July 7, 1963

MEMORANDUM FOR THE PRESIDENT

Subject: Proposed Discount Rate Boost

Since thinking on the proposed hike in the rediscount rate may begin to jell this week while I'm in Paris, I thought it best to jot down the following thoughts before taking off Tuesday.

I won't comment on (1) the possible political costs of this move (e.g., will it sour Russell Long completely on the tax cut?), nor on (2) the Administration's vulnerability if the expansion now slows down for whatever reason (i.e., the weakening of our argument that we did not repeat the monetary-fiscal mistakes of 1957 and 1960).

The Quadriad group is agreed that there are ways and means of cushioning the domestic impact of an increase in the discount rate to 3-1/2 percent. But the conditions for success -- i.e., for favorable balance-of-payments effects with little slowing down of domestic expansion -- are most rigorous:

1. The Fed has to buy vigorously in the long-term market and, if necessary, sell bills at the short end -- in other words, pursue a "twist" policy with a vengeance, and keep total reserves growing.

2. The Treasury has to cooperate fully by raising new money through the sale of bills; buying long-term securities for the trust accounts; and not refunding into long-term maturities.

Still, as the professional guardian of the Kennedy expansion, I have to resolve my misgivings by voting "no" on the discount rate rise -- not because one can't reduce its drag on the domestic economy to negligible proportions, but because I'm afraid we won't.

That is, I'm afraid the monetary authorities won't find it "feasible" to twist with enough vigor and rigor to keep long-term rates down and money availability up. Even with no lack of will and intent, the monetary authorities operate under conflicting pressures and constraints:

-- pressures to lengthen the debt;

-- pressures to finance the deficit out of "genuine savings";

-- Bill Martin's possible difficulties in controlling the Open Market Committee and the Federal Reserve Board;

-- the Fed's reluctance to "buy long," buttressed by the asserted "thinness" of the market for really long-term securities;

-- the Fed's fears of inflation as we encounter the inevitable tremors on the price front which accompany expansion.

So I'm afraid that even the best of intentions will founder, that the monetary authorities are likely

(a) to encounter "unexpected developments" and

(b) to tire of the twist before dawn.

But if you do decide to say "yes" on the discount rate boost now, your blessing should be accompanied by an understanding signed in blood that the Fed <u>will</u> buy long (real long) and that the Treasury <u>will</u> sell and refund short (i.e., bills, not bonds) -- plus an understanding that if the actions to boost the bill rate (under the higher rediscount umbrella) <u>do</u> trigger long-term increases, these actions will be abandoned or reversed.

Let me add that I don't view the "independence of the Fed" as a barrier to full Presidential control of these decisions and commitments, for two reasons:

1. A considerable part of the monetary power rests securely and squarely in the hands of the Treasury through its debt and trust management operations.

2. Most of the remaining power -- in the form of open market (reserve) operations and rediscount rate control -- also rests effectively, though more obliquely, in the hands of the Treasury through the cultivated co-operation that Doug Dillon and Bob Roosa have won from Bill Martin. To its great credit, the Treasury has thus captured for you effective control of monetary policy.

Walter W. Heller

WWH/deg
cc: black book
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