

As we learned from 1966 experience, projections cannot always hit the mark. The prudent course is to maintain a maximum degree of flexibility in order to meet unforeseen developments. But, our best judgment now is that the moderate tax increase the President has proposed will be consistent with the needs of the economy in order to prevent any resurgence of inflationary pressures. Furthermore, that increase would meet the fiscal 1968 increase in defense costs, keep our cash and administrative deficits within reasonable bounds, and provide extra leeway for a continued easing of money and credit, giving some insurance against a return to the monetary stringency of 1966.

FINANCIAL POLICIES AND DEBT MANAGEMENT

This is another factor which, I believe, has not been covered in previous statements.

Financial markets through the first two-thirds of last year were marked by extraordinarily heavy credit demands pushing against increasing monetary restraint. Interest rates rushed higher and at times the orderly functioning of the financial markets was threatened—especially in the late summer period. The avoidance of severe disruption testifies to the great strength and resiliency of our financial system—but the test was not one that bears repetition.

The heavy credit demands of 1966 came mainly from the private sector. Business borrowing, especially, made huge claims on the capital markets. Net debt and equity issues of corporations came to an estimated \$12½ billion, while business borrowing from banks rose \$10 billion. State and local government debt rose \$7 billion, and mortgage debt by \$25 billion (but this was \$5½ billion less than in 1965.) Federal credit demands on the private sector (netting out purchases by the Government investment accounts and the Federal Reserve) came to just \$3 billion, as a \$2 billion *decline* in Treasury issues in the hands of the public partly offset the \$5 billion increase in Federal agency debt and participation certificates.

By late summer, interest rates had reached their highest levels in four decades. With the announcement of the President's September 8 anti-inflationary program and the benefit of subsequent steps taken by the Congress and the financial regulatory agencies, a concerted easing of interest rates was set in motion. Since early October, there has also been a rise in average stock market prices.

From early December 1965—just before the discount rate rise, to the August-September peaks of last year, 3-month Treasury bills rose by nearly 1½ percentage points, and long-term issues also rose substantially. New issues of AA-rated corporate bonds rose about 1½ percentage points reaching almost 6¾ percent. The commercial bank prime lending rate also rose 1½ percent. Yields on new municipal bonds advanced about three-fourths percent. Rates on conventional new home mortgages as reported by FHA also rose about three-fourths percent, and the availability of funds to the mortgage market was drastically reduced.

Not quite 6 months later, rates have fallen back impressively. Three-month Treasury bills are lower by about 1 percent and long-term Treasury rates have returned to the level which prevailed before the discount rate rise. I am pleased to report that on our current