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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

January 18, 1966

MEMORANDUM FOR THE PRESIDENT

Subject: The Hike in the Discount Rate Revisited

1. Developments in money and credit markets since early December reinforce our judgment that the discount rate hike was badly timed and poorly handled. However, the booming state of the economy makes it clear that money shouldn't be any easier and may have to get still tighter to help keep things from boiling over.

2. Short-term interest rates have taken a huge jump since the discount rate hike.

   - Yields on 3-month Treasury bills are now at an all-time peak of 4.6%. They have gone up even more than the 1/2 point rise in the discount rate.

   - Intermediate Treasuries are now at 4.87%, up 1/3 of a percentage point from the beginning of December.

3. In contrast, long-term rates have had a surprisingly small rise.

   - Long-term Treasuries have increased in yield from 4.36% to 4.42%.

   - Newly issued corporate and municipal bonds are up even less, by .02 to .05 percentage points.

   - However, mortgage rates -- which were beginning to get unstuck before the discount move -- have increased more significantly.

4. The Fed did not slow down the growth of credit in December, partly because they didn't try to, and partly because demands were so strong. Total bank credit rose by a strong $2-1/2 billion; and business loans from banks scored one of their largest monthly increases of the year.

Nothing else sent to
Central Files as of 4/30/66

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5. Because it was so badly handled, the Fed move had all the wrong effects on expectations.

   - Some businessmen concluded that inflation must be here, since the Fed seemed so panicky.

   - Borrowers guessed that still higher interest rates were in the wind. This may have actually added to demands for credit and accelerated the rise in short-term rates.

6. The Fed move has had widespread financial effects -- some good, some bad.

   - Businesses are gaining profits from the higher yields on their certificates of deposits.

   - Depositors in 500 savings and loan associations have benefited from increased dividend rates.

   - On the other hand, the tight mortgage market is creating problems for FNMA and FHA programs, as you well know.

   - Treasury financing will cost an extra $350 to $400 million for fiscal year 1967, as a result of the increases in interest rates in the past 6 weeks.

7. It is too soon to tell whether the Fed's move will help to slow down overactivity in inventories and construction.

   - First of all, economic returns come in slowly. Six weeks after the tax cut, the figures did not demonstrate whether it was stimulating demand.

   - Moreover, monetary policy itself hasn't really settled down yet. As always, the Fed has so far cushioned the initial blow of the discount hike by easing up on free reserves. The key decisions are still to come.

   - If the result is a moderately tight policy, it will not have dramatic effects on the economy -- but it could take some of the edge off the investment boom.

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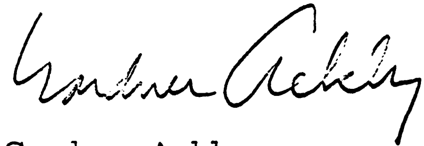
- The economy had a tremendous surge at the close of 1965, and a somewhat slower pace would be welcome.

- A housing slowdown would be less welcome, but most construction workers will keep their jobs, since nonresidential building is soaring.

- To help keep prices in bounds while defense spending forges ahead, some further restraint from monetary policy may be needed in the months ahead.

- We don't have to bless high interest rates publicly, but we will have to live with them, at least for awhile.

8. The main thing now is to be sure they are promptly reduced once the need is past.



Gardner Ackley

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