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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

June 24, 1968

MEMORANDUM FOR THE PRESIDENT

Subject: Background and Suggested Agenda for Quadriad Meeting

1. How much fiscal restraint do we now have?

. Current estimates point to a swing in the Federal budget of $15 billion or more. On the national income basis, the present deficit rate above $10 billion should shift to a surplus rate of $5 billion in the first half of 1969.

. When the Eisenhower Administration ran an $8 billion budget swing from a deficit in the first half of 1959 to a surplus in the first half of 1960, we called that "fiscal drag." Even as a percentage of GNP, the shift to restraint in the coming year is scheduled to be as large as that of 1959-60.

2. What is the economic outlook with this degree of fiscal restraint?

. The economy will finally get its much needed cooling off. This looks as certain as an economic forecast can be.

. Real growth over the coming year will probably be at only a snail's pace, less than half as fast as in the past year. Unemployment is likely to rise above 4 percent in early 1969.

. Indeed, there is a risk that we will slow down too much, unless the effects of fiscal restraint are cushioned by an upturn in homebuilding activity later this year. Our projections count on

-- a 10 percent rise in housing over the coming year, with

-- housing starts above 1.5 million (annual rate) in the second quarter of 1969.

3. <u>What about prices and the balance of payments</u>?

- We can't expect that either of these problems will be solved overnight. But as the economy cools off, we should gradually see signs of progress

  -- back toward a 3-percent rate of price increase by next spring; and

  -- in slowing the growth of imports brought on recently by overheated demands.

- The tax surcharge should give a big lift to world confidence in the dollar as well as an improvement in our trade position.

- On the price front, the Government's house is back in order. It's now up to business and labor to do their part too, and they will need to be reminded. Steel, autos, and railroads are some of the key problems we expect in the months ahead.

4. What has been happening in financial markets?

- Interest rates have already come down significantly from the peaks reached during the mid-May logjam on the tax bill. Some short-term rates have dropped half a percentage point since then.

- But rates remain high even by standards of early 1968, as shown in the table.

	January 1968 Low	May 21-24 High	June 21
Treasury Issues			
3 month bills	4.82	5.90	5.20
6 month bills	4.98	6.05	5.48
3-5 year issues	5.43	6.17	5.55
Long-term bonds	5.08	5.54	5.12
New Aa-rated corporate bonds	6.55	7.09	6.97
Long-term municipal bonds	4.25	4.71	4.43

- And the banking system remains under pressure from strong mid-year credit demands.

- Credit demands will be enlarged in the weeks immediately ahead by Treasury needs and by corporate financing of the extra tax payments required by the tax bill.

- Banks also face a squeeze stemming from possible losses of CD's which mature in heavy volume in coming weeks.

5. What are the prospects for mortgage markets and housing?

- Homebuilding activity was well sustained through the first four months of the year. But there are signs of weakening, since

  -- new mortgage commitments have slackened,

  -- housing starts dropped by 16 percent in May, and

  -- mortgage rates on new homes reached 7.15 percent in June, up .45 percentage points from the start of the year.

- Savings and loan associations and mutual savings banks also remain under pressure. Although they have had some net deposit inflow in recent weeks, the pace is slow. The outlook is for fairly sizable withdrawals at the mid-year interest crediting period.

- To assure an adequate volume of mortgage funds, the competitive position of thrift institutions must improve relative to open market securities. This requires

  -- lower interest rates on securities, particularly short- and intermediate-term ones; and, to get that result,

  -- a step-up in the expansion of bank credit from the pace of recent weeks.

6. What are the key elements confronting the Federal Reserve in charting the course of monetary policy?

- The main consideration favoring a turn toward ease is the need to avoid an excessive slowdown in the first half of 1969. That is when the effects of fiscal restraint will be most severe. Credit is very tight now, and it takes months for changes in policy to affect spending significantly. Prompt timing could thus be critical, even though current movements of prices, the balance of payments, and economic activity are not calling for relaxation.

- The desirability of protecting homebuilding from further distress and of avoiding acute pressures on thrift institutions also points in the easing direction.

- Up to now, monetary restraint has been the only defense against inflation. It makes sense to reduce monetary restraint when it is joined by fiscal restraint.

- The need to combat inflationary psychology is an argument against excessive and abrupt easing. We all want our determination to curb inflation to be crystal clear. Prices are bound to keep rising for some time after the surge in spending ends, regardless of what monetary policy does.

- International reaction is the other concern that must be recognized. The confidence in the dollar generated by the tax bill might be dissipated by a drastic monetary easing that seemed irresponsible.

- The way the Federal Reserve adds up the factors above will determine how fast and how far monetary policy shifts toward ease.

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