

**The original documents are located in Box 3, folder “Economic - Deficit Financing and Capital Markets” of the Richard B. Cheney Files at the Gerald R. Ford Presidential Library.**

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February 3, 1975

**MEMORANDUM FOR: SID JONES**  
**FROM: DICK CHENEY**

Sid, some time ago you mentioned the possibility of forwarding me a copy of a memo you did on deficit financing and the capital markets.

I don't believe I've received it yet, and would appreciate seeing a copy.



THE WHITE HOUSE

WASHINGTON

January 12, 1975

MEMORANDUM FOR WILLIAM SIMON

We have all been concerned about the prospective level of the Federal deficit and the financing of that debt.

So that we may consider this issue fully, I would appreciate it if you would provide me with your personal analysis of the effect on credit markets of the various possible levels and timing of Federal financing.

I would be particularly interested in seeing:

1. Realistic quantitative data of actual and prospective credit supply and demand;
2. The calculated effects on interest rates and on the private sector of Federal borrowing and attendant money supply actions; and
3. The specific alternatives you see and the consequences of them that you feel we should consider.

I would like your thoughts on these matters by Tuesday, noon, so that I will have time to study them before I present the State of the Union. Also, I would like you to include any thoughts Alan Greenspan, Bill Seidman and Roy Ash may have in an attachment. Unfortunately Arthur Burns is overseas at the moment.

I look forward to hearing from you.

Honorable William E. Simon  
Secretary of the Treasury  
Washington, D. C. 20220



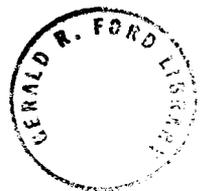
MEMORANDUM

THE WHITE HOUSE  
WASHINGTON

January 15, 1975

FOR: DICK CHENEY  
FROM: DONALD RUMSFELD

Here are Simon's answers to the memo the President sent him. Hold that until we get the Ash memo today, and then we will send the Simon answers to the President's memo and the Ash memo in together.





THE SECRETARY OF THE TREASURY  
WASHINGTON

MEMORANDUM FOR THE PRESIDENT

Subject: Deficit Financing and the Capital Markets

I am deeply troubled by the size of the demands that the Federal Government will be placing on the financial markets this year. Normally, financial conditions ease very substantially in a recession, and normally they remain fairly easy for some time after the economic recovery gets underway. This happens because private demands for credit fall off at the same time that the Federal Reserve moves to maintain or increase the rate of growth in money and credit. Accordingly, interest rates decline and credit becomes more readily available -- all of which is a part of the process by which the economy pulls out of a recession and gets back on the road to prosperity.

This process has been underway since late summer. Interest rates have declined in both the short-term and long-term markets. I have doubts, however, whether the decline will continue.

In the first place, pressures on the financial markets from the private economy are heavier than normal for a recession. Business demands for credit have been and are being raised by the inflation itself. They have been raised further by the fact that for years most corporate managers have been relying on short-term rather than long-term debt, and on debt rather than equity, to the point where their balance sheets are seriously out of kilter. With the stock market so low that many issues are selling well below book value, new equity financing is not a feasible source of funds. Therefore, there is an unusual demand -- unusual for this stage of the business cycle -- for new long-term debt issues.



The second factor is the Federal Government. Our present estimate is that we will be coming into the capital markets for almost \$70 billion of net new financing this year. That is an enormous sum. In each of the years 1972-74 Treasury and Federal agency net requirements totaled between \$25 billion and \$30 billion. Perhaps the best way to grasp the enormity of this year's requirements is to note that this year the Federal Government will be raising more net new money in the capital markets than the entire net amount raised in those markets by all borrowers last year -- indeed, more than in any previous year.

Capital Market Financing\*  
(billions of dollars)

	<u>Total Funds Raised</u>	<u>Treasury and Agencies</u>	<u>Percent of Total</u>
1972 (actual)	\$ 52.2	\$24.6	47.1
1973 (actual)	53.2	29.3	55.1
1974 (estimated)	66.1	28.6	43.2
1975 (projected)	109.3	68.8	62.9

\* includes corporate and government securities but not mortgages or bank loans and other short-term credit. Figures represent new financing, net of retirements.

The financial consequences of the large Federal demand can work out in a variety of ways. Compared to our present expectations, for example, if the recession is deeper, inflation subsides more, the OPEC nations put a larger amount of their accumulating funds into investments in this country, and/or the American people save more and spend less of their tax rebate -- then the deficits can be financed without difficulty and interest rates could even decline farther. Moreover, many financial economists expect this to take place even with a set of economic projections similar to our own.

I believe, however, that there is a clear danger that interest rates will rise sooner and faster and further than otherwise, and that the Federal Government will crowd other borrowers out of the market.

-- Housing is usually at the end of the line in the credit markets and thus the first sector to be crowded out. I believe the recovery in housing starts we have been anticipating will get underway, but I also believe there is a real



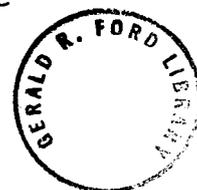
possibility that its vigor will be vitiated, or even that the recovery will abort at an early stage.

- Business firms of marginal financial strength, especially small businesses, will also be cut off from the supply of credit. In a typical business recession, large Treasury borrowings do not create a problem, because the needs of other credit users shrink appreciably. In the current recession, however, the borrowing needs of only a few sectors have moderated and the external financing needs of business have remained unusually large. Under these conditions huge deficits will complicate the problems of firms that desire to improve their liquidity. The U.S. Government will be able to obtain all the new cash it seeks, but only at the expense of some other credit users. This will further weaken the credit-worthiness of marginal business firms. Lenders will then intensify their preference for high quality debt issues, and marginal firms will be unable to obtain enough credit. Their ability to expand will therefore be limited and bankruptcies could result.

I am not predicting these events, I'm just suggesting possible financial and economic scenarios that we can see unfolding.

There is, of course, one way by which these difficulties could be avoided for a time: if the Federal Reserve were to adopt more aggressively easy policies. That is, to prevent the Federal Government's demands from crowding others out of the financial markets, the Federal Reserve would make the market larger by increasing the total supply of money and credit. Instead of increasing the money supply 5-6 percent, for example, the Fed could add 9-10 percent. This, however, is a formula for still higher inflation rates when the recovery gets into full swing -- if not sooner. It does not allow us to solve our economic problems, only to postpone them.

In sum, then, I am concerned that the financial consequences of our 1975/76 budgets might be extremely serious. I hope not, but there is a clear danger. The

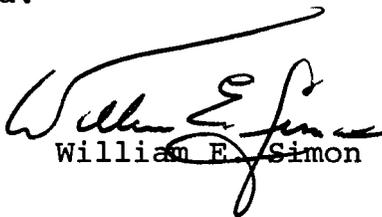


financial markets are already under more pressure than usual for this situation, as evidenced by abnormally high interest rates and risk premiums. The Federal Government will be entering the capital markets this year for more funds than have been raised in any previous year. Not far down the road, therefore, we could see the recovery in housing thwarted and perhaps some bankruptcies. Alternatively, the Federal Reserve might take action to postpone our problems for a few months, but only by setting the stage for a new round of economic difficulties and, in particular, a new explosion of inflation.

The policy dilemma is that a monetary policy adequate to finance both the deficit and the economic recovery may be excessive for long-run price stability. This dilemma emphasizes the fundamental importance of a tough policy to restrain the growth of budget outlays by reducing less urgent programs and preventing new initiatives that are not included in your package of economic and energy policies. Federal outlays can always be financed because of the priority given to government borrowers but investors have already emphasized quality to the point where many businesses have become ineligible for financing even at very high interest rates.

It is impossible to predict the outcome of economic events precisely but I believe there is a serious risk that disrupted financial markets may restrict the hoped-for economic recovery and future stability. It may turn out that other factors such as an even sharper drop in business activity, a rapid decline in the rate of inflation or large inflows of funds from foreign investors may offset the strains I have described, but we cannot base our policy decisions on such assumptions.

Arthur Burns concurs with this view. Roy Ash's views are contained in a memo attached.

  
William E. Simon

Attachment



THE WHITE HOUSE  
WASHINGTON

Jan. 15, 1975

Dick:

Lee got the attached memo from Jerry Jones this morning. She indicated that DR gave you instructions on how to handle it this morning.

kat



THE WHITE HOUSE

WASHINGTON

JAN 15 1975

MEMORANDUM FOR THE PRESIDENT

FROM : ROY A. ASH

SUBJECT: Impact of Federal Borrowings on Capital Markets

I share the concern you expressed in your recent memo to Bill Simon over the possible adverse impacts of large budget deficits on financial markets. While risks clearly do exist, the limited data provided by Treasury do not lead us to conclude that they are not tolerable or that your program should be altered. The need persists to deal with the present high rates of unemployment and losses in real economic output.

We understand that the Treasury and Federal Reserve projections of the rate of growth in the money supply necessary to accommodate increased Federal borrowings do not appear unreasonably out of line with desirable long term growth rates. Clearly, however, the Fed's policies during this period will require great balance in providing funds to meet increased capital needs while avoiding the fueling of future inflation.

While Treasury suggests that some marginal borrowers may be forced into bankruptcy, their projections indicate that despite increased Federal debt, private borrowings in securities markets will increase slightly in 1975 and reach almost twice the level of 1973. Furthermore, with a reasonably accommodative monetary policy, Treasury has estimated that interest rates a year from now will be level with or lower than today. This does not seem to imply intolerably increased stress on financial markets or significantly reduced availability of funds. Nothing in the data provided to us suggests that adequate short-term funds would not be available through 1975. While it might be



desirable to extend the maturities of corporate debt, the broader needs of the economy would seem to take precedence at this time. A healthier economy should benefit all corporate borrowers in the long run.

The importance of the Federal Reserve's role in determining the degree of stringency in credit markets underlines the necessity for careful coordination of fiscal policy with the decisions of the monetary authorities. While we cannot dictate Fed policy, we should make every effort to communicate to them our objectives and financing plans. The need for coordination is particularly important while we are pursuing a policy of stimulus simultaneously with energy policies which will have significant impact on prices.

Limited knowledge exists within government as to the precise effects of Federal borrowings on capital markets. It is critical for us to learn more about the complexities and sectoral differences of credit markets and how different parts of the economy respond to varying monetary and fiscal policies.

To summarize, I share the concerns expressed with regard to possible distortions in capital markets. Nevertheless, based on the information available, I believe the risk of such distortions is not so great as to deter us from your present policy course. We must be continuously vigilant in monitoring capital markets and Fed actions to assure that we make policy changes in a timely manner when required. This is of particular importance as we look beyond 1975 to 1976 since the Treasury paper did not focus on potential problems next year. We must also upgrade our analytic tools to improve our effectiveness in dealing with capital markets problems. Finally, it goes without saying that we should continue to press wherever and whenever possible to restrain Federal spending in order to alleviate future pressures of large budget deficits.

