BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON

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MEMBER OF THE BOARD

July 13, 1966.

MEMORANDUM FOR THE PRESIDENT:

A Better Mixture of Monetary and Fiscal Policy Would Be Advantageous

I agree with major parts of Representative Ullman's letter:

> Interest rates except at a disastrously high level cannot halt inflation.
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> A temporary repeal of the Investment Tax Credit and increased income and profit taxes would reduce the pressure on interest rates.
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> The housebuilding industry, without additional aid from the Government, will probably sink to an undesirably low level.
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> Excess investment in plant and equipment--potentially the most destabilizing of all expenditures--has not been slowed.
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> Higher interest rates may account for 10 to 20 per cent of the increase in prices since last December. This is probably less than Representative Ullman believes to be true.

Monetary Policy Has Not Been as Tight as Most Believe. It Has Some Accomplishments to Its Credit

An extreme excess of demand for money rather than a curtailment of supply has caused the apparent credit shortage. Between December 1965 and the present, the money supply expanded at an annual rate of 5.4 per cent, member bank credit at a rate of 8.5 per cent, and business loans at a rate of 24.3 per cent. All are growing at record-breaking rates far above normal.

Higher interest rates and the failure of credit to expand as rapidly as demand has had some positive effects. It has eased pressures on the Voluntary Foreign Credit Program. It has reduced some construction and investments of smaller businesses. It may have lowered individual spending slightly.

In a period when demand rises faster than supply, the Federal Reserve should attempt to hold credit creation to normal levels. Such a policy makes credit a neutral rather than a positive force increasing inflation.

What Governmental Actions Are Possible?

Action should be taken both to help hold (or perhaps roll back) interest rates; and also to deal with related specialized problems.

A bill giving the Fed, FDIC, and FHLBB the right to set a ceiling on consumer-type savings and CD's at 5 per cent would be useful.

An increase in taxes, particularly the repeal of the Investment Tax Credit, would do more good than anything else.

The housebuilding industry will be in trouble. Immediate legislation should be requested to give FNMA the right to lend $2 billion under its special assistance functions (Title 12, section 1720, U.S.C.). The proposed increase in FNMA secondary market operations under present procedures will be but slight help. The mortgages purchased under the special assistance program can be rolled out through participation certificates so as to have a minimal administrative budget impact.

Necessary legislation should be requested and action taken to separate the United States from foreign capital markets. Unless they are separated, our domestic interest rates will be dominated by foreign central bank decisions. We need a variable tax on all new foreign investment plus other balance of payments action.

Consideration should be given to a voluntary credit restraint program for domestic lending by United States commercial banks.

Another Increase in the Discount Rate?

The present relationship between the discount and money market rates is unstable. Policy action to stabilize the situation should be taken within the next week. My own preference is for a public statement by the Federal Reserve Board that it sees no need to raise the discount rate. We should announce plans to live with member bank borrowing of one to two billion dollars if necessary. This policy would aim at using the discount window administration to influence banks to curtail the rate of loan expansion.

On economic grounds, a decision to raise the discount rate or not is nearly a toss-up.

> It might have bad announcement effects causing another rush for credit and a further escalation of interest rates.
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> It would be bad politically both for the Federal Reserve and the Administration.
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> A move following directly any increase in the United Kingdom's rate would look like a reaction to their action. If the market gained the impression that the Board had to follow blindly the pressures of the money market and foreign central banks, expectations in the future would be harder to control.

I judge that the other members of the Board will vote to raise the discount rate. If they do, I will probably join with them. Making an action unanimous at this time will lend it credibility. It may also reduce its bad side effects. By joining the majority, I will have more influence on the public policy statement.

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