BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DATE June 24, 1977

TO Chairman Burns

FROM JAMES L. KICHLINE

The attached memorandum is an evaluation of Albert Wojnilower's proposed capital standard for banks which you had requested. We believe that Wojnilower's proposal has serious deficiencies and would not contribute to the pursuit of macroeconomic stabilization goals.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 24, 1977

To Chairman Burns

From Division of Research and Statistics
(B. Wolkowitz & D. Tucker)

Subject: Summary and Evaluation of Wojnilower's Proposal for a Capital Standard for Banks

SUMMARY OF PROPOSAL: Albert M. Wojnilower, Senior Vice President and Director of the First Boston Corporation, has proposed that relatively fixed capital requirements be established for commercial banks as a technique of economic stabilization. (See attached letter to Senator Proxmire.) He suggests that all banks (or all above a certain size--e.g., the largest 500) be required to maintain a stable ratio of capital to total liabilities. The average size of the required ratio for each bank should be based on that bank's actual ratio of the preceding year or two; however, it is presumed that banks with low capital ratios will be brought up to the national average. Banks failing to comply with the requirement will be penalized by prohibiting them from acquiring any risk assets until the ratio is restored.

The purpose of the proposal is to "enable the Federal Reserve to restrain undesirable monetary expansion with lesser rises in interest rates and disruption of financial markets."1/ Wojnilower observes that during periods of inflation banks have an incentive to expand money and credit at rates of growth that may exceed Federal Reserve targets. Open market operations designed to restrain monetary expansion may provide a setting in which banks compete aggressively for funds, thereby driving up interest rates. Consequently, present monetary policy practices

1/ This proposal is not concerned with the protection of depositors or stockholders in banks, although it may make a contribution in that direction.

generate substantial cyclical volatility in interest rates. Furthermore, banks have an incentive during such periods to circumvent Federal Reserve policy by expanding and inventing new forms of borrowing not subject to high reserve requirements or constrained by aggregate Federal Reserve money supply growth targets (e.g., CD's and Euro-dollars).

Wojnilower's proposal would presumably deter such bidding for funds and attempts to circumvent the aggregate constraints because it requires that banks increase their capital as they expand their liabilities. The rationale behind a constraint on bank liability expansion based on capital is that capital is a relatively expensive source of funds. Consequently, a bank will be less likely to expand its liabilities if it has to match this expansion even partially with capital. This restraint by banks, it is argued, will also reduce the cyclical variability of interest rates.

<u>EVALUATION OF PROPOSAL</u>: If the demand for credit is relatively inelastic during inflationary periods, banks may be able to pass along the increased cost of funds resulting from having to expand capital along with liabilities. Therefore Wojnilower's proposal, because it increases the cost of funds to banks, could have the perverse effect of encouraging even higher interest rates during inflationary periods.

Even if it would not have this perverse effect, it is difficult to see how Wojnilower's proposal could lead to lower interest rates for any given level of the monetary and credit aggregates. Interest rate levels are determined by the supply and demand for credit from all sources, not just banks. While Wojnilower's proposal would restrain the growth of credit going through banks and limit banks' ability to bid up interest rates in their competition for funds, this would merely shift some of the credit demands to other suppliers of credit, probably at higher cost. In addition, the proposal might limit the growth of the supply of money during expansionary periods, since banks might be constrained by the capital requirement not to expand their deposit liabilities as much as would be permitted by the existing level of bank reserves set by the Fed. If this result occurred, it would also tend to drive up interest rates further, not stabilize them.

Furthermore, this proposal would appear to be somewhat inflexible, since bank liability expansion will be constrained at all times, not just during periods of inflationary pressure. Capital has historically been a relatively expensive source of funds regardless of the state of the economy, and this is especially true when equity markets are depressed during a cyclical contraction. Therefore, the expansion of bank liabilities and loans may be constrained, under this proposal, during periods in which public policy favors expansion of the commercial banking sector as well as during the inflationary periods to which Wojnilower refers. Thus such a capital requirement, which is presented as a countercyclical policy tool, could also have the perverse effect of prolonging a depressed state in the economy.

The inflexibility of this proposal has broader implications since the degree of constraint it would impose would not be constant but rather would vary with price fluctuations in the equity market. Wojnilower seems to regard this characteristic as an advantage of the proposal. However, these market fluctuations would complicate the selection of an appropriate capital requirement for a given policy objective.

For these reasons, the Wojnilower proposal appears to us to be without merit for macroeconomic stabilization. The only possibility for making capital requirements a potentially helpful complement to open market operations would be to amend the basic proposal to make the capital requirement a policy variable. That is, the requirement could be adjusted periodically to respond to changing needs for a constraint and to changing equity market conditions. This would require the creation of a new body of policy analysis dependent at least in part on the condition of the equity market.

Attachment

Copy

THE FIRST BOSTON CORPORATION

MEMBER NEW YORK STOCK EXCHANGE, INC.

1977 JUN -3 PM 12:55

RECEIVED
OFFICE OF THE CHAIRMAN

ALBERT M. WOJNILOWER
SENIOR VICE PRESIDENT AND DIRECTOR

20 EXCHANGE PLACE
NEW YORK, N.Y. 10005
CABLE: FIRSTCORP, N.Y.

May 31, 1977

The Honorable William Proxmire,
Chairman,
Committee on Banking, Housing and Urban Affairs
United States Senate
Dirksen Office Building
Washington, D.C. 20510

Dear Chairman Proxmire:

The following note is submitted in response to your request for further background to my proposal to establish capital requirements for commercial banks.

Purpose

Such requirements would enable the Federal Reserve to restrain undesirable monetary expansion with lesser rises in interest rates and disruption of financial markets. The intent of the proposal is strictly to assist stabilization policy. It is not intended for the protection of the depositors or shareholders in banks, although it may make some contribution in that direction.

The Proposal

All banks (or all above a certain size -- say the largest 500 banks) should be required to maintain an at least stable ratio of capital to total liabilities. The daily average ratio for each calendar quarter should be required to be at least equal to that in the same quarter the year before (or, if this requirement is not met, the same quarter two years before). Failure to comply should be penalized by the prohibition of any acquisition of risk assets until the required ratio is restored. Such restoration could be achieved by raising new equity, curtailing or eliminating dividends, increasing profits, or reducing liabilities.

The effect would resemble that of a special reserve requirement, with the profound difference that the judgment as to what quantity of reserves to supply, and to which banks, would rest with the market rather than the Federal Reserve.

The reason for allowing a "two-year-ago" benchmark in the event the one-year-ago standard is not met is to avoid creating a disincentive for voluntary increases in capital ratios. Some such provision is necessary to permit banks to undertake "lumpy" additions to capital -- for example, through a large public offering of stock -- without thereby locking themselves into a high base ratio that would restrict their ability to grow in line with the addition to capital.

Why A Capital Requirement Is Needed

From a purely macroeconomic standpoint, major commercial banks really do not need any capital, provided they are important enough so that the banking authorities cannot afford to permit them to fail for fear of triggering a run against the whole banking system. In periods of inflationary intoxication such as 1973-74 or 1968-70, such banks perceive considerable incentive to expand money and credit at rates of growth that exceed Federal Reserve targets, and there is little or no market discipline to prevent their doing so. As a result, efforts by the Federal Reserve to restrain undue monetary expansion by open market operations and other conventional means result in sharp increases in interest rates, as these banks continue to bid aggressively for funds. The burgeoning of interest rates and the accompanying turmoil in financial markets, in their turn, make the Federal Reserve reluctant to tighten further in fear of causing a "crunch." Such reluctance is quickly detected in the marketplace and tends to confirm inflationary expectations and actions. This is particularly true under the regime of floating interest rates, in which banks expect to protect or enlarge their profit margins by virtue of prompt, semiautomatic increases in interest rates on a large fraction of their preexisting portfolio of loans in response to every upward step in money market rates. Banks also have an incentive to try to circumvent Federal Reserve policy by expanding and inventing new forms of borrowing not subject to high reserve requirements or to aggregate Federal Reserve growth targets, such as CD's and Eurodollars among others. While the banking system as a whole can escape monetary restraint by such tactics only to a limited degree if at all, the ability of particular banks to expand (or even their illusion that they will be able to do so) causes interest rates to be bid up disproportionately. A game of "chicken" develops between the banks and the Federal Reserve as a result of which interest rates rise inordinately.

The present proposal would tend to deter such bidding by putting banks on notice that they must increase their capital as their liabilities increase. This would be only fair, since at present much of the true capital of these well-known banks, which enables them to attract deposits and shareholders even in the most turbulent of times, derives from their presumed access to unlimited Federal Reserve credit in the event of emergency. Absent a formal capital requirement, these banks enjoy a competitive advantage over other banks, financial institutions and businesses that lack an equivalent Federal Reserve or other official backstop. Such capital requirements would also be useful in minimizing the remote but terrifying contingency that some time an epidemic of threatened bank failures might overwhelm the human beings at the Federal Reserve and the FDIC.

Some Technical Points

For these purposes, long-term debt should not be counted as capital since the servicing of such debt by banks is also regarded by the public as backstopped by the Federal Reserve. That is to say, a bank unable to meet obligations on its long-term debt would probably have to be regarded by the authorities as equally endangered as to its survival, and as much a threat to general financial stability, as a bank unable to meet deposit drains. Subordinated debt convertible into stock, and preferred stock, might possibly be regarded as eligible for inclusion in capital to a limited extent.

The proposed regulation does not presume to establish any given capital ratio as appropriate for any particular bank. That issue remains for the banking authorities and Congress to decide. Presumably, efforts will continue to bring banks with low capital ratios closer to the national average.

Thank you very much for the further opportunity to present these viewpoints.

Respectfully yours,

Albert M. Wojnilower / Emily Schaaf
in his absence

AMW:es

Wojnilower

First Boston
THE FIRST BOSTON CORPORATION

ZIGZAGGING ALONG THE STRAIGHT AND NARROW

SOME ASPECTS OF THE ECONOMIC AND FINANCIAL OUTLOOK*

The economic recovery has been progressing in a manner that gives promise of a long life. Time and again, the widely-expressed fears of imminent explosions in consumer, business, or Federal spending; shortages in key materials; and major rises in prices, wages, and interest rates, are proving unjustified. Indeed these very fears, by impressing caution and even timidity on lenders and spenders, and by engendering an inordinately high volume of security issuance and level of long-term interest rates, are themselves a form of insurance that no economic runaway can develop.

The Bond Market, the Fed, and the Economy

Since early last year when the recession was ending, recurrent concern that a new cycle of inflation, shortages, credit crunch, and recession might be in the launching has touched off three or more major upheavals in the bond market. Each of these episodes shared with the others a rather unusual syndrome, and each exerted an adverse feedback on the economy. Every time, an intense fall in bond prices was triggered by the same combination of a turn in business news for the better, some bad behavior in a price index, and a flare-up in the growth rate of the monetary aggregates usually followed by Federal Reserve action to push up the Federal funds rate. In every case, longer-term interest rates defied the textbook by shooting up as many or more basis points as did short-term rates, as issuers of securities raced to market with new flotations as though there were no tomorrow. And every time the bear panic subsided after, in relatively prompt order, the monetary expansion slowed abruptly, the business statistics softened, and the price indexes calmed down. Having had to sweat out these swings, it is sometimes hard for market participants to believe that both short and long-term rates are actually lower now than they were fifteen months ago when the business upturn began.

The monotony of the pattern -- one that may well be repeated many times more -- is unlikely to be a coincidence. When the Federal Reserve responds to excessive monetary growth by pushing up short-term interest rates, it is in the expectation that the public will be induced to switch out of deposits into money market instruments, thereby retarding or reversing the monetary expansion. This shift from deposits to securities is apt to be far quicker and greater when, in reaction to the Fed's measures, not only short rates but also intermediate and long-term rates as well as the volume of

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*Prepared by Dr. Albert M. Wojnilower, Senior Vice President and Director, for a press luncheon held on July 27, 1976, to announce publication of the 27th biennial edition of First Boston's Handbook of Government Securities.

new issues on offer also bulge suddenly and sharply. That is precisely what has happened lately whenever short rates have ticked up and may well go far to explain why it has seemed relatively easy to halt and reverse outbursts of rapid monetary expansion.

The repercussions on the economy are also more immediate and severe. Familiar by now is the adverse impact of higher interest rates on flows into savings deposits and the mortgage market. More important currently, however, is the climate of financial unease that sharp rises in long rates create. After their recent lessons, builders and manufacturers are anyhow jittery about making any large long-range commitments. They no longer blithely assume that rises in interest rates or other costs can routinely be passed on to tenants or buyers. Thus any sizable increase in long-term rates, even if transient, is meaningful. As a result, the launching of new ventures in income properties or plant expansion is delayed and the construction and capital goods sectors understandably linger in a relatively depressed condition.

The flood of new security issues in these times of market disarray tends to retard consumer buying as well. When institutional buyers hold back, security prices must adjust until individuals are enticed to absorb the overflow. Individuals may finance their security purchases by drawing on deposits or by additional borrowing, but some must be made at the expense of retail sales. While probably no one ever consciously decides to buy Treasury bonds or A.T.&T. stock in lieu of a television set, it is virtually an accounting necessity that consumers save more and spend less whenever there is an unusually large outpouring of new security issues.

But then, as soon as the market has done its work in generating the "good" news that monetary growth has slowed and the economic outlook softened, the sunshine breaks through. Interest rates and the volume of new issues fall, reopening the door to more rapid business expansion. The fact that we had 11.4% real growth in the third quarter last year, followed by a drop to 3.3% in the fourth, then 9.2% in this year's first quarter followed by 4.4%, probably reflects these financial-market flip-flops.

<u>A New Way to Manage the Economy</u>

From a broader point of view, these alternations may be regarded as flowing from new Federal Reserve techniques that really amount to an attempt to employ a series of "mini-crunches" in order to forestall another "maxi-crunch" and recession. In the past, generally speaking, Federal Reserve policy tended to resist rises in interest rates long into the expansion phase of the business cycle -- for as long as unemployment remained unduly high, industrial capacity slack, and the cost-of-living rise reasonably steady. No brakes were applied until the upward momentum of the economy, embodied for example in large-scale construction programs launched beyond recall, was well entrenched. But by that late hour, the tightening of money caused sharp and irreversible rises in interest rates without much slowing down the economy. Ultimately, savage credit-market confrontations became the only way to break the inflationary wave.

Under present procedures, by contrast, any excessive gathering of economic momentum is presumably revealed early on by a surge in the monetary aggregates. Even though many outbursts in monetary growth turn out to be temporary and of no fundamental significance, the Federal Reserve has been taking no chances. It has reacted with alacrity and determination to beat back every undue increase. Restraining forces are thus called into play well before irresistible upward economic momentum has been established. The business expansion is stretched out over a longer span and rendered less inflationary. A price is paid in limiting the speed and intensity of the upswing and the level of the ultimate peak of prosperity, but on the other hand the danger of imbalances leading to another serious recession is reduced correspondingly.

Put still more abstractly, the Federal Reserve's monetary growth targets (4 1/2 to 7% for M_1 and 7 1/2 to 9 1/2% for M_2) really do not allow for much more than a 10% rate of increase in nominal GNP. Subtracting an embedded inflation rate of 5 or 6% hardly leaves room for breakneck increases in real demand. Over the last two years, in fact, M_1 has increased at a rate of only 4 1/2%, which happens to be the lower bound of the Fed's most recently announced target range.

Cautious Optimism on Inflation

The economic and monetary climate are thus propitious for the containment and eventual further reduction of inflation. Prices of food and oil may rise little more or possibly even less than the average price level. To be sure, prices of many other raw materials have increased sharply, but so long as items in widespread and irreplaceable use do not double, triple, and quadruple in price (as happened to grains and fuels in 1972-74), the impact on the overall price level is not large. Moreover, in offset, the rate of increase is probably slowing in regulated prices -- such as utility rates, insurance premiums, transit fares, local taxes, or postage stamps -- which have been belatedly reflecting the fuel cost and public-employee wage explosion of 1973-1974. We appear to have returned to a more normal environment in which labor costs are the critical determinant of the price level. Here recent developments have been encouraging. In the private sector, wage rates in the first half of 1976 rose at a rate of about 7%; in the public sector, they probably increased even less. While the pace of wage increase will probably accelerate, even a 9 or 10% rate of gain (should that be reached) would still, given average productivity improvement, remain consistent with mild cyclical fluctuations in the pace of general inflation around a 5 to 6% base.

Interest Rates in a Crosswind

And what about interest rates? As with the economy and inflation, the cyclical pressures are upwards, but the surprise is likely to be how mild these pressures are. By many standards, such as the level of short rates, the pace of inflation, or the degree of slack in the economy, long rates are high. However, the likelihood that short rates will be rising, in a market whose participants are much more worried about a major updraft in all rates than they may be hopeful of a moderate decline, tends to keep long rates up or even to lift them. But, as pointed out earlier, this asymmetry of viewpoint which keeps rates up also holds the economy down. In a marketplace increasingly dominated on both the buying and issuing sides by gunslingers resembling the late and unlamented stock market operators of the late 1960s, bond yields are likely to persist in shuttling wildly up and down within the 8 1/4-9% range (for triple-A utilities), based on nuances in the weekly money figures and the Federal funds rate. The lower end of the range may predominate for the next six or nine months, and the higher part over the balance of 1977. As for short-term rates, the Federal Reserve's operating procedure probably will continue to produce two or three upward lurches per year of 50-100 basis points each, with some part of each rise being retraced in the intervening periods of quiet. Paradoxically, if the market keeps long-term rates high, then monetary growth and the economy will be weaker, tempering the rise in short rates. Conversely, if the market lets long rates fall, monetary and economic expansion would be furthered, and short rates might rise faster, flattening the yield curve more rapidly.

These days more than ever, the volume of new issues is more a result than a cause of interest rate movements and expectations. There has been a fair diminution in the volume of flotations by domestic issuers compared with last year's huge calendar, but it has not been nearly so pronounced as the improvement in corporate cash flows and balance sheets would have indicated. Moreover, the ebbing of domestic issues has been offset significantly by a remarkable expansion of foreign, most notably Canadian, borrowing in this market.

Corporations have turned to bond issuance at the expense of bank loans. This is only natural. Bond issuance is cheap measured against a 7 or 7 1/4% bank prime rate -- raised to 8 or even 8 1/2% by compensating balance requirements or their equivalent, and subject to a sizable upward float if anticipated rises in money market rates materialize. Any time that issuers cease to anticipate major increases in short rates or banks adjust their rate-setting, a deep drought of new corporate bond flotations will set in.

Politics

Finally, what about the influence of the presidential election? It is ironic that, probably for the first time in the postwar period, the normally cynical market participants have not been taking it for granted that stock and bond prices were somehow insured against decline till after Election Day. When the candidates have promised good business or low interest rates, security prices usually have declined. And perhaps rightly so, since the monetary authorities seem to have been leaning to the tighter side sooner and harder than they might have in an ordinary year -- recognizing that the taking of overt restrictive measures shortly before or after Election Day might be inopportune. When, as now, the public is frightened and suspicious of the intent and effect of governmental actions, the best thing officials and candidates can do for themselves is to maintain a low profile. While the rhetoric may change and occasionally get louder, actual policy moves are likely to be modest and gradual.

One may reasonably hope, therefore, that the current economic expansion will not overheat badly, that the next recession will be distant and mild, and that as these developments persuade the public that the economic tragedy of 1968-1974 is not being replayed, substantially lower inflation and interest rates can eventually be achieved.

Such an outlook may seem unduly optimistic, but it is asking less of the future than has already been accomplished in the recent past. By way of reminder, we take the liberty of citing below the opening and closing paragraphs of the introductory section of the 27th edition of our biennial Handbook of Government Securities, which is being published today.

> During the past few years this country not only survived, but to a remarkable degree, was able to recuperate from a brutal series of blows to its pride, power, and pocketbook. Both Vice President and President resigned under cloud of serious violations of the laws of the land. Our ally South Vietnam was militarily overwhelmed by the North and Communist influence spread in various parts of the globe. A group of relatively small nations comprising the Organization of Petroleum Exporting Countries asserted their control over the supply and price of oil vital to the industry of the world. On the domestic economic scene, inflation and interest rates reached unprecedented fever pitch in 1974, with both short-term interest rates and the cost-of-living escalating well into the double digits. The chill of the worst unemployment in two generations followed soon after. And here and abroad, bankruptcies, defaults, and near misses involving major economic entities kept on multiplying —in banking, real estate, insurance, retailing, even at the state and municipal level—on a scale not experienced since the Great Depression of the 1930s.
>
> It would have been daft optimism in 1974 to have predicted that the body politic not only would withstand these shocks, but also manage to regain passable health and composure in time for the bicentennial celebrations of mid-1976. Notwithstanding all the disheartening experiences, however, the governmental process did revive; domestic unrest, as expressed in demonstrations, riots, and politically-motivated violence, subsided; and the international influence of the United States recovered, albeit not to the preeminence of the 1950s and 1960s. The underlying inflation slowed to perhaps as little as 5%—a rate far too high for the long pull, but nonetheless dramatically reduced from its peak. Between early 1975 and 1976, real output rebounded by 7%, the unemployment rate receded from near 9% to 7½%, and the number of persons with jobs advanced to a new record. Stock prices rebounded strongly from ten-year lows and interest rates fell appreciably. The financial structure, though still shaken and beset, had been shored up and seemed safe from holocaust. The state of affairs was far from the best of all conceivable worlds, but perhaps not so far from the best attainable in the aftermath of the havoc that had been wreaked.

Withal, despite the apparent return to a more orderly state of existence, the experiences of the concluding years of the bicentennium left many scars—some of them unhealed, some never to heal—on incomes, balance sheets, thought habits, and lives. The comforting concepts of a universe of limitless bounty, and a world within unbounded reach and power of the United States to lead, evanesced. Unemployment was declining, but toward 7%, not 4% or 5%. Inflation had receded, but only a handful of optimists thought the rate could be brought lastingly below 5% any time soon. Most banks were recovering their composure, but few were believed near completing the write-off of major loan defaults. Except for single-family homes, the real estate industry lay in the doldrums and certain parts, notably real estate investment trusts, had been smashed to smithereens. The ability of the so-called third and fourth-world countries (except those producing oil) to cope with internal strains and to meet their debts remained in doubt. At home, the agony of New York City clouded the future not only of its creditors and its hitherto world-leading financial community, but of all its citizens and those of other urban centers.

Compared, however, with the narrowly averted catastrophe of contagious bank and commercial failures, disintegrating foreign exchange and domestic financial markets, and runaway inflation and mass unemployment, the world appeared almost hospitable. America seemed to have lowered its voices and sights, but within this new restrained perspective, a cautious optimism was trying to emerge.

(212) 344-1515

ALBERT M. WOJNILOWER
Senior Vice President and Director

THE FIRST BOSTON CORPORATION

20 EXCHANGE PLACE
NEW YORK

First Boston
THE FIRST BOSTON CORPORATION

For your information this is a letter that I recently wrote to a Washington economist. Also appended are some tables having to do with the flow of funds and the financing of the deficit for 1975.

Additional copies are available through Mrs. Braha, ext. 788.

THE FIRST BOSTON CORPORATION
MEMBER NEW YORK STOCK EXCHANGE, INC.

ALBERT M. WOJNILOWER
SENIOR VICE PRESIDENT AND DIRECTOR

20 EXCHANGE PLACE
NEW YORK, N.Y. 10005
CABLE: FIRSTCORP, N.Y.

March 18, 1975

At your request, below are some hasty comments concerning the financial impact of the contemplated large budget deficits.

The main issue to be resolved, in my judgment, is not the financial but the economic impact of the deficits. If the deficits, in conjunction with monetary easing, do not stimulate a strong recovery in the growth of GNP (real or inflation), then private credit demand will remain depressed, and Treasury financing will offer no particular difficulty. My own view is that budget deficits on the order of $40 billion for the current fiscal year and $80 billion for fiscal 1976, or even somewhat larger ones, are unlikely to produce a revival of economic activity (or inflation) strong enough to create general financial congestion until 1977 at the earliest. Indeed, in the absence of such large deficits, total credit demand may well be insufficient to allow the Federal Reserve to promote adequate monetary expansion without creating "sloppy" money markets in whose wake all manner of domestic and international troubles follow. In the first ten weeks of this year, for example, the Treasury has been borrowing at a $70 billion annual rate (not seasonally adjusted) and monetary expansion has remained negligible.

A substantial part of the increased Treasury financing, it may be noted, directly replaces borrowing that would otherwise have to be done by the public. This is particularly evident with respect to the $25 billion or so enlargement of the deficit caused by reduction in corporate tax revenues reflecting the recession and likely profits-tax reduction. Were corporations to have to pay this $25 billion, they would have to borrow every penny from private lenders. The financial markets will find it much easier to absorb high-quality and highly liquid Treasury securities than to furnish huge additional amounts of credit to corporations.

The same argument also applies, though more indirectly and to a lesser degree, to the role of the deficit vis-a-vis the financial position of individuals. Until there is a substantial economic recovery, we should be talking about "substitution" of Federal for private borrowing, rather than about "crowding out".

It is likely, by the way, that foreign official buyers--OPEC and others--will finance a substantial part of these budget deficits. So far in calendar 1975, they have acquired over $6 billion in government securities and this figure is likely to be multiplied many times in the next couple of years. It is inherent in present world financial structure, I believe, that much of the budget deficit must be financed externally, whether by foreign support of the dollar, or through other developments--such as a further drastic drop in dollar exchange rates or controls on international capital flows--that have the effect of keeping multi-national business and other funds "captive" to the U.S. money markets.

Of course I may be wrong, and economic activity may revive strongly and promptly. In that case, and especially if the Federal Reserve pursues appropriately cautious policies, "crowding out" will develop as it should if renewed inflation is to be avoided. To reduce the "risk" of early over-strong recovery it might be useful to keep some considerable part of forthcoming tax remission in forms that are not automatically repetitive. That would also assuage market fears of a future runaway in interest rates--fears that are already operating to raise interest rates now and partly countervailing the impact of expansionary government policies.

You can see that I believe that a financial market problem is in any case unavoidable once the economy gains momentum. It would be helpful if there were broader recognition that budget deficits and monetary expansion create liquidity, and that when, finally, people want to spend that liquidity, short-term interest rates are likely to and probably should rise sharply. But, the desired revival of spending can't really begin until after sizable amounts of "excess" liquidity have already been created. Market participants are well aware of the dilemma and therefore insist, after every credit squeeze, on stockpiling enough liquidity to safely carry them through the next one. This attitude retards economic recovery. What to do? Some conclude that fiscal and monetary easing should be correspondingly more aggressive. Others will emphasize the future problems such policies build in. Personally, I would tend to the aggressive side, but it must be underlined that it is only a question of <u>when</u> and not <u>whether</u> the financial confrontation will occur.

This "no-win" trade-off is the penalty we have to pay for our past mistakes. It cannot, in my judgment, be avoided by any policy that currently has any political chance of adoption--if indeed by any policy designed and executed by human beings rather than gods.

It is my understanding that the above comments are furnished in the nature of an expert opinion and will not be used in a manner intended primarily for adversary or partisan purposes.

Thank you for this opportunity.

Sincerely yours,

Albert M. Wojnilower
Senior Vice President, Economist

Approximations to a Projected Flow of Funds for Calendar 1975

	$ billion
Net increase in U.S. Gov'ts/agencies	80
Acquired by:	
Commercial banks	28
Rest of world	35
Federal Reserve	6
Nonbank financial	10
Corporations	6
State & local gov't	2
Dealers, etc.	3
Individuals	-10

Commercial Banks

Uses			Sources		
U.S. Gov'ts/agencies	28		Pvt. demand dep.	13	+5.9%
Municipals	6		Gov't. " "	0	
Mortgages	5		C/D's	10	
Consumer credit	0		Other time	29	
Domestic bus. loans, paper	4		Stocks/bonds	6	
International	10		Other domestic	2	
Security loans	5		Foreign	-2	
	58	+8.3%		58	

A.M. Wojnilower
3/20/75

Nonfinancial Corporations

$ billion

	1975	1974
Profits after tax	50	65
- Dividends	30	30
+ Foreign profits	5	10
- IVA	2	36
+ Capital consumption allowance	79	72
Internal funds	102	81
Fixed investment	114	116
Inventory change	- 5	10
	109	126
+ Discrepancy	13	13
	122	139
= Net financial investment	-20	-57
Liquid assets	18	12
Consumer credit	0	1
Misc.(net) assets (mainly foreign)	14	- 1
Net trade credit	2	5
= Funds to be raised	54	75
Bonds	31	21
Stocks	6	3
Mortgages	7	11
Bank loans (domestic)	0	28
Paper/other loans	10	12

A.M. Wojnilower
3/20/75

Households - Net Change in flows from 1974

		Floors
Personal saving	+22	99 (Nat'l income a/c)
Plus Debt incurred		
Mortgage	- 6	
Consumer	- 6	4
Security	+ 2	
Other	+ 4	
Available for investment	+16	
Money	+ 6	10
Time/savings dep.	+20	79
Municipals	- 4	8
Corporate bonds	+ 9	6
Stocks, mutual funds	+ 6	7
Private life, pension reserves	+ 2	
U.S. Gov'ts	-23	-10

A.M. Wojnilower
3-20-75

THE FIRST BOSTON CORPORATION

MEMBER NEW YORK STOCK EXCHANGE, INC.

ALBERT M. WOJNILOWER
VICE PRESIDENT AND DIRECTOR

20 EXCHANGE PLACE
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CABLE: FIRSTCORP, N.Y.

March 18, 1975

Dr. Nancy Teeters
Assistant Director
House Budget Committee
221 House Office Building Annex
Washington, D. C. 20515

Dear Nancy:

At your request, transmitted through Len Santow, below are some hasty comments concerning the financial impact of the contemplated large budget deficits.

The main issue to be resolved, in my judgment, is not the financial but the economic impact of the deficits. If the deficits, in conjunction with monetary easing, do not stimulate a strong recovery in the growth of GNP (real or inflation), then private credit demand will remain depressed, and Treasury financing will offer no particular difficulty. My own view is that budget deficits on the order of $40 billion for the current fiscal year and $80 billion for fiscal 1976, or even somewhat larger ones, are unlikely to produce a revival of economic activity (or inflation) strong enough to create general financial congestion until 1977 at the earliest. Indeed, in the absence of such large deficits, total credit demand may well be insufficient to allow the Federal Reserve to promote adequate monetary expansion without creating "sloppy" money markets in whose wake all manner of domestic and international troubles follow. In the first ten weeks of this year, for example, the Treasury has been borrowing at a $70 billion annual rate (not seasonally adjusted) and monetary expansion has remained negligible.

A substantial part of the increased Treasury financing, it may be noted, directly replaces borrowing that would otherwise have to be done by the public. This is particularly evident with respect to the $25 billion or so enlargement of the deficit caused by reduction in corporate tax revenues reflecting the recession and likely profits-tax reduction. Were corporations to have to pay this $25 billion, they would have to borrow every penny from private lenders. The financial markets will find it much easier to absorb high-quality and highly liquid Treasury securities than to furnish huge additional amounts of credit to corporations.

The same argument also applies, though more indirectly and to a lesser degree, to the role of the deficit vis-a-vis the financial position of individuals. Until there is a substantial economic recovery, we should be talking about "substitution" of Federal for private borrowing, rather than about "crowding out".

It is likely, by the way, that foreign official buyers--OPEC and others--will finance a substantial part of these budget deficits. So far in calendar 1975, they have acquired over $6 billion in government securities and this figure is likely to be multiplied many times in the next couple of years. It is inherent in present world financial structure, I believe, that much of the budget deficit must be financed externally, whether by foreign support of the dollar, or through other developments--such as a further drastic drop in dollar exchange rates or controls on international capital flows--that have the effect of keeping multi-national business and other funds "captive" to the U.S. money markets.

Of course I may be wrong, and economic activity may revive strongly and promptly. In that case, and especially if the Federal Reserve pursues appropriately cautious policies, "crowding out" will develop as it should if renewed inflation is to be avoided. To reduce the "risk" of early over-strong recovery it might be useful to keep some considerable part of forthcoming tax remission in forms that are not automatically repetitive. That would also assuage market fears of a future runaway in interest rates--fears that are already operating to raise interest rates now and partly countervailing the impact of expansionary government policies.

You can see that I believe that a financial market problem is in any case unavoidable once the economy gains momentum. It would be helpful if there were broader recognition that budget deficits and monetary expansion create liquidity, and that when, finally, people want to spend that liquidity, short-term interest rates are likely to and probably should rise sharply. But, the desired revival of spending can't really begin until after sizable amounts of "excess" liquidity have already been created. Market participants are well aware of the dilemma and therefore insist, after every credit squeeze, on stockpiling enough liquidity to safely carry them through the next one. This attitude retards economic recovery. What to do? Some conclude that fiscal and monetary easing should be correspondingly more aggressive. Others will emphasize the future problems such policies build in. Personally, I would tend to the aggressive side, but it must be underlined that it is only a question of <u>when</u> and not <u>whether</u> the financial confrontation will occur.

This "no-win" trade-off is the penalty we have to pay for our past mistakes. It cannot, in my judgment, be avoided by any policy that currently has any political chance of adoption--if indeed by any policy designed and executed by human beings rather than gods.

It is my understanding that the above comments are furnished in the nature of an expert opinion and will not be used in a manner intended primarily for adversary or partisan purposes.

Thank you for this opportunity.

Sincerely yours,

Al Wojnilower

AMW:fb

P.S. Would you mind if I circulated these remarks within my firm or to clients? And, just now I have been invited to a Thursday P.M. meeting at the Treasury on this issue. Can I use this there?

Approximations to a Projected Flow of Funds for Calendar 1975

	$ billion
Net increase in U.S. Gov'ts	75
Acquired by:	
Commercial banks	25
Rest of world	35
Federal Reserve	5
Nonbank financial	10
Corporations	5
State & local gov't	2
Dealers, etc.	3
Individuals	-10

Commercial Banks

Uses			Sources		
U.S. Gov'ts/agencies	28		Pvt. demand dep.	13	+5.9%
Municipals	6		Gov't. " "	0	
Mortgages	5		C/D's	10	
Consumer credit	0		Other time	29	
Domestic bus. loans, paper	4		Stocks/bonds	6	
International	10		Other domestic	2	
- Security loans	5		Foreign	-2	
	58	+8.3%		58	

A.M. Wojnilower
3/20/75

Nonfinancial Corporations

$ billion

	1975	1974
Profits after tax	50	65
- Dividends	30	30
+ Foreign profits	5	10
- IVA	2	36
+ Capital consumption allowance	79	72
Internal funds	102	81
Fixed investment	114	116
Inventory change	- 5	10
	109	126
+ Discrepancy	13	13
	122	139
= Net financial investment	-20	-57
Liquid assets	18	12
Consumer credit	0	1
Misc.(net) assets (mainly foreign)	14	- 1
Net trade credit	2	5
= Funds to be raised	54	75
Bonds	31	21
Stocks	6	3
Mortgages	7	11
Bank loans (domestic)	0	28
Paper/other loans	10	12

A.M. Wojnilower
3/20/75

Households - Net Change in flows from 1974

		Levels
Personal savings	+22	99 (Nat'l income a/c)
less Debt incurred		
Mortgage	- 6	
Consumer	- 6	4
Security	+ 2	
Other	+ 4	
Available for investment	+16	
Money	+ 6	10
Time/Savings dep.	+20	79
Municipals	- 4	8
Corporate bonds	+ 9	6
Stocks, mutual funds	+ 6	7
Private life, pension reserves	+ 2	
U.S. Gov'ts	-23	-10

A.M. Wojnilower
3-20-75

40

Dec 75 June 76

Prime rate

AA~~A~~ utility rate

March 17, 1975

Dear Mr. Wojnilower:

It was good of you to take the time to think over the problem we discussed, and to write me so fully. You have my warm thanks.

With kind regards,

Sincerely yours,

Arthur F. Burns

Mr. Albert M. Wojnilower
Vice President and Director
The Fisst Boston Corporation
20 Exchange Place
New York, New York

THE FIRST BOSTON CORPORATION
MEMBER NEW YORK STOCK EXCHANGE, INC.

20 EXCHANGE PLACE
NEW YORK, N.Y. 10005
CABLE: FIRSTCORP, N.Y.

ALBERT M. WOJNILOWER
VICE PRESIDENT AND DIRECTOR

#512

March 10, 1975

Dr. Arthur F. Burns, Chairman
Board of Governors of the Federal Reserve System
Twentieth St. and Constitution Ave., N.W.
Washington, D.C. 20551

Dear Dr. Burns:

When we last met, you asked me to write if, on reconsideration, I still held that inflation of inventory prices was not a sufficient reason for higher short-term interest rates.

I have been through many rounds of thinking on what turned out to be a more complex question than I had imagined. Much depends on what is held constant and what base situation is used as a benchmark. Here is where I came out.

Quite aside from the issue of inflation, any desired or actual increase in the ratio of net inventory (or any other) investment to GNP will raise the level of interest rates above what it would otherwise be. Resources must be diverted from consumption. Assuming that the public's savings propensities or schedules are given, an increase in interest rates is necessitated. While inflation may be the cause of the rise in the investment/GNP ratio, the resultant rise in interest rates would be the same whether there was inflation or not.

But this is not the whole story.

What about the effect of inflation on the replacement cost of inventories? If I bought inventory for $10 and must now replace it for $11, the critical issue becomes the price at which I sell my old inventory. In the securities business, I would also be selling my old inventory for $11, which would enable me to finance an equal quantity of new inventory without additional resort to credit. The same result holds if I sell my inventory to another firm at $10, but they resell it to an ultimate user at $11. Then I must borrow an extra dollar, but the other firm has an extra dollar to lend.

If, however, I make a final sale at the old $10 price, then I must indeed demand a net additional dollar of credit to maintain a constant physical inventory. Your original question thus appears to resolve into the empirical issue as to whether actual transactions pricing (not accounting, which is irrelevant) is done on a historical or current (opportunity) cost basis. While I would be inclined to argue that opportunity cost has recently predominated (especially because of fear of future price controls), there is surely a good deal of historical cost pricing as well. To that extent, greater inflation will have increased the net demand for credit and raised interest rates. Thus, you are right.

For symmetry, let us consider the case of deflation. If I had bought stock at $10 and must now sell it at $9, I will be short one dollar of what I need to pay off the loan that financed my original inventory purchase. Even though a new unit costs only $9, my credit demand will remain at $10. Thus, again, under opportunity cost pricing, price level changes do not affect credit demand. If, however, I am able to sell my old stock at $10 (as, for example, grocery stores may be trying to do with their old sugar), then I can pay down $10 of old borrowings and need to incur only $9 in new ones. Under historical cost pricing, again, credit demand prompted by inventory replacement moves up and down in line with the price level.

The foregoing sketch deliberately ignored the influence of money and expectations. Inflation presumably raises the demand for money balances. If this demand is not accommodated by the "right" increase in the "right" basket of monetary aggregates (whatever these "rights" may be), the rate of interest will rise. Some would also argue that a rise in the actual and/or anticipated rate of inflation would by itself raise the rate of interest. My observation is, however, that institutional restraints, transaction costs, and other market imperfections greatly reduce if not eliminate such expectational effects, especially for short-term rates.

It is always a privilege to be able to visit with you.

Sincerely yours,

Al Wojnilower

AMW:fb

May 3, 1974

Dear Mr. Wojnilower:

Before leaving for Europe, Dr. Burns asked me to thank you for your letter of April 26th and its enclosures.

Sincerely yours,

Catherine C. Mallardi
Administrative Assistant
to the Chairman

Mr. Albert M. Wojnilower
Vice President and Director
The First Boston Corporation
20 Exchange Place
New York, New York

THE FIRST BOSTON CORPORATION

MEMBER NEW YORK STOCK EXCHANGE, INC.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

1974 APR 29 PM 1:11

RECEIVED OFFICE OF THE CHAIRMAN

ALBERT M. WOJNILOWER
VICE PRESIDENT AND DIRECTOR

20 EXCHANGE PLACE
NEW YORK, N.Y. 10005
CABLE: FIRSTCORP, N.Y.

#680

April 26, 1974

Dr. Arthur F. Burns, Chairman
Board of Governors of the
Federal Reserve System
20th Street & Constitution Ave., N.W.
Washington, D.C. 20551

Dear Dr. Burns:

Some weeks ago I wrote you that I had responded to two advertisements soliciting purchases of gold coins. The answers have only just now come in.

One company offered only U.S. coins and thus was mainly numismatic in its appeal. Interestingly, however, they guaranteed for the indefinite future to repurchase at the original price any coins bought through them.

The other, whose flyer I am enclosing, offers Mexican and English gold coins, and also solicits Swiss bank accounts.

Best regards.

Respectfully yours,

Albert M. Wojnilower

Albert M. Wojnilower
Vice President and Director

Encl.

New York Bullion Exchange

Division of Giannini Financial Corp.

1841 Broadway, New York, N.Y. 10023
Telephone [212] 757-2516

Fact Sheet for

SILVER BULLION, GOLD COINS PLATINUM BULLION & INVESTOR SERVICES

DESCRIPTION

SILVER BULLION: Silver Bullion is refined silver in bars assaying at least .999 fineness, and is stamped with one or more of the official brands or markings customary in the trade. Bullion is the least expensive form of owning silver. Bullion is available in bars weighing 100, 500, and 1,000 ounces.

SILVER MEDALLIONS: Silver Medallions are struck from silver planchets assaying at least .999 fineness, and weigh 1 Troy ounce each. Each medallion is struck with a guarantee as to weight and purity and thus is the most convenient negotiable silver in the world.

GOLD COINS: Mexican, English and United States' gold coins are offered in bulk to pu chasers of 100 or more coins.

PLACER GOLD: Unrefined nuggets and grains. Americans can legally own placer gold.

PLATINUM BULLION: Platinum Bullion is refined in 1 through 50 ounce plates. Our platinum assays at least 99.9% pure. Platinum is the most precious of metals and is the most convenient medium of storing your wealth.

PRICES

SILVER BULLION The New York Spot Price for silver is quoted daily in the Wall Street Journal. New York Bullion Exchange gives daily buy-sell quotes on all its silver bars.

SILVER MEDALLIONS: The tooling and workmanship required to strike our gem quality medallions commands a premium over bullion of the same weight and purity of silver. Hence, New York Bullion Exchange daily quotes higher buy and sell prices on medallions than on bullion.

GOLD COINS: New York Bullion Exchange gives daily buy-sell quotes on Mexican, English, and United States' gold coins.

PLACER GOLD: Placer Gold is quoted daily by New York Bullion Exchange.

PLATINUM BULLION: Platinum Bullion is quoted daily by New York Bullion Exchange.

DELIVERY

SILVER BULLION & SILVER MEDALLIONS: On orders over 1,000 ounces, delivery will be made from the nearest depository. West of the Mississippi is shipped FOB Los Angeles; east of the Mississippi is shipped FOB New York. Shipping charges include insurance. New York Bullion Exchange will ship via the least expensive method available. Delivery runs from two to six weeks, depending on conditions in the silver market. On orders for less than 1,000 ounces, your Precious Metals Broker will deliver to your home or office, and collect nominal shipping and insurance charges.

GOLD COINS: Delivery will be made by registered, insured mail; postpaid.

PLACER GOLD: Delivery will be made by registered, insured mail; postpaid.

PLATINUM: Delivery will be made by registered, insured mail; postpaid.

WEIGHT VARIATION

We guarantee all silver and platinum bullion to be of at least the weight per bar ordered.

BROKERAGE COMMISSION

New York Bullion Exchange does not charge brokerage commission when buying or selling silver, silver medallions, gold coins, or platinum bullion.

MONTHLY INVESTMENT PLAN

You may participate in our monthly investment plan for the purchase of silver bullion, silver medallions, or platinum bullion. Minimum subscription is $25.00 a month. Your monthly investment may be made by check or by a Check-O-Matic Plan whereby your bank makes your monthly investment from your checking account. When your monthly investment plan account contains sufficient funds to purchase a 100 ounce bar of silver, 25 medallions, 1 ounce of platinum bullion or 1 ounce of placer gold, it is immediately shipped to you.

ORDERING BY MAIL

You may order by sending your personal check, cashier's check, or money. Use the last price known to you. If the price has gone up, we will bill you the difference and ship upon receipt of amount due. If the price has dropped, we will refund the overage at the time we ship.

ORDERING BY TELEPHONE

The prices of silver bullion, silver medallions, gold coins, and platinum bullion may change at any time, so we cannot give you an exact price on this Fact Sheet. However, if you call our Precious Metals Broker, or call our home office at (212) 757-2516 we will give you the day's price. If you decide to invest, we will trust your word and confirm your order over the phone. You can then send your check for the exact amount.

INVESTOR SERVICES

SWISS BANK ACCOUNTS: New York Bullion Exchange believes that every sophisticated person of means should maintain at least a portion of his funds in Gold-backed Swiss Francs, deposited in accounts in Swiss banks. The Swiss franc is safe currency, solidly backed by 82% gold (compared to the approximate 4% for the dollar). Switzerland has a record of monetary stability unmatched by any other country in the world. New York Bullion Exchange handles all arrangements in connection with establishing an interest bearing account at one of our correspondent banks in Switzerland. Accounts may be opened in the client's name or in the form of a "numbered" account. Our service fee for such arrangements is $300.00.

CLIENT PORTFOLIO ANALYSIS: New York Bullion Exchange provides a client portfolio analysis service. Upon completion of a CPA form, our staff of financial analysts will review the client's portfolio, submit a detailed analysis, and submit recommendations on the most effective ways the client can protect his assets in face of threatening economic conditions. Our staff is comprised of experts in the fields of equities, debt, real estate, international banking, and finance. No charge is made for this service.

CHRONICLE OF THE DEATH OF THE DOLLAR

'33 Government prohibits U.S. citizens from owning gold bullion.
Government recalls all gold coins and repudiates gold certificates (paper currency). (Value of a $20 gold piece is now $125.)

'65 Government stops minting coins of 90% silver.

'67 Government is unable to hold the price of silver in the free market at $1.29 per ounce and silver becomes a free market.

'67 Government is now calling in and melting all silver coins in circulation, but will not allow citizens to do the same.

'68 Government will no longer redeem silver certificates (paper currency) for silver bullion.

'68 Silver hits a high of $2.56½ per ounce

'69 Treasury lifts melting ban on silver coins.

'69 Treasury Department has sold over 2 billion (2,000,000,000) ounces of silver from its stockpile and now has only a few million ounces remaining.

'71 Government gold reserves drop from $22 billion ($22,000,000,000) in 1957 to just over $10 billion ($10,000,000,000.)

'71 Government removes the 25% gold backing for paper currency.

'71 Government stops redeeming dollars held by foreign countries for gold at $35.00 per ounce.

'71 Dollar devaluated. Revaluation of all major foreign currencies is, in effect, a devaluation of the dollar.

'73 Wage and price controls dropped.

'73 Dollar devaluated

'73 Gold Hits $100/ounce

?? Next dollar devaluation.

New York Bullion Exchange
1841 Broadway
New York, New York 10023
(212) 757-2516

GOLD & SILVER BULLION/COIN VALUE REPORT

MID MONTH PRICE	N. Y. SILVER BULLION/OZ.	%	$1000 BAG SILVER COINS	%	LONDON GOLD BULLION/OZ.	%	BRITISH SOVEREIGN GOLD COIN	% *	U. S. DE $20 GOLD COIN	% *	MEXICAN 50 PESO GOLD COIN	% *	COLUMBIA 5 PESO GOLD COIN	% *	COIN VALUE OVERALL CHANGE (%)
Jan.1972	1.51		1180		46.17		14.00		72.50		69.00		13.40		* Gold Coin Average only
Apr.	1.54	+2.4%	1195	+1.3%	49.43	+7.1%	14.50	+3.6%	76.50	+5.5%	66.75	-3.2%	14.25	+6.3%	+3.05%
July	1.70	+12.7%	1285	+8.9%	67.05	+45.2%	18.30	+30.7%	84.75	+16.9%	90.05	+30.5%	17.50	+30.5%	+27.15%
Oct.	1.80	+19.4%	1350	+14.4%	65.10	+41.0%	18.15	+29.6%	85.50	+17.9%	89.00	+28.9%	17.10	+27.6%	+26.00%
Jan.1973	2.04	+35.2%	1466	+24.2%	65.01	+40.8%	22.50	+60.7%	112.50	+55.2%	100.25	+45.3%	21.25	+58.6%	+54.95%
Apr.	2.22	+47.6%	1660	+40.7	89.30	+93.4%	29.20	+108/6%	147.50	+103.4%	134.00	+94.2%	28.25	+110.8%	+104.25%
July	2.80	+85.4%	2045	+73.3%	119.90	+159.7%	45.00	+221.4%	199.00	+174.4%	185.00	+168.1%	44.00	+228.3%	+197.97%
Aug.	2.63	+74.2%	1970	+66.9%	103.00	+123.1%	35.75	+155.4%	174.00	+140.0%	154.00	+123.1%	34.75	+159.3%	+144.45%
Sept.	2.63	+74.4%	1970	+66.9%	104.00	+125.2%	36.75	+162.5%	170.00	+134.4%	153.00	+121.2%	34.75	+159.3%	+144.35%
Oct.	3.01	+99.4%	2100	+80.0%	101.25	+119.3%	35.25	+151.8%	173.50	+139.3%	148.50	+115.2%	33.50	+150.0%	+139.08%
Nov.	2.83	+87.4%	2035	+72.5%	91.25	+97.6%	34.00	+142.9%	168.50	+132.4%	135.00	+95.7%	32.50	+142.5%	+128.38%
Dec.	3.20	+112%	2210	+87%	109.00	+136	44.50	+217%	203.00	+180%	172.00	+150	40.50	+200%	+187%
Jan.1974	3.98	+164%	2710	+130%	132.50	+187%	46.50	+232%	230.00	+217%	197.00	+186%	43.00	+221%	+206%

NOTE: % Change Based on January 1972 Base Prices

NEW YORK BULLION EXCHANGE
Division Giannini Financial Corp.
1841 Broadway New York, N.Y. 10023 (212) 757-2516

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

1974 MAR -4 PM 4:39

RECEIVED
OFFICE OF THE CHAIRMAN

THE FIRST BOSTON CORPORATION

MEMBER NEW YORK STOCK EXCHANGE, INC.

CABLE ADDRESS
FIRSTCORP, NEW YORK

20 EXCHANGE PLACE
NEW YORK, N.Y. 10005

March 1, 1974

Dr. Arthur F. Burns
Chairman
Board of Governors of the
Federal Reserve System
20 Street & Constitution Ave., N.W.
Washington, D.C. 20551

Dear Dr. Burns:

Thank you again for the time you spent with me on February 28. As you may recall, you raised a question about gold coins. The two enclosed advertisements appeared in the New York Times that very morning. I have answered both from my home address and will send on to you whatever material they send me.

Sincerely,

Al Wojnilower

Albert M. Wojnilower
Director and Economist

Encl.

(212) 344-1515

ALBERT M. WOJNILOWER
Vice President and Economist

THE FIRST BOSTON CORPORATION

20 EXCHANGE PLACE
NEW YORK

The First Boston Corporation

BROADCAST January 25, 1972
ALL OFFICES (Including Zurich and London)

BRIEF NOTES ON THE DEFICIT

The new budget estimates, which call for a $38.8 billion deficit in fiscal 1972 and $25.5 billion in 1973, are both interesting and puzzling. While they are largely free of the gimmicks common to earlier budgets, they also imply a spending speed-up over the next few months of unprecedented (peacetime) rapidity.

The new estimates include lower revenue figures than before, the reduction being attributed to lower-than-expected profits and incomes. However, it has been apparent all year from economic data and from the daily reports of tax collections, that receipts would fail to come up to the initial highly optimistic predictions. Indeed, the new estimate of about $198 billion for the current fiscal year is very close to the figure that I have been using ever since August 16.

The real surprise is on the expenditure side. In the July-December 1971 period, expenditures were only about $112 billion and they would seasonally tend to be somewhat smaller in the following January-June period (reflecting lower farm support outlays). To reach the estimate of $236.6 billion in total spending for the full year, expenditures in the current six months would have to jump to about $125 billion. The rise is apparently to be accomplished (if it can be done) by shifting forward $8 billion or more of payments to defense contractors and to state and local governments from the summer to the spring. In addition, the assumption is made that over $2 billion in revenue sharing funds will have been paid out by June 30.

As a result of this immediate bulge in spending, the increase in spending for the next fiscal year is held to less than $10 billion, when it would otherwise have been well over $20 billion. By this ploy, the government appears to have succeeded in getting the press to highlight the smallness of the expenditure rise and to attribute the deficits mainly to revenue shortfalls. It may also have succeeded in preventing the opposition from offering significant new spending programs of its own, partly because of the huge deficit and partly because the new budget already shows sizable increases in spending or forward commitment authority in virtually every important category.

The government may also feel that the increased budget deficit will buoy the economy. However, the recipients of the added funds that may be spent in the next few months are not getting more money; they are just getting it sooner. They will not spend appreciably more; rather they will simply buy the extra short-term securities the Treasury will have to issue. Because nonbanks will more or less readily absorb the added securities, moreover, the deficit is unlikely to push the Federal Reserve into a more expansionary posture, as the government might have intended.

Indeed, the impact on the real GNP may well be adverse. Inflation fears are likely to be inflamed, partly because few people will believe that next year's spending increase will be as small as is projected. (If the government is to spend as fast as possible to June 30, why shouldn't it continue to do so later on?) As a result, issuance of new securities and sales of speculative holdings are likely to accelerate, while sophisticated buyers become more cautious. The consequence might be that interest rates, long rates in particular, would rise -- on an expectation of huge budget deficits that may not materialize and that do not have strong stimulative qualities! When interest rates rise before rather than after business improves, and when individuals are forced to become buyers of securities because institutions stand aside, strong economic upturns are unlikely to develop.

The large budget deficits are also apt to impart an upward bias to marginal wage and pricing decisions and to increase the odds on new international troubles that might lead to new direct controls on dollar inflows by foreign countries.

In the abstract, given the sluggishness of the economy and high unemployment, a deficit close to $40 billion might well be justified. However, just as deficits of less than $5 billion frightened capital during the Depression, so deficits of $40 billion, because of the potential inflationary repercussions, frighten people today. It may well be that, Milton Friedman to the contrary, the public and perhaps even the economists are not all Keynesians any more.

(Billions of dollars)

Fiscal Year (Year Ending June 30)	Expenditures and net lending	Receipts	Balances
1971	211.4	188.4	-23.0
1972	236.6	197.8	-38.8
1973	246.3	220.8	-25.5

AW