rate again, and by July 1969 it reached 6 percent; the effective fed funds rate topped 10 percent.

What were the drivers of this inflation? To be sure, Johnson's policies produced a sharp rise in deficit spending, which Johnson failed to offset with higher taxes until the waning days of his presidency. From 1965 to 1968, the deficit jumped from 0.2 percent of gross domestic product to

2.7 percent. But the inflation of the 1960s also can be traced to the expansion of the money supply. From the mid-to-late 1960s, it grew at an annualized rate of 5 percent to 7 percent, well above the average of 4 percent in the first half of the decade. Among the newer Fed economists at the time, the growth of money supply was getting increasing attention as one indicator among several that merited consideration. But in terms of policy adjustment, the Fed didn't set targets for money growth as an intermediate step in controlling inflation; rather, economists were still debating how to measure it and what role it should play as an indicator.

The Changing of the Guard

Martin's term was set to end in January 1970, but with the election of Nixon, Martin feared his leverage would be diminished in his remaining months. Nixon had long resented Martin — believing that the Fed's tightening policy of the late 1950s caused the brief recession of 1960 and cost Nixon the election — and settled on the economist Arthur Burns to replace Martin. An awkward arrangement was reached in which Burns would succeed Martin as Fed chair once Martin served out his formal term — but until then, Burns would work for Nixon as a White House adviser. This close political relationship is one reason why many scholars, in retrospect, consider Burns' tenure to have been compromised from the start.

Many economists today view the 1970s a "lost decade" for monetary policy, when the Fed, under Burns, failed to craft a consistent and effective approach to address ever-rising inflation. As the data show, however, the inflation crisis began in the 1960s, with two important drivers in particular: strong stimulus on the fiscal side, including deficit spending, and the rapid growth of the money supply. Martin secured some temporary successes — like the 1965 rate hike and the 1968 tax increase — but inflation accelerated all the same. One constant challenge was that the increases in domestic and war spending were more substantial than initially expected. But the Fed's own efforts to control inflation were not always consistent, due in part to the Board's divisions; one example was Martin's decision to hold off until late 1965 to act, even though he had wanted to move earlier that year. Finally, Martin himself later admitted he may have placed too much emphasis on tax policy as a sufficiently powerful tool to reach his desired outcome, after the 1968 tax hike failed to have much impact on tamping down inflation.

Testifying before Congress in 1969, Martin addressed the issue of consistency, suggesting he regretted the Fed's decision to ease in 1967 in hopes of getting the tax hike. "[A] credibility gap has developed over our capacity and willingness to maintain restraint," he said. "We have been unwilling to take any real risks."

Some scholars also note the problems with the Fed's own approach. As a traditionalist who preferred studying the financial markets rather than formal models, Martin had parted company with many of the younger economists joining the Fed, who began assessing a broader range of indicators, including the money supply. But these refinements had not been fully incorporated into the FOMC's own decision-making during those critical years in the mid-1960s, as Meltzer noted in *A History of the Federal Reserve*. For example, rather than take note of the rapid rise in total reserves — the sum of all bank deposits and cash — and other monetary aggregates in late 1965 and early 1966, Martin focused primarily on the much smaller amount of free reserves — what a bank has on hand to lend — and short-term market rates.

"Martin had not raised the discount rate [in 1965] to reduce money growth," wrote Meltzer. Martin and his backers relied "on the decline in free reserves and the rise in the federal funds rate and other short-term rates. Once again, these indicators misled them."

The persistence of inflation weighed heavily on Martin in his final days as chair — so much so that at his lavish farewell party at the White House, he shrugged off a series of laudatory toasts. Instead, he offered an apology for the state of the economy. "I wish I could turn the bank over to Arthur Burns as I would have liked," he said. "But we are in very deep trouble. We are in the wildest inflation since the Civil War." He then sat down, to uneasy applause. **EF**

Readings

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