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SECRETARY OF THE TREASURY

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OCT 19 1967

TO THE PRESIDENT:

Here is our latest table on interest rates movements over the past few years. I receive an updated version every Friday and will be sending each one along to you.

Also attached is a memorandum dealing with the potential impact on interest rates of a failure to enact the tax surcharge and analyzing the table of interest rate movements.

Henry H. Fowler
Henry H. Fowler

Attachments

P.S. Marvin Watson said you wanted something on this order.
HHF.

Orig to Mrs. Lerrite

Major Interest Rate Swings Since July 1965
(In percent)

	Vietnam escalation begins 7/28/65	Discount rates rise 12/3/65	Peak yields Aug.-Sept. 1966	12/30/66	1967 Through 10/11 Low	1967 Through 10/11 High	Tax Message Aug3 1967	Latest 10/17/67
Treasury bills:								
3-month	3.81	4.12	5.59	4.81	3.33	4.85	4.15	4.67
6-month	3.88	4.26	5.98	4.92	3.71	5.10	4.68	5.17
12-month	3.90	4.30	5.94	4.84	3.80	5.22	4.99	5.24
Treasury coupons:								
1-year	4.00	4.42	5.99	5.00	4.07	5.34	5.08	5.41
5-year	4.15	4.52	5.89	4.80	4.38	5.52	5.19	5.62
10-year	4.20	4.52	5.51	4.64	4.45	5.42	5.20	5.49
20-year	4.21	4.44	5.12	4.58	4.44	5.29	5.06	5.40
Federal agency:								
1-year	4.28	4.60	6.36	5.49	4.35	5.69	5.39	5.74
New Aa-rated Corporate bonds	4.58	4.86	6.35	5.87	5.22	6.43	6.17	6.42p
New municipal bonds	3.25	3.50	4.24	3.77	3.40	4.25	3.91	4.33
New home mortgages	5.78	5.88	6.69 1/	6.66 2/	6.40	6.66	6.51 3/	6.55 4/

Office of the Secretary of the Treasury
Office of Debt Analysis

1/ This peak was reached on December 1, 1966.
2/ As of January 1, 1967
3/ As of August 1, 1967
4/ As of October 1, 1967
p Preliminary

monetary policy will become more definite—and tighter."
Actually, money will become more

1966 1967 est.
Data: Salomon Bros. & Hutzler

THE SECRETARY OF THE TREASURY
WASHINGTON, D. C. 20220

OCT 19 1967

MEMORANDUM FOR THE PRESIDENT

The question has been asked "What will happen to interest rates if we do not get the tax surcharge?"

All evidence and nearly unanimous opinion from responsible sources points to the conclusion that without the tax surcharge interest rates will rise markedly above today's already very high levels -- which in the long term area already exceed last year's record-breaking levels. It is difficult for me to understand why anybody who was concerned with high interest rates last year can do anything but strive for the early enactment of your tax proposals this year.

There is no significant dissent as to the direction of interest rate movements or the conclusion that their movement upward will be more than moderate in the absence of the adoption of your tax proposals.

Among the experts there is an unwillingness to put a precise price tag upon the future cost of credit in the event the tax bill does not become law.* Part of this reluctance to forecast reflects the fact that a failure to pass the tax bill is almost beyond the comprehension of the experts because to them the need seems so clear and urgent. Another reason for not making a specific forecast is the difficulty of pricing-out not only all the factors of money market supply and demand but also an inability to price the wild card called "expectations".

Indeed, I have seen only one public reference to quantitative estimates. In a Business Week article in the issue of September 30 (see Attachment A) entitled "Is a Money Crunch On Its Way?" there is the following excerpt:

> "Prices. In contrasting money market conditions that lie ahead with 1966, economists stress the expected impact of inflation itself. During late 1966, the wholesale price index remained relatively stable. But if price increases get larger in coming months, interest rates are almost sure to climb.

* See Attachment B

"'People who borrow under conditions of sharp inflation are willing to pay any amount for money,' says Milton Friedman of the University of Chicago, 'and people who lend ask high rates to protect themselves from loss of purchasing power.' If the Fed doesn't tighten, Friedman expects prices to rise by at least 5% and possibly 7% during 1968 and predicts that interest rates will be in the '9% to 10% range.' While most economists won't go that far either on prices or interest rates Lawrence Ritter, a New York University economist, talks of an 8% interest rate 'if the tax bill doesn't pass.'"

With this exception, the experts resist any inclination even to estimate the range of rise in interest rates that would be ahead without the surcharge. Looking at the recent past and the unprecedented impact of Federal credit demand and the supply demand relationships in the credit market, they view the situation as too unusual to make quantitative estimates.

I am attaching a series of statements from the experts.* Most of them were made in the recent hearings of the House Ways and Means Committee. These comments from economists and experts of a variety of backgrounds support, in no uncertain terms, the statement in your August Tax Message that without a tax increase there would be a damaging spiraling upward of interest rates.

<u>Recent Experience</u>

The attached record of interest rate swings since July 1965 shows the following:

1. During the fall and spring money market rates on Treasury bills moved from their peaks in August and September 1966 back to levels below the rates existing on July 28, 1965 when you made your announcement on Vietnam. Rates on Treasury coupon issues moved down from their August and September peaks to within a quarter of a point of the levels existing in late July 1965. The same is true of agency issues and municipal bonds.

2. However, long-term private bond rates and new home mortgage rates, while they declined very markedly from their peaks of last August and September and during the early part of the year, did not even approach the levels existing at the time of your Vietnam statement in 1965. They have proved somewhat

*See Attachment B

2nd half 1966

2nd half 1967 est.

Data: Salomon Bros. & Hutzler

Once these questions are clarified, monetary policy will become more definite—and tighter."

Actually, money will become more

"sticky" in their movement downward even in the light of a very expansive monetary policy, the sharp inventory adjustment downward that gave a flat tone to the economy in the first six months of this year, and the prospect of a tax increase announced in your January State of the Union Message.

3. The movement downward of interest rates from their peak levels of last August and September, which followed close on your September 1966 Message to Congress and the fiscal steps and monetary steps that followed moving to fiscal restraint and the shift in monetary policy from restraint to ease, had bottomed-out in all sectors of the market by June and rates began to move up in all sectors of the market.

4. In the two and one-half month interval since your recent Tax Message to Congress on August 3, interest rates have climbed appreciably. In the long-term area -- for 20-year government, new AA-rated corporate bonds, and new municipal bonds -- the yields are now higher than they were at the peak of the credit "crunch" in August-September 1966. In the short-term area money market rates have moved up sharply since June to a point where the gap is narrowed to a dangerous point between present levels and the risk of serious "disintermediation". Failure of Congress to act has already contributed to the movement upwards to a point where the pound is seriously involved. And the rationing of credit through high interest rates is already ruling out certain local communities from the money market and forcing the postponement of projects they had planned. (See Attachment C.)

<u>Federal Credit Demands Without The President's Tax Proposals and Supply Demand Relationship In The Credit Markets</u>.

Our Treasury experts point out that if we assume no tax increase and only a modest success in restraining expenditures, we face a fiscal 1968 deficit upwards of $23 billion. This could necessitate a $20-22 billion net demand on private credit markets to meet Federal needs in Fiscal 1968.

When one remembers that our Federal demands on private credit sources was a negative $6 billion in Fiscal 1967, one sees a change from a minus 6 to a plus 20 to 22 -- or a swing in Federal credit demand of roughly $27 billion.

Once these questions are clarified, monetary policy will become more definite—and tighter."
Actually, money will become more

2nd half 1966 | 2nd half 1967 est.
Data: Salomon Bros. & Hutzler

To what does one relate this $27 billion swing in Federal credit demand? Not to a $800 billion GNP as some would. It is a component of net credit demands upon our savings and capital markets. These demands totaled about $60 billion in Fiscal 1967, but with Federal credit demand a negative $6 billion, over $65 billion of private credit needs were supplied.

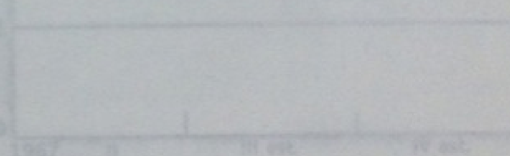
But look what happens to the supply and demand picture in Fiscal 1968 if we added over $20-22 billion of Federal needs to private demands of $65 billion or more. More than $85 billion would be needed on the supply side. These supplies just aren't likely to develop with or without an expansive monetary policy and the supply shortfall would have to hit some private sector requirements -- a $10-20 billion reduction in private credit financing from Fiscal 1967 to 1968 illustrates the possibilities. Thus our $20-22 billion financing need, without a tax increase, is not 2½ percent of an $800 billion GNP, but is 25-30 percent of a $65-75 billion supply of credit.

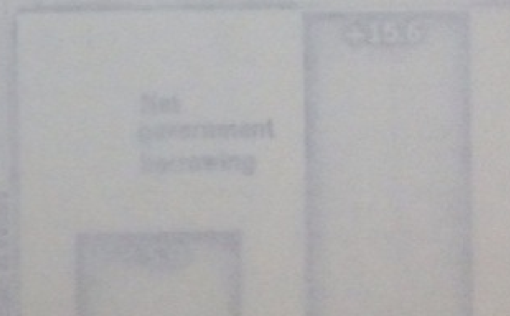
Against this backdrop -- which is the real world -- the prospective inflow on a fiscal year basis of an additional $10 billion in revenue resulting from your tax measures has very sharp relevance to the future of the credit markets of our nation -- the avoidance of a credit crunch or sky-high interest rates that are bound to dislocate both the national and international economy.

Henry H. Fowler

Henry H. Fowler

Attachments





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2nd half 1966

2nd half 1967 est.

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The citation for the original is:

Business Week, “Is a Money Crunch on Its Way?” September 30, 1967.

B

STATEMENTS OF EXPERTS BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ON INTEREST RATE PROSPECTS IN THE ABSENCE OF A TAX SURCHARGE

William McChesney Martin, Jr. (9/14/67, Chairman, Board of Governors of the Federal Reserve System

"Inasmuch as long-term interest rates for corporate and municipal borrowers have already moved up, partly in fear of over-reliance by the Government on monetary restraint, confirmation of that fear could stimulate a scramble for funds that would drive interest rates to unprecedented levels."

Walter B. Wriston, President, First National City Bank (9/13/67)

"If the Federal deficit is permitted to balloon without the tax surcharge the additional Treasury borrowing will push interest rates higher. ... The ingredients we are looking at here -- burgeoning credit demands, inflationary pressures, a huge Federal deficit and need for credit restraint -- could cause critical disorders for the nation's credit institutions."

Douglas Dillon, former Secretary of the Treasury (9/13/67)

"Without a tax increase we face the alternatives of further sharp increases in prices or a period of tight money and higher interest rates that could make last year's experience look like a picnic. Neither course is acceptable."

Otto Eckstein, Harvard University (9/12/67)

... "long-term interest rates are extraordinarily high now, and we are only in the sixth month of the renewed expansion. Where will interest rates be six months from now? Without a tax increase on the books before the Congress adjourns this year, I shudder at the prospect."

Joseph Pechman, The Brookings Institution (9/12/67)

"The economic situation that lies ahead is not identical to that of 1966, but the similarities are clear enough. Without a tax increase there will be another episode of tight credit and 'disintermediation', another threat to the stability of the money and capital markets, and another squeeze on the housing industry."

Raymond J. Saulnier, Columbia University and former Chairman of the Counsel of Economic Advisers under President Eisenhower (9/12/67)

"Contemplate for a moment what would be involved if money policy were to take a turn toward tightness. It is not necessary to think of a turn as abrupt as that taken in 1966, when money supply stopped increasing altogether and created a near-crisis in financial markets; all one needs to posit is a significant reduction in the rate at which money supply is increasing. The result would be to escalate interest rates to levels well above even the record heights at which they are currently perched: to stir the money markets into the turbulence nowadays called 'disintermediation'; to reverse the revival of the housing industry; and to bring the recovery, so far only a timorous one, to a halt."

Although he did not appear before the House Ways and Means Committee, the recent comment of Mr. Sidney Homer, a noted expert from Salomon Brothers & Hutzler, is pertinent:

"What if the Congress fails to pass the surtax, or unduly postpones it, or cuts it down importantly? If my earlier credit analysis is correct, the answer I believe is obvious. Even larger Treasury credit demands would be matched by even larger private credit demands and at the same time monetary policy would be forced to a restrictive posture. Soaring short-term interest rates would quickly slowdown deposit flows and bring housing to a halt. A full-fledged credit crunch would be avoided only by direct Government intervention to ration credit (or scarce materials) to needy areas. Furthermore, the apprehension of such thing to come might create

a stampede of business borrowers to market which would hasten and exaggerate this sequence of events.

"I do not believe this will happen. If Congress delays or compromises, an anticipated rise in rates and in market pressures will make the lesson plain to the most reluctant legislator. In other words, there will then have to be two painful pieces of tax legislation in quick succession instead of one.

"There is some specious talk of another option -- just sitting back and enjoying a burst of inflationary prosperity by accepting the cruel fact that restraint is politically impossible in an election year. There is no such easy option. Some inflation is in prospect, stemming from fiscal errors in 1965, 1966 and 1967, but this can be limited by early fiscal restraint. But sustained unchecked inflation will lead at a very early date to distortions and stoppages in our capital markets and in our credit consuming industries so severe as to make a mockery of the word prosperity and thus wreck the political futures of its sponsors."

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The citation for the original is:

Associated Press, “Bonds-Interest,” [from the AP News Wire], October 19, 1967.