BC/LE

EXECUTIVE

FI 8

FG 233

FG 11-2

January 18, 1966

Note to Mr. Marvin Watson:

Attached hereto is a memorandum for the President, which is submitted at his request pursuant to a communication to us from Mr. Ackley.

Sherman J. Maisel

J. L. Robertson

Members of the Board of Governors
of the Federal Reserve System

Attachment

Nothing else sent to
Central Files as of 1/20/67

WHCF Bn/50

January 18, 1966

Memorandum for the President:

Subject: The Discount Rate Increase from Hindsight

The action had the immediate effect of leading borrowing rates upwards significantly without curtailing the expansion of bank credit. As a matter of fact, the expansion of bank credit increased after the action was taken. For example, business loans have expanded at an annual rate of 22 per cent since the discount action compared to an 11 per cent rate in the previous five months.

There has been a general increase of 1/2 per cent in the "prime rate" and in other loan rates. Treasury bill rates have risen 54 basis points in the three month maturity, but long term bond rates have only risen slightly because of a shortage of new issues over the year end. Banks do not pay interest on demand deposits (more than half of their liabilities), but they have increased the rates paid on certificates of deposit by 50 basis points or 1/2 per cent along with very minor increases in the rates paid on savings deposits - representing the bulk of bank time and savings deposits - where a legal ceiling of 4 per cent still prevails.

Memorandum for the President:--#2

We have no exact information on savings banks and savings and loans, but it appears that a major per cent of savings bank depositors will receive an increased rate of 1/4 per cent while only a small percentage of savings and loan depositors will get any increase.

Because larger savers, particularly those with over $5,000 in savings, will find better rates at banks and particularly in the United States Treasury bill market, the rate of growth in these other institutions seems certain to slow down. Scattered reports indicate this is true.

Although it is impossible to say what would have happened if another course had been followed, it is probable that expectations of still higher rates were whetted by the discount rate action. This may have intensified credit demands as well as increased manifestations of inflationary tendencies.

It is possible that over time the higher borrowing rates will dampen some credit demands. We would expect that rising rates will have a significant effect on house building, some on inventory accumulation (since some businesses will not get the money to increase their stock of goods) and eventually on investment in plant and equipment.

Memorandum for the President:--#3

However, this dampening probably will not be sufficient to cope with inflationary forces. It now looks as if it will be necessary to curb more sharply the availability of money and credit or reduce spending power through taxation. If monetary policy is to help control inflation, the rate of credit expansion must be slowed down. A more restrictive monetary policy will result in further increases in the interest rate pattern, pushing rates upward from the high levels triggered by the discount action.

When monetary policy is reversed, it will require a long time to reduce the level of interest rates to levels comparable to those we have experienced in the last few years. This means that we must learn to live with a higher level of interest rates across the board. We cannot immediately back up and change the course of action without serious repercussions.

Consequently, whatever level of interest rates may prevail at any given time, we must still design policies (monetary and non-monetary) to assure sustainable economic growth and relative price stability, both of which are essential to the preservation of our national economic strength and our position of leadership in the free world.

Sherman J. Maisel

J. L. Robertson

Members of the Board of Governors
of the Federal Reserve System