The original documents are located in Box C11, folder "Presidential Handwriting, 1/27/75 (4)" of the Presidential Handwriting File at the Gerald R. Ford Presidential Library.

[PU 2-3 EXEC]

RETURN TO ROOM 84

Gary Jones

Suggest it be referred

To Al Greenspan or ask that

he chat with me about it

GRF

THE WHITE HOUSE

WASHINGTON

January 22, 1975

MR. PRESIDENT:

The attached letter is forwarded for your information and will be handled routinely unless otherwise indicated.

JHJones

Jerry H. Jones
Staff Secretary

UNIVERSITY OF VIRGINIA
JAMES WILSON DEPARTMENT OF ECONOMICS
CHARLOTTESVILLE
22901

ROUSS HALL

January 20, 1975

President Gerald Ford
The White House
Washington, D.C. 20000

Dear Mr. President:

At the last Cabinet meeting before my departure from the Government you invited me to return when I felt that I should give you some advice. I replied that I thought that I would wait until the inflation blew over before I gave any more advice. The inflation has not blown over, but I am impelled to put some thoughts before you anyway.

I fear that the economic program which has been announced is too weak, comes into effect too late and lasts too short a time to put a floor to the economic decline and initiate a safe recovery. I hope that you will consider moving to a moderately more expansive policy if the opportunity arises.

It may be that you have decided it is worthwhile in order to assure a sharp and lasting cut in the inflation rate to see the unemployment rate rise to more than eight percent and stay there for one-and-a-half or two years. Although I would consider that a risky decision, I do not think it could be rejected as resulting from bad economic analysis. However, I have the impression that the decision to recommend only a small and temporary net tax cut results from fear of deficits which in turn results from two related doubtful pieces of economic argument, both reflecting all-or-nothing thinking.

1. Some people seem to be saying that an enlarged budget deficit will not be expansionary, and will not reduce unemployment, because the borrowing to finance the deficit will drive private borrowers and investors out of the capital markets. Ironically, this is precisely the argument used by the British Treasury in the 1920's, which came to be known as "The Treasury View", and which helped to consign Britain to a serious depression.

There are three main views on this subject, which have, at different times, dominated professional thinking.

The oldest view is that the Government securities that finance the deficit would all be bought by people who would otherwise make private investments, and interest rates would rise to the point where a volume of private investment equal to the deficit is crowded out. This is the old British Treasury view.

In the late 1930's, following Keynes further than he intended, many economists went to the opposite extreme. They denied that the deficit would displace any private investment. In their opinion all of the additional borrowing by the Treasury would be financed by people who would buy Treasury securities instead of holding money.

But gradually economic thinking settled down to an intermediate view that both effects would take place in some degree. That is, the Treasury borrowing would displace some private borrowing but that displacement would not be 100 percent. Some of the borrowing would be financed out of existing cash balances. There would be a net increase in total spending as a result of the deficit, but that net increase would not initially be as large as the deficit.

What proportion of the Treasury borrowing displaces private borrowing will depend on the state of the economy. When the economy is depressed the displacement of private borrowing will be small. The private demand for credit at such times is weak. Although long-term interest rates may remain high, because lenders expect more private demand for credit later, when the recession is over, in the meantime funds are available at those rates. And there are plenty of short-term funds available at low interest rates.

You should beware of calculations which show that, despite the recession, private credit demands will absorb all the available funds. This will always be true if the government doesn't run a deficit. If private investment is weak and net private credit use is small the economy will sink to a level where savings are small enough to match the investment. Then people will be able to point to the fact that there were no excess savings to finance a government deficit. But that will be true only because the economy was allowed to fall into a deep recession. If there had been a government deficit the national income would have been higher and savings would consequently have been higher, to finance a larger total of private and public borrowing.

How much of the Treasury borrowing displaces private borrowing and investment will depend in part on how generously the Federal Reserve provides additional money. The more money, the less displacement there will be.

2. This brings me to the second, and more obvious fallacy, which seems to be common in Washington and downtown New York today. It is the idea that if the Federal Reserve doesn't finance the deficit the deficit will have no effect or even be depressing whereas if the Federal Reserve does finance it the result will be wild inflation. This implies that there is no course between the Federal Reserve financing everything and financing nothing. But if zero financing is too little and 100 percent financing is too much there is presumably something in between - 25%, or 50%, or 75% - which is just right.

In fact, this whole way of looking at things is archaic. The basic point is that to get a reasonable, safe recovery we will need a substantial increase of the money supply - perhaps a 10 or 12 percent rate of increase of M_2. Whether the Federal Reserve brings this about by purchasing Treasury securities or in some other way is of secondary importance.

I think I was the first to use the expression "the old-time religion" to describe the economic policy of early 1974. But I also said that the old-time religion did not call for self-immolation. I fear that we are on a dangerously contractionary course. I hope you will ask your advisers to think this over again.

Thank you for sending the bound copy of your swearing-in remarks, which Mildred and I appreciated.

Please be assured of my respect for the way in which you are bearing your heavy burdens and of my sincere wishes for your success which will be the success of the Nation.

Herb Stein

Herbert Stein

HS/ceu

THE WHITE HOUSE

WASHINGTON

January 27, 1975

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: ALAN GREENSPAN

FROM: JERRY H. JONES

The attached material was returned in the President's outbox with the following notation:

> -- Suggest it be referred to Al Greenspan and ask that he chat with me about it.

Please follow-up with the appropriate action.

Thank you.

cc: Don Rumsfeld

original to Greenspan