Chapter 1

Approaching Full Employment

THE AMERICAN ECONOMY took a giant step in 1965 toward the achievement of the Employment Act's goals of "maximum employment, production, and purchasing power." It was the fifth year of uninterrupted economic expansion, and the second year of declining unemployment as output moved closer to the economy's growing productive potential.

Since the Revenue Act of 1964 became effective, the economy has shown new vigor. Living standards have risen at an unprecedented rate, and businessmen have found new and stronger incentives to expand and modernize their productive facilities. Employment has forged ahead dramatically, enlarging job opportunities, particularly for the young and the less advantaged groups in the labor force. As the year closed, the unemployment rate was 4.1 percent, within inches of the 4 percent interim goal set by the Kennedy Administration in the 1962 Economic Report and below any rate achieved since the mid-1950's. Meanwhile, despite some pressures on prices for particular commodities, the over-all price record remained far better than in that earlier period. In addition, last year witnessed significant progress toward equilibrium in the balance of payments.

Today, our vigorous economy is in a strong position to carry the new burdens imposed by expanded national defense requirements. With another large advance in total production ahead, defense needs will be met while consumer living standards again improve strongly and the capital stock is further enlarged. Indeed the *increase* in output available for civilian uses this year is expected to be one of the largest in our history.

National security, of course, has first priority on the budget and the first claim on production. It certainly represents a less welcome use of our national output than would Federal civilian programs or the private spending that would come from tax reduction. Progress will continue in building the Great Society, but the pace of Federal civilian programs reflects the current urgency of national defense.

Furthermore, rising defense requirements clearly complicate the task of economic policy. The stimulative fiscal policies of recent years have achieved their mission. Consumer spending and investment demand have both been invigorated. The same logic that called for fiscal stimuli when demand was weak now argues for a degree of restraint to assure that the pace of the economy remains within safe speed limits. Measures to moderate the growth of private purchasing power are needed to offset, in part, the expansionary influence of rising defense outlays if intensified price and wage pressures are to be avoided. A combination of such measures—affecting excise tax rates and the timing of individual and corporate tax payments—is thus a key proposal in the President's fiscal program.

At the same time, the Administration looks toward further declines in unemployment during the year ahead—indeed, to the lowest level since 1953. These ambitious targets are a renewed expression of confidence in the vigor, adaptability, and productivity of our private economic system—a confidence which has been richly reaffirmed and rewarded in the past 2 years by the Nation's smooth progress and efficient performance in approaching full employment. Nonetheless, this is a year of many uncertainties: the advance into the new territory of still lower unemployment must be made with care; meanwhile, defense requirements could shift suddenly in either direction in the months ahead. Fiscal policy stands ready to meet any changing needs and unanticipated developments, and will look to assistance from monetary policy in maintaining flexibility.

This chapter reviews the recent record of progress toward full employment, appraises the current state of the economy, evaluates the outlook for gross national product and employment in 1966 in the light of fiscal and monetary policies, and explores future contingencies. Chapter 2 examines in detail the outlook for price-cost stability. Problems of the U.S. balance of payments are reviewed in Chapter 6.

PROGRESS TOWARD FULL EMPLOYMENT

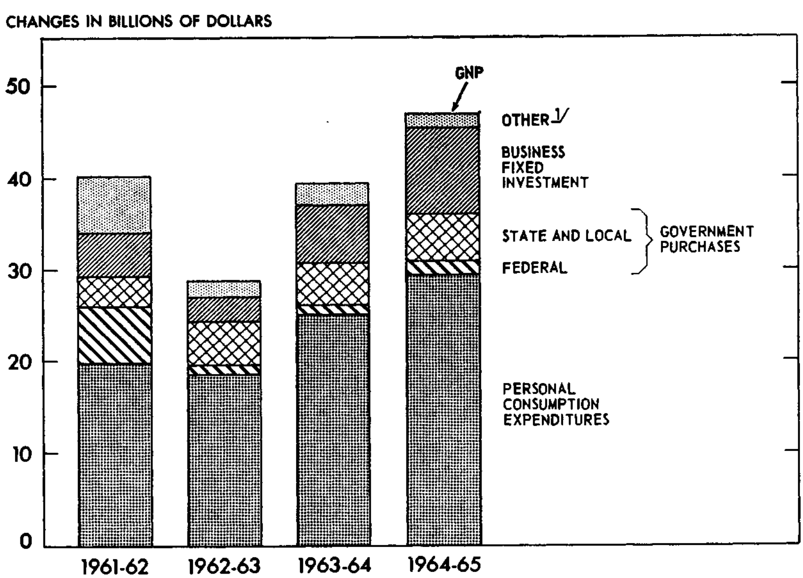
Nearly 5 years of expansion have yielded a gain of $190 billion in gross national product (GNP). Revised historical estimates of our national product through 1964 were published last August by the Department of Commerce, and updated provisional estimates for 1965 were released at the start of this year; these new estimates give a more accurate picture of the growth of GNP and the relationship of its components. They show that total GNP advanced at a 7.0 percent annual rate in the last 4¾ years. After adjustment for the modest upward drift in prices, the average annual rate of growth of real output over this period was 5.5 percent.

When measured from the peak year of 1960 to 1965, real growth averaged 4.5 percent, in sharp contrast to the 2.4 percent annual rise from 1953 to 1960. This rapid growth in the United States exceeds the target rate for the 1960's established collectively by the member countries of the Organization for Economic Cooperation and Development (OECD). At mid-decade, the Secretary General of the OECD reported to the Ministers, "During the period 1960–65, gross national product for OECD countries taken together has increased at a somewhat higher rate than that needed to meet the target of 50 percent for the decade 1960–1970 [4.1 percent a year] set by the Ministers in 1961." The United States accounts for virtually all of the surplus above the target rate. In contrast to the decade of the 1950's, when most OECD countries enjoyed virtually uninterrupted expansion while the United States suffered periodic downturns, it has been the United States that has experienced continuing strong expansion thus far in the 1960's.

Sustained and balanced progress is the hallmark of the current expansion. But the pace of the advance has varied over time (Chart 1). In the initial recovery period from the 1960–61 recession, output rebounded sharply; the unemployment rate, which had been 7 percent early in 1961, fell rapidly late in the year, reaching 5½ percent by mid-1962. The upswing was spurred by the characteristic shift from liquidation to accumulation of inventories, and by higher Federal Government spending, partly associated with the 1961 Berlin crisis. However, the expansion then faltered when fixed investment outlays failed to take over as the main expansionary force in the economy. As the growth of total output slowed, unemployment threatened to be stuck on a 5½ percent plateau. The Kennedy Administration was convinced that adequate total demand could reduce

Chart 1

Changes in Gross National Product Since 1961



1/ RESIDENTIAL STRUCTURES, CHANGE IN BUSINESS INVENTORIES, AND NET EXPORTS OF GOODS AND SERVICES.
SOURCE: DEPARTMENT OF COMMERCE.

unemployment at least to 4 percent without inflation. To accomplish this objective, it developed a comprehensive program of tax measures, including lower personal and corporate tax rates, depreciation reform, and an investment tax credit. The personal tax cuts raised after-tax earnings and spurred more spending by consumers. The corporate measures added further to private investment incentives and to the volume of investible funds.

The economy responded well to these measures, and especially to the major tax cut of February 1964. GNP rose by nearly $40 billion in 1964, compared with the gain of almost $30 billion in 1963, and the unemployment rate fell to 5.0 percent by the end of the year.

Statistical analysis of the impact of the tax reduction suggests that it was responsible for nearly the entire $10 billion step-up in the annual increase of GNP. The reduction in tax liabilities in 1964 boosted the after-tax incomes of households and businesses. Spending by these sectors, particularly consumer outlays, rose in response to these larger after-tax incomes. This higher spending increased sales, employment, and earnings. Larger earnings, in turn, provided the basis for still more consumption spending. Investment was also stimulated by gains in business sales and higher capacity utilization. By early 1965, the contribution of the tax cut in lifting consumption and investment spending was more than $20 billion (annual rate). Since the effects of the tax cut cumulate through time, its contribution has grown further, reaching $30 billion by the end of 1965.

As 1965 opened, the remaining lift from the Revenue Act of 1964 was not in itself sufficient to assure a sustained reduction in unemployment. Consequently, a good opportunity was presented for a long-awaited reduction in excise taxes and a liberalization of Social Security benefits, both of which were desirable on equity grounds. These actions were proposed in the fiscal 1966 budget, presented in January 1965. In combination with expected modest increases in other expenditures, they more than offset the normal growth of Federal revenues, and thus provided a net fiscal stimulus for calendar 1965. The stimulus was planned for the second half of the year since heavy stocking of steel inventories in anticipation of a strike was expected to stimulate demand early in the year and subsequently to be reversed.

The fiscal actions in 1965 were a success. The economy did move further toward full employment, even more rapidly than anticipated; yet demand did not outstrip capacity to produce.

SOURCES OF STRENGTH

Personal consumption and business fixed investment, the two types of spending expected to be most responsive to the major 1964 tax reduction, surged ahead in 1964 and 1965. Buoyancy in these sectors outweighed sluggishness in residential construction outlays and moderation in inventory investment (Table 1).

TABLE 1.—*Changes in gross national product since early 1961*

Expenditure group	1961 I	1963 IV	1965 IV [1]	Percentage change per year: 1961 I to 1965 IV [1]	Percentage change per year: 1963 IV to 1965 IV [1]
	Billions of dollars [2]				
Gross national product	503.6	603.6	694.6	7.0	7.3
Personal consumption expenditures	328.4	379.5	440.1	6.4	7.7
Private business fixed investment	46.0	56.5	73.2	10.3	13.8
Change in business inventories	−3.5	8.1	7.0	(3)	(3)
Residential structures	21.7	27.9	27.2	4.9	−1.3
Net exports of goods and services	6.6	7.3	7.4	(3)	(3)
Government purchases of goods and services	104.3	124.3	139.6	6.3	6.0
Federal	55.4	64.4	69.7	5.0	4.0
State and local	49.0	59.9	69.9	7.8	8.0

1 Preliminary.
2 Seasonally adjusted annual rates.
3 Percentage change not computed because of small or negative base.

NOTE.—Detail will not necessarily add to totals because of rounding.

Sources: Department of Commerce and Council of Economic Advisers.

Consumption

The consumer was a bulwark in the strong general economic gains of 1964 and 1965. Except for the fourth quarter of 1964, when strikes curtailed automobile sales, consumption grew by $7 billion or more in every quarter of this period. Only twice before, once at the start of the Korean war and again at the beginning of 1959, had quarterly increases of this size occurred.

A notable feature of the recent sharp advance in consumption expenditures is its pervasiveness. The sharpest relative increases occurred in purchases of durables, which are generally most sensitive to fluctuations in the growth of income. From the end of 1963 to the end of 1965, real expenditures on automobiles toppled all previous records, rising on average by 11 percent a year. Yet this strong rise was closely paralleled by outlays for other durables. And real outlays on both nondurables and services rose at an unusually strong 5½ percent annual rate.

Consumers were able to take these forward strides because of rapid gains in their purchasing power. Real disposable income grew at an average annual rate of 6.3 percent in the 2 years after the 1964 tax cut, in contrast to the growth rate of 3.9 percent in the preceding 2 years. The consumer continued to be a dependable performer in the economy. During the past 2 years, the rise of almost $61 billion in consumption amounted to 91 percent of the $66 billion increase in disposable income. Spending on consumer goods and services has typically absorbed approximately this proportion of increases in disposable income, when allowance is made for some lag in adjustment to unusually large income gains.

The largest beneficiaries of the rapid rise in income were workers rescued from unemployment. Other consumers also benefited, although less dra-

TABLE 2.—*Changes in employment and income since early 1961*

[Seasonally adjusted]

Series	Unit	1961 I	1963 IV	1965 IV[1]	Percentage change per year: 1961 I to 1965 IV[1]	Percentage change per year: 1963 IV to 1965 IV[1]
Civilian labor force:						
Employment	Millions of persons	[2] 66.6	69.3	73.0	2.0	2.6
Unemployment	do	[2] 4.9	4.1	3.2	−8.4	−12.1
Personal income: [3]						
Total (before taxes)	Billions of dollars	406.6	475.6	546.0	6.4	7.1
Wage and salary disbursements	do	270.9	318.8	368.1	6.7	7.5
Disposable (after taxes)	do	354.8	414.0	480.3	6.6	7.7
Corporate profits: [3]						
Before taxes	do	45.0	60.8	[4] 74.6	[4] 11.9	[4] 12.4
After taxes	do	24.4	33.8	[4] 44.5	[4] 14.3	[4] 17.0

[1] Preliminary.
[2] Adjusted for comparability with subsequent data.
[3] Quarterly data at annual rates.
[4] Profits data relate to 1965 III.

Sources: Department of Labor, Department of Commerce, and Council of Economic Advisers.

matically, through lower taxes, higher wages, and fuller work schedules (Table 2). Thus, expansionary fiscal policies were translated for most Americans into rising standards of living—more and better provision of the physical necessities, the social amenities, and the personal conveniences of civilized life. Real consumption per capita (1958 prices) grew over the 2-year interval by $190—as much as in the preceding 8 years.

Investment

A buoyant economy with rising sales and operating rates, surging profits, and the incentives of tax reduction gave new stimulus to business to expand and modernize capacity. The result was an 11½ percent jump in outlays for business fixed investment in 1964 and a 15½ percent spurt in 1965. These gains compare with an average annual rate of increase of 7½ percent in the preceding 2 years.

Investment plans were repeatedly revised upward in 1964 and 1965 as business confidence grew. The second time that businessmen reported spending plans for a given quarter—in the Department of Commerce-Securities and Exchange Commission survey—their plans exceeded the first anticipations. Their actual outlays invariably topped the second anticipations (Table 3)—a clear indication of the general availability of capital goods. In sharp contrast, during 1956 and early 1957, businessmen were not able to invest as much as they had planned because of bottlenecks in construction and delivery of equipment.

The stepped-up pace of final sales in 1964 and 1965 also required additional inventories. Nevertheless, the $5.4 billion accumulation of nonfarm stocks in 1964 was unusually small in relation to the advance in final sales as inventory-sales ratios declined during most of the year. During

TABLE 3.—*Planned and actual expenditures for new plant and equipment, 1964–65*

[Billions of dollars, seasonally adjusted annual rates]

Quarter	Planned expenditures		Actual expenditures
	Middle of preceding quarter	Middle of current quarter	
1964: I	40.8	41.2	42.6
II	42.7	43.4	43.5
III	44.3	44.6	45.6
IV	46.2	46.7	47.8
1965: I	47.9	48.8	49.0
II	49.6	49.6	50.4
III	50.8	51.2	52.8
IV	53.0	54.8	(1)

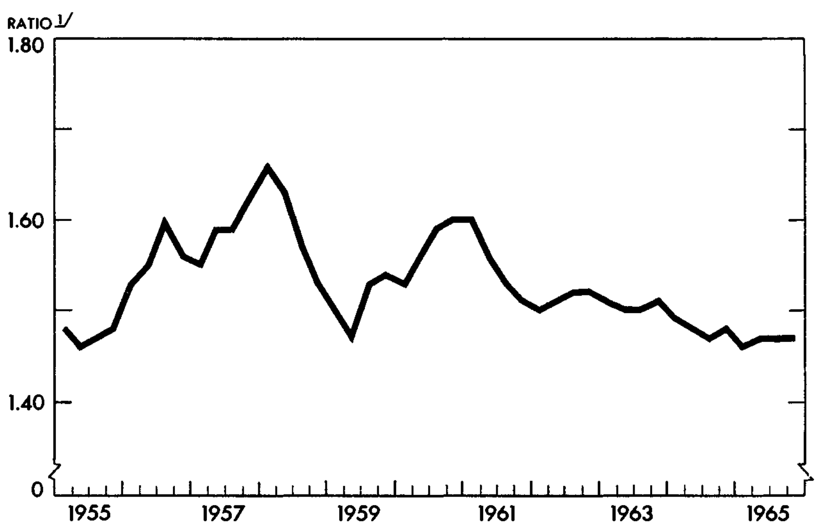
[1] Not available.

Sources: Department of Commerce and Securities and Exchange Commission.

1965, quarterly rates of inventory investment reflected temporary influences: the post-strike rebuilding of automobile inventories, the buildup of steel stocks, and the backlog of exports associated with the dock strike, early in the year; and, on the other hand, liquidation of steel stocks in the closing months. For 1965 as a whole, however, nonfarm inventory investment of $7.1 billion was in line with the growth of final sales. As Chart 2 shows, inventory-sales ratios remained remarkably stable throughout the past 4 years, in marked contrast to the cyclical ups and downs in the late 1950's. In recent

Chart 2

Business Inventory-Sales Ratio



1/ RATIO OF MANUFACTURING AND TRADE INVENTORIES TO SALES; BASED ON SEASONALLY ADJUSTED QUARTERLY AVERAGES OF MONTHLY SALES AND END-OF-MONTH INVENTORIES.

SOURCE: DEPARTMENT OF COMMERCE.

years, businessmen's sales expectations were validated or surpassed by performance; moreover, prudent management helped to keep stocks closely geared to sales.

Residential construction was the only major component of private spending which remained weak in 1964 and 1965. In the 1961–63 period, the average annual addition of 1.46 million units to the private housing stock exceeded by an unusually large margin the average annual rate of net family formation (870,000). Excess supply developed in particular housing markets, especially in the West and in high priced apartments in scattered other locations. Thus, the upswing in residential construction activity ended early in 1964. The number of private housing starts fell from an annual rate of 1.7 million units in the first quarter of 1964 to a low of 1.4 million units in the third quarter of 1965. The real value of home construction held up somewhat better—because of a shift toward bigger and better quality new homes. Nevertheless, residential construction added practically nothing to the growth of GNP—even in current prices—in 1964, and was again a conspicuously lagging sector in 1965.

THE RECENT RECORD

The strength of the advance in 1965 was exceptional and surpassed expectations. The Council's Annual Report of 1965, which contained one of the more optimistic forecasts current at that time, estimated a gain of $38 billion in GNP for the year—the midpoint of a $33–43 billion range. In contrast, the actual gain was a record $47 billion.

The major reason for the unforeseen gain was the unusually large revision in investment plans. Evidence available at the beginning of 1965 pointed to a rise in business fixed investment for the year which would be close to, but not quite match, the increase in 1964. The actual advance, however, totaled $9½ billion, substantially exceeding the $6 billion rise in the preceding year. Federal purchases of goods and services rose by $1½ billion for the year as a whole, compared with the $½ billion increase that had been anticipated. Consumption outlays exceeded the Council's original estimate, but this was primarily because of higher disposable income that, in turn, reflected the greater strength of other sectors.

The extraordinary strength of demand became more clearly established as the year 1965 progressed. Much of the unusually large advance in the opening quarter was attributable to the rebound from the strike in the automobile industry, which had depressed output in the closing quarter of 1964. Even though automobile output retreated in the second quarter, GNP advanced strongly. Sharp increases in fixed investment in the third and fourth quarters reinforced continued rapid rises in consumption.

Finally, defense outlays added to demand, particularly from the second to the fourth quarter, when they rose by $2.8 billion. About $1 billion of this rise came from the military pay increase enacted in September.

Moreover, the prospect of further substantial increases in Federal defense expenditures was a major factor contributing to buoyant expectations and investment demand in the second half of the year.

Thus, gains in GNP grew to $13 billion each in the third and fourth quarters of 1965. The advance in the fourth quarter was especially remarkable in view of the liquidation of steel inventories, at an annual rate of about $2 billion, following the September labor settlement. Although the impact of the slowdown in steel production was evident in the industrial production index in September and October, the index rose strongly thereafter; for the year as a whole, it was 8 percent above the 1964 average.

The strength of spending lifted the economy toward more complete use of its resources. Under the influence of favorable fiscal and monetary policies, the economy has achieved the best balance of over-all demand and productive capacity in nearly a decade.

THE BALANCE OF THE ECONOMY TODAY

The potential output of the American economy has continued to grow rapidly in the past 5 years. Aggregate demand, however, has advanced even faster. Output has risen to within 1½ percent of the economy's estimated potential. Meanwhile, private investment has forged ahead to match high-employment private saving. The good balances of demand with potential output and of investment with high-employment saving are two related measures of our progress.

BALANCE OF OUTPUT AND POTENTIAL

In 1965, the American economy achieved fuller utilization of its vast human and physical resources than at any time since 1957. Jobs were provided for more persons able and willing to work, thus leading to a more equitable distribution of the Nation's output and reducing the ranks of those unfairly condemned to a meager subsistence because they cannot find work. More and more Americans have had the chance to exercise their preference for employment rather than doles. Adult males had an unemployment rate of 5.7 percent in 1961. The rate fell to 2.6 percent by the end of 1965, not because attitudes toward work were uplifted, but because opportunities for work widened greatly.

A high-employment economy generates benefits for the rest of the Nation as well as for the previously unemployed. The additional output directly attributable to the efforts of the reemployed is just one part of the larger output that accompanies increased employment. In addition, productivity is higher as a result of improved utilization, primarily reflecting the more efficient use of overhead labor, such as clerical, professional, maintenance, and managerial employees.

Improving employment opportunities also attract more persons into the job market and thus add to the measured labor force. Manpower supplies are further increased in periods of advancing activity by the lengthening of the work week, as part-time employees are converted to full-time and as overtime work increases.

In the last four Economic Reports, the Council has discussed the concept of potential GNP, defined as the volume of goods and services that the economy would ordinarily produce at the interim target unemployment rate of 4 percent. The measurement of potential GNP must incorporate the effects of the higher productivity, the larger labor force, and the fuller work schedules which accompany reduced unemployment.

Potential GNP does not stand still. Over time, population trends add to the number of persons in the labor force. Furthermore, increases in the quantity and quality of capital, advances in technology, and improvements in the quality of labor raise the potential productivity of the labor force.

The evidence indicates that, from the mid-1950's and into the early 1960's, the potential labor force grew at the rate of about 1¼ percent a year. Normal growth of man-hour productivity for the entire work force (including Government as well as private workers) was 2½ percent a year. Hours worked a year trended downward at a rate of nearly one-fourth of 1 percent annually. Thus, potential GNP grew by 3½ percent a year.

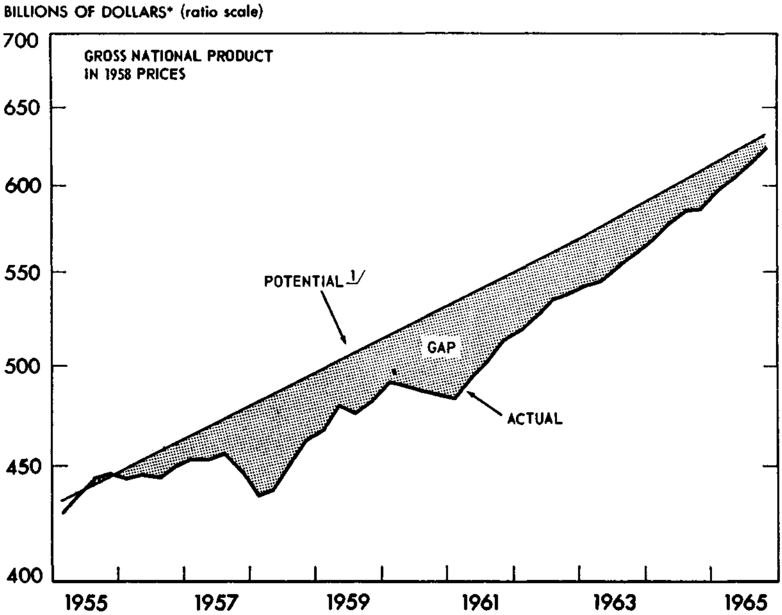
For recent years, a real growth rate of actual GNP somewhat greater than 3½ percent has been required to hold the unemployment rate constant. Hence, the Council last year raised its estimated rate of growth of potential GNP to 3¾ percent, beginning in 1963. More rapid growth of the labor force will further increase the growth rate of potential GNP in the years ahead. During 1966, the Department of Labor will release a study, summarizing the results of extensive research on the prospects and patterns of growth by 1970.

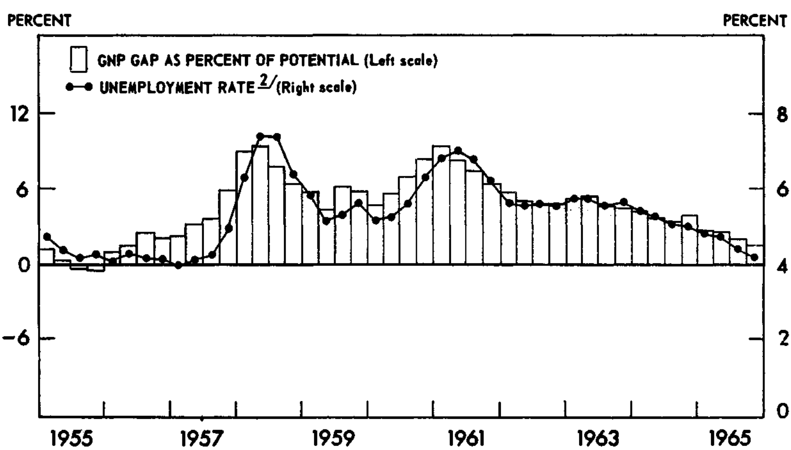
The disparity or "gap" between potential and actual output (Chart 3) represents the goods and services foregone because of the underutilization of resources. The persistent gap since the mid-1950's has meant a total of $260 billion (in 1958 prices) in lost output. This loss was at a peak annual rate of $50 billion in the first quarter of 1961. The gap was reduced during the next few years. It shrank dramatically in 1965, reaching $10 billion, in the final quarter when the unemployment rate was 4¼ percent.

During the second half of 1965, unemployment fell somewhat more rapidly than would have been expected from the rate of advance of real GNP. It now appears likely that the unemployment rate will reach 4.0 percent while the trend calculation still shows a small GNP gap. Recent experience has been influenced by the expansion of the armed services and of Government antipoverty programs for training young unskilled workers, both of which have a stronger effect on unemployment than on output. Despite the discrepancy between the estimate of the gap and the movement of unemployment that emerged late in 1965, it is clear that the Council's estimates of the potential GNP associated with 4 percent unemployment have been close to the mark throughout the expansion. Potential

Chart 3

Gross National Product, Actual and Potential, and Unemployment Rate





* SEASONALLY ADJUSTED ANNUAL RATES.

1/ TREND LINE OF 3½% THROUGH MIDDLE OF 1955 TO 1962 IV; TREND LINE OF 3¾% THEREAFTER.

2/ UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE; SEASONALLY ADJUSTED.

SOURCES: DEPARTMENT OF COMMERCE, DEPARTMENT OF LABOR, AND COUNCIL OF ECONOMIC ADVISERS.

output has proved to be quantifiable within a sufficiently narrow range to justify its use as a key concept in the analysis of stabilization problems and policies.

The 4 percent unemployment rate has been viewed consistently by the Administration as an interim target obtainable by aggregate demand policies *alone* without sacrificing essential price stability. But aggregate demand policies have *not* been alone. Other public and private policies have improved the functioning of markets and the skills of the labor force, as Chapters 2 and 3 explain in detail. These policies have now made prudent a reduction in the unemployment rate to a level below 4 percent.

BALANCE OF INVESTMENT AND SAVING

The resurgence of private demand in 1965 was marked by an improved balance of investment and private saving.

As statistically measured, total national saving—personal saving, gross business saving, and the net surplus of Federal, State, and local governments—is always necessarily equal to private investment (except for whatever statistical discrepancy may creep into the measurement of income and product flows). Total gross national income equals the value of spending for current production—consumption, government purchases, and investment. Saving is that part of total income which is neither spent for personal consumption nor used for government purchases. Therefore, it must equal the value of spending for the remaining portion of GNP, i.e., investment.

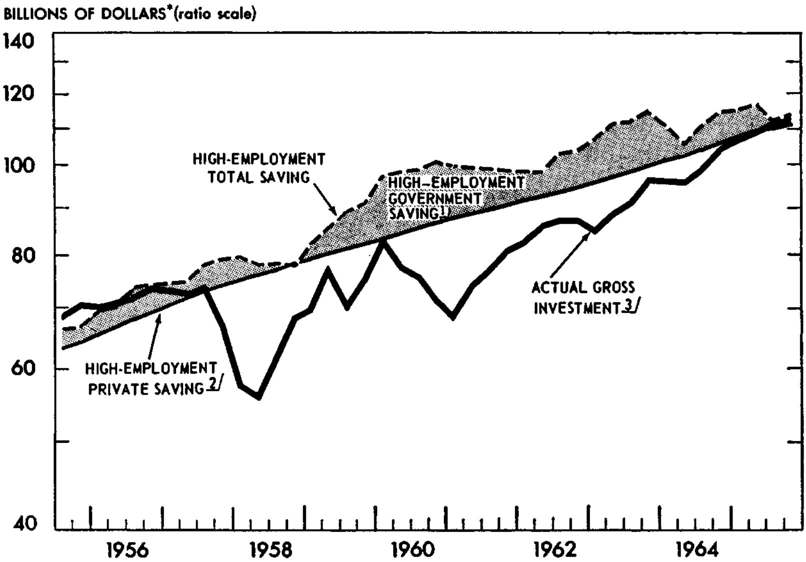
This equality of saving and investment will hold whether the economy is depressed or fully employed. But the economy can have high employment only if actual investment demands of businesses are large enough to match the amount that consumers, businesses, and governments wish to save at high-employment incomes. If actual investment falls short of high-employment saving, total spending will fall short of high-employment output. Because of insufficient demand, production will be held to some lower level where a smaller volume of saving does match the forthcoming investment.

Actual gross investment did, in fact, fall short of high-employment saving for nearly 8 years after 1957. Balance between the two was finally restored during 1965. Much of the discrepancy prior to 1965 is attributable to a fiscal policy that would have yielded excessively large surpluses at high income levels. Since investment demand was not strong enough to match this excessive Federal high-employment surplus, lower incomes resulted.

A comparison between actual private investment and estimated total high-employment saving from 1956 to 1965 is given in Chart 4. At high employment, total private saving would be expected to remain a fairly stable fraction of GNP, between 15½ and 16 percent. It will, of course, vary from year to year, reflecting changes in the personal saving rate, changes in tax rates and transfer payments that would alter the share of disposable income in GNP, and shifts in corporate dividend policies or in depreciation allowances.

Chart 4

Investment and High-Employment Saving



* SEASONALLY ADJUSTED ANNUAL RATES.
1/ FEDERAL HIGH-EMPLOYMENT SURPLUS PLUS STATE AND LOCAL ACTUAL SURPLUS.
2/ 15¾ PERCENT OF TREND GNP IN CURRENT PRICES.
3/ GROSS PRIVATE DOMESTIC INVESTMENT PLUS NET FOREIGN INVESTMENT.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

Nevertheless, no great variation would ordinarily be expected; total private saving is approximated on the chart at 15¾ percent of potential GNP. Private saving thus appears as an almost straight line in the chart since potential GNP (even in current dollars) grows rather smoothly. State and local governments typically stay very close to balanced budgets on a national income accounts basis. Their contribution to high-employment saving is approximated by their actual small surpluses or deficits.

The Federal contribution to total high-employment saving is measured by its high-employment surplus, a concept that has been explained in previous Annual Reports. It is the excess of Federal revenues that would be generated by high-employment incomes over actual Federal expenditures, adjusted for the reduced level of unemployment compensation.

The unevenness of the total high-employment saving line is due almost entirely to fluctuations in the high-employment Federal surplus. This reflects the major changes in fiscal policy during the post-1957 period. The dip in 1958 is a result of vigorous fiscal measures to stimulate recovery from recession; the steep rise in 1959 and 1960 marks an extremely restrictive fiscal policy. This rise is reversed in 1961 and early 1962, reflecting expenditure measures taken by the Kennedy Administration to stimulate recovery and strengthen defense, as well as the 1962 depreciation reform and investment tax credit. The line turns up sharply late in 1962 as a result of leveling expenditures. The Revenue Act of 1964 shows up in a sharp decline in saving, as do the late 1965 excise tax reduction, social insurance liberalization, and step-up in defense purchases.

These fiscal measures have brought total high-employment saving down from excessive levels. Equally important, they have had a decisive impact on the investment side of the balance. Investment demand looked particularly weak in 1962 and 1963, and there were doubts that it could reach the range of 15½ to 16 percent of GNP, even at high employment. In that event, sizable and persistent Government deficits would have been required to achieve high employment. But the experience of the past 2 years has refuted these pessimistic assessments of the strength of private demand. With stronger consumer markets and higher after-tax profits, business fixed investment has broken out of its earlier lethargy. Balance was restored in 1965 between private investment and private high-employment saving, demonstrating that high employment was in fact achievable without substantial, permanent Government deficits.

FINANCING BALANCED EXPANSION

The availability and cost of credit significantly influence spending. Stable prosperity must have a sound underpinning of credit. And the appropriate growth of credit is an important element in the over-all balance of the economy.

The appropriate amount of credit expansion depends on a variety of factors including (1) the balance between total demand and potential output in the economy—with proper allowance for the role of fiscal policy; (2) the structure and position of financial institutions; and (3) the ability of borrowers to absorb further debt. Only from an over-all view of the needs of the economy can the appropriate growth of credit and the appropriate role of monetary policy be evaluated.

The Federal Reserve System exerts a major influence on the cost of credit and the rate of growth of credit from all financial institutions. The reserve credit it supplies is particularly significant, because it provides the base for a multiple expansion in commercial bank credit to borrowers, thereby affecting all credit markets. Reserve credit is the keystone of the system, although it is only a small portion of total credit. It rose by only $3.8 billion in 1965, compared with almost $55 billion of funds supplied by financial institutions as intermediaries and the total of almost $72 billion raised in all credit markets.

PATTERN OF CREDIT FLOWS AND THE DEMAND FOR FUNDS

The flow of funds through financial markets accelerates when the pace of economic activity is stepped up. The similarity in the behavior of credit flows between the current upswing and the two weaker preceding expansions is striking. In 1965, however, total credit flows to private domestic sectors rose somewhat faster relative to GNP than in earlier periods of prosperity—primarily in response to the growing external financing needs of businesses (Table 4).

TABLE 4.—*Net funds raised by private domestic nonfinancial sectors, 1953–65*

Period	Net funds raised as percent of GNP [1]	Types of credit as percent of funds raised [1]				
		Consumer credit	Bank loans to business [2]	State and local government obligations	Corporate securities	Home mortgages [3]
Expansion years:						
1955	8.94	17.98	14.89	9.27	13.48	34.83
1956	7.78	10.74	18.40	9.20	18.10	33.13
1959	8.46	15.65	13.45	11.00	12.71	31.78
1962	7.89	12.44	10.86	11.31	11.54	29.41
1963	8.47	13.43	12.02	13.43	7.21	30.46
1964	8.88	12.37	13.62	10.57	9.68	28.32
1965 [4]	9.61	13.71	19.57	10.02	10.79	23.42
Downturn or early recovery years:						
1953	5.84	18.31	−3.76	17.37	24.41	35.21
1954	5.92	5.09	(5)	20.37	23.61	43.06
1957	6.96	8.47	5.86	14.33	28.66	28.01
1958	6.39	.70	3.15	18.18	27.27	34.27
1960	6.55	13.64	8.79	10.91	15.15	31.82
1961	6.52	5.01	6.49	14.45	20.94	33.63

[1] Net funds raised by private domestic nonfinancial sectors include, in addition to types of credit shown here, mortgages on multi-family dwellings and on farm and commercial land and buildings; and acceptances, commercial and finance company paper, and Commodity Credit Corporation (CCC) loans.
[2] Bank loans to nonfinancial business not classified elsewhere.
[3] Mortgages on one- to four-family homes.
[4] Preliminary estimates.
[5] Loans were less than $50 million.

NOTE.—Data are based on flow of funds accounts.

Source: Board of Governors of the Federal Reserve System.

The composition of borrowing during the current expansion has also been similar to that of other recent expansions, although the sources of funds have differed. Consumer credit and bank loans to business have risen substantially, relative to other types of borrowing. When employment and income are high, a larger proportion of households' income typically is spent for durable goods and housing which are likely to be financed by credit. The share of GNP going into inventories and plant and equipment also rises, spurring business borrowing, particularly from banks.

Households

Borrowing by households has been rising significantly since the end of 1961. As a proportion of disposable personal income, however, it reached a peak of 6.5 percent in 1963; this figure had been surpassed only in 1955 and 1959. Since 1963, the proportion has edged down to about 6 percent. Nevertheless, borrowing remains large relative to consumers' "capital" expenditures. Even though there has been a rapid advance in

795-983 O—66——4

consumer expenditures on durable goods, total household expenditures for durable goods plus home construction have been smaller relative to disposable income than in previous expansions since the Korean war.

Households have simultaneously stepped up their borrowing and the growth of their financial assets. Households' financial assets have grown annually by 10 to 11 percent of disposable income since 1962, compared with slightly below 9 percent in 1955–56. Higher incomes have made more households both creditworthy and able to save. Moreover, the growing importance of contractual saving, through insurance and pension funds, has often led even the same households to add both to their financial assets and to their liabilities.

Business

While borrowing by households and State and local governments maintained a fairly rapid pace in 1965, it was the financial demands of businesses which accounted for the acceleration in credit flows. Last year, business capital expenditures significantly outpaced the strong rise in gross retained earnings, and the ratio of capital outlays to retained earnings rose abruptly. Indeed, it exceeded the ratio for all years in the post-Korean period, except 1956. External financing, however, rose even more sharply, reaching a new high relative to gross retained earnings that surpassed even the 1956 relationship. This strong rise is partly attributable to the growing volume of funds committed by corporations to uses other than capital outlays. In the past 2 years, corporations have markedly increased their net extensions of trade and consumer credit. Meanwhile, corporate holdings of liquid assets have declined steadily as a proportion of their financial assets. Consequently, corporations are now less able to economize on liquid assets in order to provide for other uses of funds.

A number of special factors in 1965 also contributed to the sharp increase in business borrowing. Inventories were rising rapidly and foreign investment by corporations was unusually high early in the year.

All in all, the volume of borrowing was not significantly out of line with past experience. Furthermore, the total demand for goods and services—supported in part by the expansion of credit—was in good balance with the supply capabilities of the economy in 1965.

POSITION OF FINANCIAL INSTITUTIONS

Sustainable growth of credit depends on the sound operation of financial institutions. As new types of financial "intermediation" evolve to meet new needs, more lending and institutional saving will take place. Such credit growth will occur smoothly if financial institutions adjust to innovations without assuming dangerous risks.

During the current expansion, the most striking institutional change in the financial area has been the rapidly growing role of commercial banks.

Total bank credit has risen at an average rate of 8½ percent a year since the end of 1960, while total credit to nonfinancial sectors of the economy has risen by 7 percent a year. Commercial banks have accounted for over one-third of total funds raised in credit markets during recent years, in contrast to the one-sixth share in earlier post-Korean periods of prosperity. The larger proportion of credit flowing through the commercial banking system has resulted from various influences: first, a sequence of increases in the ceiling rates of interest permissible on time and savings deposits, which has enabled the commercial banks to compete more aggressively for deposits and thus to expand their lending; second, the greatly expanding scope of bank lending and investment practices; and third, the more liberal policy pursued by the Federal Reserve System in supplying bank reserves.

Much of the recent growth of bank deposits has taken the form of time certificates of deposit. Another sizable increase in such certificates and in commercial bank lending can reasonably be expected in the early part of this year, in response to the increase last December in the maximum permissible interest on time deposits. Nevertheless, banks which have expanded lending greatly on the basis of short-term certificates of deposit have at times found it costly to raise needed funds when the certificates mature in quantity. This experience should introduce more caution in the pursuit of new business.

Savings and loan associations and mutual savings banks have borne the brunt of competition from commercial banks. Meanwhile, the demand for mortgages, in which such institutions customarily place most of their funds, has grown less rapidly than other types of credit, and yields on mortgages showed little change during most of the 1960's. Consequently, some savings institutions eager for growth, have sought higher yielding and occasionally more risky outlets for investment while repeatedly raising their dividend or deposit rates. In order to prevent the assumption of excessive risk by savings and loan associations, the Federal Home Loan Bank Board strengthened its surveillance and issued several new selective regulations in the past year.

The President's current legislative program includes proposals to reform the structure of financial regulations, to give regulatory agencies a greater variety of enforcement powers, and to increase deposit insurance coverage. This important legislation includes proposals that will make regulations over various types of financial institutions more consistent with each other, thus fostering competition while providing the authority to curb speculative excesses. These same objectives have prompted legislative recommendations to allow Federal chartering of mutual savings banks for the first time.

POSITION OF BORROWERS

Rapid growth in borrowing by households and businesses relative to their incomes raises the question whether still more debt can be readily absorbed without threatening an abrupt cutback in future spending. Danger signals are commonly sought in three basic types of indicators: growth of the ratio of debt repayment to income or of total debt to total assets; growth of "easier" credit terms, such as smaller downpayments, longer maturities, or higher appraisal values; and growth of certain losses, such as foreclosures or defaults.

The ratios of household debt repayments or income commitments to disposable personal income have risen over the past 12 years (Table 5).

TABLE 5.—*Relation of selected commitments of the household sector to disposable personal income, 1951–65*

Year	Percent of disposable personal income			
	Repayments of instalment debt	Repayments of instalment and mortgage debt	Basic fixed commitments [1]	Basic fixed commitments and essential outlays [2]
1951	10.2	12.0	16.3	57.7
1952	10.7	12.7	17.0	58.3
1953	11.1	13.2	17.8	57.6
1954	11.8	14.3	19.0	59.1
1955	12.2	14.7	19.5	58.5
1956	12.7	15.3	20.1	58.5
1957	12.9	15.8	20.6	58.9
1958	12.6	15.7	20.6	59.3
1959	12.6	15.8	20.7	59.1
1960	13.1	16.4	21.5	59.7
1961	13.1	16.4	21.5	59.5
1962	13.1	16.4	21.6	59.2
1963	13.6	17.2	22.5	59.7
1964	13.9	17.3	22.7	59.2
1965	[3] 14.2	[3] 17.8	[4]	[4]

[1] Consists of repayments of instalment and mortgage debt, tenant rent, and property taxes on households.
[2] Essential outlays consist of consumer outlays for food, clothing, utilities, and local public transportation.
[3] Based on first 2 quarters.
[4] Not available.

Sources: Board of Governors of the Federal Reserve System, Department of Commerce, National Industrial Conference Board, and Council of Economic Advisers.

Most of the rise is accounted for, however, by widening use of instalment credit rather than the rise in the average repayment burden for families using credit. Almost one-fourth more families, particularly young parents, are now using instalment credit. Debt repayment, however, is only one type of commitment undertaken by households. Whether households are overextending themselves must be viewed in terms of a broader concept of commitments including other contractual obligations and essential consumer outlays. When viewed in this way, the measure of "burden" has been roughly stable. Certain claims on income substitute for others: mortgage payments for rent, and automobile payments for some purchased transportation.

Use of aggregate ratios can hide distributional problems. Surveys suggest that families which have a relatively small amount of liquid assets account for a large proportion of the instalment debt outstanding; their creditworthiness is established by their earnings rather than their accumulated assets. However, there was a slight decline from 1954 to 1965 in the proportion of families which have as much as 20 percent of their disposable income committed to instalment debt repayments.

"Easier" terms of credit may be either a warning signal of excessive credit expansion or a welcome evolution. The widening availability of credit has been a key feature of American financial development over the long run. Certain types of lending that were once considered "risky"—such as consumer instalment credit—have proven to be quite sound and profitable. Other such innovations have come at a rapid pace in recent years.

Delinquency rates on consumer credit have varied in the post-Korean period—mainly reflecting fluctuations in economic activity—but they have remained consistently well below their 1950–53 level.

In contrast, the rate of mortgage foreclosures has shown a distinct upward trend during the past 15 years. From World War II through the Korean war, the inflation of real estate values bailed out poor credit risks and held down mortgage defaults. Subsequently, foreclosures on conventional mortgages began to rise, but they have increased only slightly since 1961. Much of the uptrend in the over-all foreclosure rate since 1961 has taken place in Federal Housing Administration (FHA) insured mortgages which had been written with unusually liberal terms. Thus, FHA procedures and regulations have recently been tightened. By any reasonable criterion, today's over-all foreclosure rate on home mortgages, about ½ percent a year, is not out of line with the risk premium that such assets carry.

Nevertheless, a sharp drop in incomes could certainly have unfavorable financial repercussions. Despite the strong position of financial institutions and the insurance of various types of deposits and mortgages, the quantity of outstanding credit is an element increasing the economy's vulnerability to cumulative declines if aggregate demand is permitted to collapse. Well-timed fiscal and monetary policies to maintain economic stability hence become even more important.

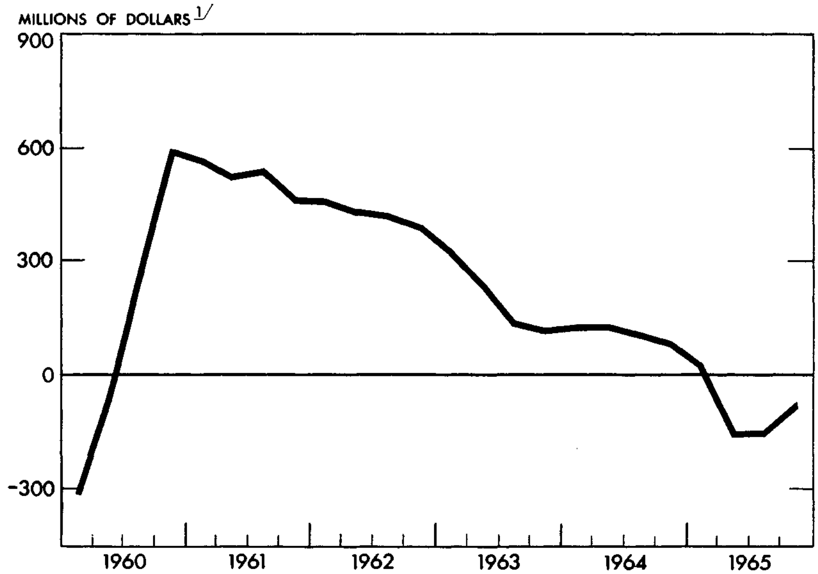
MONETARY POLICY

The growth of total credit in the current expansion has contributed to the improved balance between total spending and potential output. Until mid-1965, the cost and availability of credit remained unusually stable for a period of strong advance in economic activity. The increase in the discount rate announced last December 5 was the first monetary policy action aimed specifically at domestic credit flows.

Previous movements toward less ease in monetary policy had been directed primarily toward restraining the flow of funds abroad for balance of payments reasons. The discount rate increase in November 1964 was aimed at forestalling outflows of short-term capital threatened by an increase in the British Bank rate. Reserve availability was again reduced after new balance of payments measures were announced last February (Chart 5). Following this move, free reserves remained almost continuously in the

Chart 5

Free Reserves



1/ AVERAGE OF DAILY FREE RESERVES OF MEMBER BANKS (EXCESS RESERVES LESS BORROWINGS).
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

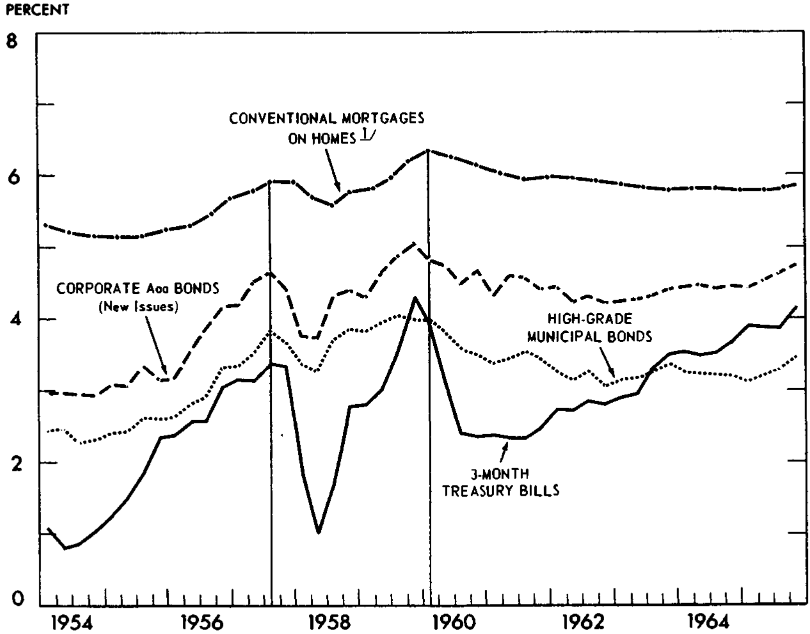
negative range (i.e., borrowings from the Federal Reserve System exceeded member bank holdings of excess reserves).

From October 1964 to the end of 1965, Treasury bill rates rose by nearly 1 percentage point, almost equaling the total rise in the discount rate. Moreover, in 1965, long-term interest rates turned up after a period of remarkable stability (Chart 6). Yields on newly issued corporate and State and local bonds began to rise in the first quarter of the year as the volume of new issues expanded rapidly, relative to the supply of funds. Short-term funds remained readily available during the spring and summer, buttressed by the exceptionally large cash flow to particular industries (such as automobiles and steel) early in the year, by funds repatriated from abroad in connection with the new balance of payments measures, and by net repayments of Treasury debt during this period. After mid-summer, however, these funds had largely been absorbed, and virtually all interest rates began to rise more substantially. Expectations were buoyant, corporate security flotations began to grow again, and the Treasury became a net borrower.

Furthermore, despite a rapid growth of total bank credit and of deposits at commercial banks (Table 6), rising interest rates reflected both surging credit demands and firmer monetary policy. During 1963 and 1964, most of the reserves needed by the commercial banking system to meet credit demands were supplied through the open market operations of the Federal

Chart 6

Selected Interest Rates



1/ SERIES BEGINS IN 1954; NEW AND EXISTING HOMES THROUGH 1960 I, AND NEW HOMES ONLY THEREAFTER.
NOTE: VERTICAL LINES SHOW GNP PEAK QUARTERS: 1957 III AND 1960 I.
SOURCES: FEDERAL HOUSING ADMINISTRATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE AND STANDARD & POOR'S CORPORATION.

TABLE 6.—*Changes in commercial bank credit, money supply, and time deposits, 1963–65*

[Based on seasonally adjusted data]

Item	Percentage change (annual rate) during						
	1963	1964	1965				
			Year [1]	I	II	III	IV [1]
Commercial bank loans (excluding interbank) and investments	8.0	8.4	10.0	12.4	10.6	4.8	10.9
Investments:							
U.S. Government securities	−4.8	−1.1	−6.2	−11.7	−12.8	−8.3	7.8
Other securities	19.9	10.6	15.2	14.5	20.0	13.3	10.1
Loans (excluding interbank)	11.6	11.8	14.8	20.8	16.4	7.0	12.0
Money supply and time deposits [2]	8.2	7.9	9.8	8.5	7.2	11.0	11.0
Money supply [3]	3.8	4.3	4.8	1.5	3.8	6.2	7.6
Time deposits [4]	14.7	12.8	16.0	17.4	11.5	16.8	15.0

[1] Preliminary.
[2] Changes based on averages of daily figures for last month in period.
[3] Currency outside banks and demand deposits.
[4] Time deposits at all commercial banks.

Source: Board of Governors of the Federal Reserve System.

Reserve System. During the first three quarters of 1965, however, open market operations supplied a smaller proportion of the growth in banks' required reserves—resulting in slower growth of nonborrowed reserves. More reserve needs were met by borrowing at the discount window. Reduced availability of reserves tended to moderate the growth of bank credit.

THE CURRENT FISCAL PROGRAM

The strong advance of the economy over the past 2 years is reflected in a remarkable rebound of Federal revenues following the 1964 tax reduction. From the close of 1963 to the final quarter of 1965, Federal revenues advanced by about $9 billion; yet during this period, tax reductions of $16 billion had taken effect through the Revenue Act of 1964 and the Excise Tax Reduction Act of 1965. As Federal expenditures grew very modestly in 1964 and early 1965, the budget on the national income accounts basis swung quickly into balance and showed a surplus exceeding $3½ billion in the first half of 1965. Its subsequent retreat to a $2½ billion deficit in the second half of the year resulted from several important deliberate stimulative measures plus the unforeseen rise in defense spending.

THE IMPACT OF 1965 BUDGET ACTIONS

The President proposed excise tax reduction in last January's budget; his specific recommendations were submitted to the Congress in May and the legislation was enacted 1 month later. The final act called for $4.6 billion of reductions in several stages extending to 1969. The first stage took effect immediately in mid-June and reduced taxes by $1¾ billion (annual rate), mostly on consumer durable goods.

In line with recommendations by the President, the Social Security Act was amended by the Congress last July. In addition to the initiation of medical insurance for the aged, which will take effect this July, and increased payroll tax rates, effective January 1, 1966, the legislation provides for increased old-age benefits which were made effective retroactively to January 1, 1965. The retroactive portion of increased benefits, amounting to $885 million, was disbursed in September. The liberalization raised transfer payments thereafter by more than $2 billion annually.

Furthermore, once payments on 1964 tax liabilities were completed last spring, a final dividend of personal tax reduction provided by the Revenue Act of 1964 helped to lift disposable income in the second half of 1965. These measures, together with the unexpectedly strong rise of Federal purchases, provided expansionary actions totaling $10½ billion (annual rate) in the second half of 1965. With normal semiannual revenue growth of a little more than $3½ billion at high employment, there was a net fiscal stimulus of about $7 billion in the second half of 1965.

Scheduled tax changes are having a marked restrictive fiscal impact in the first half of 1966, as the rise in payroll taxes of nearly $6 billion far outweighs the expansionary influence of the $1¾ billion "second-stage" of excise cuts that took effect at the start of 1966. On the other hand, further increases in defense expenditures will be stimulating the economy in this period, and will continue to do so throughout the next 18 months. The combined effect of budgeted expenditures, including the benefits that will begin under hospital insurance in July, and tax laws now in effect would be more stimulative than now seems appropriate for the period ahead.

FISCAL PLANS FOR 1966–67

The objective of promoting balance between over-all demand and productive capacity pointed to tax cuts in recent years when demand was inadequate. That same criterion now calls for tax action to moderate the growth of private spending. In line with these principles, the President has asked the Congress to enact promptly four measures affecting tax payments.

The first of these would reform the withholding system for individual income taxes and place the income tax more firmly on a "pay-as-you-go" basis. The present system, with a single 14 percent rate, overwithholds from some low-income individuals and underwithholds from many other taxpayers, requiring large final settlements the following year. The proposed graduated rate schedule and other modifications will reduce both underwithholding and overwithholding. Once in effect, the new system will siphon off $1.2 billion (annual rate) from disposable income for the rest of 1966.

The second proposal would place corporate tax payments also on a more nearly current basis. Under present law, corporations with tax liabilities exceeding $100,000 are scheduled to pay only 68 percent of the estimated tax due on 1966 incomes by the end of the calendar year, with the remaining 32 percent not paid until the first half of 1967. There is already a formula under existing law that would move corporations to a current basis by 1970. It is now proposed to accelerate this step-up to achieve current payment status within 1967. This action would increase cash payments to the Treasury by an estimated $1 billion this spring and $3.2 billion in the spring of 1967, reducing the carry-over of unpaid liabilities into 1967 and 1968 by comparable amounts.

The rescheduling of corporate tax payments will not add to final tax liabilities nor will it alter after-tax profits in either business or national income accounting. It will nonetheless reduce the availability of internal funds for investment and should thus have a moderating influence on investment demands, particularly in the light of firmer credit conditions.

A third proposal to put tax payments on a more current basis affects the social security taxes of the self-employed. It calls for quarterly declarations, paralleling those of the individual income tax, instead of a single large payment at year end. It also more nearly parallels the treatment of wage earners, whose social security taxes are collected on a current basis through withholding. The proposal would increase revenues by $100 million in each of the fiscal years 1966 and 1967. It will reduce disposable income by $400 million (annual rate) in the second half of this calendar year.

The fourth proposal affects excise taxes. In view of the large revenue involved in the excise taxes on automobiles and telephone service, they were scheduled to be cut gradually in the Excise Tax Reduction Act of 1965. The Congress is being asked to reschedule the reduction to meet current economic needs. Each step in the present timetable, commencing with the January 1, 1966 instalment, would be shifted forward 2 years. The reinstatement will restore $0.9 billion of revenues, and the postponement of the scheduled January 1967 cuts will avoid a further revenue drop of $0.6 billion next year.

With these measures, both the actual and high-employment budgets on the national income accounts basis are expected to be approximately in balance in fiscal 1967. Over the full budget planning period to the first half of 1967, Federal expenditures are estimated to rise about $17½ billion from their level in the second half of 1965. The increase includes $6 billion in defense purchases, $6½ billion in transfers, and $3 billion in grants to States and localities. Normal revenue growth at high employment will total about $11½ billion over this period. Meanwhile, tax measures that have already been enacted and those now proposed will result in a net addition of $7 billion to Federal revenues.

The aim of fiscal policies in the next 18 months is to preserve the sound expansion enjoyed in 1965—to maintain a strong and healthy prosperity; to promote a cautious movement toward lower unemployment without moving so far or so fast that bottlenecks and inflationary pressures arise.

THE OUTLOOK FOR ECONOMIC ACTIVITY

In the light of the fiscal program outlined above, GNP for 1966 is expected to be within a $10 billion range centered on $722 billion, given the $675.6 billion level now estimated for 1965. At the midpoint of this range, the advance would be $46½ billion, virtually identical with the gain scored in 1965. No major departure is expected from the 1.8 percent increase of over-all prices in 1965, as explained in Chapter 2. Thus, total real output should advance by nearly 5 percent in 1966.

Civilian employment, which rose by 1.8 million persons in 1965, should register a similar large increase this year. In addition, the armed services will expand by 300,000. On the other hand, the total labor force will rise strongly. The unemployment rate, which averaged 4.6 percent in 1965, should decline this year to about 3¾ percent, the lowest rate since 1953.

GAINS BY SECTOR

While strong demands will be characteristic of most sectors of the economy, defense spending and business fixed investment will provide the major thrust to over-all demand. The special implications of these sectors are explored in more detail below. In brief, the increase in Federal purchases made necessary by the Vietnam situation will deliver a major stimulus to the economy, accounting for most of the prospective $7 billion rise in total Federal purchases. Business expenditures for fixed investment will rise strongly again in 1966, although the advance is not expected to match the 15½ percent increase of last year. According to present indications, capital outlays are likely to exceed the 1965 total by about $7 billion.

State and Local Government

State and local government purchases, a particularly reliable component of GNP, are expected to rise by about $5 billion, continuing their recent trend. They will receive continuing support from growing Federal grants that meet pressing needs for public services.

Inventories

Last year's inventory investment of $7 billion (1958 prices) was in line with the real growth of $29 billion in final sales. Still, irregular and special factors in the automobile and steel industries added a little, on balance, to inventory investment last year. In the absence of such special influences, a fractional decline from last year's rate is probable in 1966.

Homebuilding

The fundamental demographic factors influencing residential construction will not change significantly in 1966: the increase in the number of households is expected to be about the same as the 1960–65 average. Financing conditions may be less favorable, since conventional mortgage rates began to rise last September for the first time in 5 years and some further increases appear possible. On the other hand, the excess supplies of new housing in selected areas seem to be dwindling. On balance, the value of residential construction is likely to change little in 1966.

Consumption

Consumer outlays depend primarily on the growth of disposable income. Unlike 1964 and 1965, tax reductions and increases in transfer payments will provide no net stimulus to consumer incomes this year. Between 1963 and 1965, cuts in personal income taxes added about $10 billion directly to consumer take-home pay, and government transfer payments increased by nearly $4 billion. This year, transfer payments are expected to rise strongly, paced by the launching of the hospital insurance program. However, social insurance taxes are higher, the new withholding system will moderate the growth of after-tax income, and the second stage of excise reduction will be adding very little to household purchasing power once the President's proposals are enacted. Nevertheless, rapid gains can be expected in disposable income this year owing to strong increases in wages and salaries, interest, dividends, and self-employment incomes.

Little change in the personal saving rate is anticipated for 1966. The saving rate of 5.4 percent in 1965 was close to the average of recent years. Consumer confidence and spending intentions remain high. Allocation of income among various types of consumer goods may shift moderately. The fraction of disposable income spent on automobiles and parts may decline somewhat from the exceptionally high 6.4 percent in 1965 (which included purchases deferred by the late-1964 strike). Prospects seem particularly bright, however, for durable goods other than cars; color television sets are a notable example. Sales of nondurable goods other than food should also rise strongly and continue to reflect upgrading of quality.

In sum, consumer expenditures are expected to account for about 60 percent of the rise in GNP this year, compared with their 63 percent share in the 1965 advance.

KEY ROLE OF BUSINESS FIXED INVESTMENT

This year, business fixed investment is again expected to be one of the two major expansionary forces in the economy. After 2 years of rapid increases, it reached 10½ percent of GNP late in 1965. This surge followed a period of weak investment dating from 1958 and extending into the early years of the current expansion. The proportion of GNP devoted to nonresidential fixed investment averaged only 9.2 percent from 1961 to 1963, well below the 9.6 percent average during the preceding decade.

Major Determinants

The revival of fixed investment in the past 2 years can be traced to improvements in three major determinants of investment demand. First, the economic expansion has raised final demands relative to the stock of productive facilities. In manufacturing, for example, 91 percent of capacity was utilized in 1965, in contrast to an average of 85 percent in the preceding 10 years. To avoid bottlenecks, delays, and lost sales, businessmen now have the incentive to build capacity in advance of rising demand. Second, the generation of internal funds through profits and depreciation has facilitated corporate financing, while monetary policy has enabled external financing needs to be satisfied readily. Third, the anticipated future returns from investment have been enhanced by the prospect of continuing economic expansion and by the investment tax credit, the liberalized depreciation rules, and the lowered corporate income tax rates.

This year, financing conditions may be less favorable, after-tax profits are unlikely to repeat last year's exceptional 20 percent spurt and available internal funds will be held down by the new corporate payments schedule. Nevertheless, the major determinants of investment spending suggest that capital outlays should rise strongly again in 1966. According to the investment anticipations reported in the Government survey last November, the annual rate of plant and equipment spending by nonagricultural businesses in the first half of 1966 will exceed the full-year 1965 level by $6 billion, or by 11½ percent. The rise is expected to continue in the second half of the year. Nonresidential fixed investment for the entire year will probably be slightly above 10½ percent of GNP.

Longer-Term Prospects

The current strength of investment demand provides new evidence and, at the same time, raises new issues concerning the longer-term prospects for capital outlays. Nagging doubts about a possible secular weakening of capital spending have now been resolved. Yet, it is obvious that business fixed investment cannot continuously grow twice as fast as GNP, as it did in 1964 and 1965, and that it cannot always be a propelling sector of demand. Nor is it certain that the economy can regularly maintain the current 10½ percent investment share at full employment, a share which matches the postwar peak.

Some of the current strength in investment demand may represent a catching-up after a period marked by slow growth of plant and equipment capacity and by aging of the capital stock. From 1957 to 1963, manufacturing capacity grew less than 3½ percent a year. This kept pace with actual manufacturing output but was considerably less than the normal full-employment growth of manufacturing output. As the economy returns to full employment, additional capital facilities are needed to complement higher employment and output. The same catching-up process occurs in the modernization of the capital stock. Prolonged economic slack leaves the Nation with older productive facilities. Because the Great Depression and World War II reduced investment drastically, the average age of capital rose from about 16.5 years in the mid-1920's to over 21 years by the end of 1945. Rapid investment during the first postwar decade reduced the average age of the capital stock to 17 years by 1957. This trend was subsequently altered by the sluggish pace of investment. Now, however, businessmen have stronger incentives to make up for lost time in their pursuit of modernization programs.

Even after catching-up is finished, several factors are likely to be working to strengthen investment demand. A higher prospective return can stimulate "capital deepening", i.e., investment that provides each worker with more capital. Profitability will be higher owing to the investment tax credit and lower corporate income tax rates, as well as improved prospects for sustained full utilization. Some cost-cutting investments which would not have been profitable in the past may now yield an expected after-tax return high enough to justify the required outlay.

In addition, a more rapidly growing labor force can add to investment demand, providing full employment is maintained. In that event, unless capital is expanded more rapidly, each worker would have fewer tools. Businessmen will find it profitable to equip the additional workers. If businessmen respond fully, the extra growth of capital stock will match the additional growth of employment. Over the remaining years of the 1960's, the labor force is expected to grow about one-half of 1 percent faster, on average, than its yearly growth rate of 1.3 percent in the past decade. Adding an extra 0.5 percent to employment in any year, and providing the new workers with the usual amount of equipment and facilities would require a matching 0.5 percent increment to the capital stock. It would take an addition of about 5 percent to the current annual total of investment to provide that extra capital.

To be sure, the possibility cannot be ruled out that a part of the strength of current investment might be associated with overly optimistic expectations by some businessmen. Errors can be made in investment decisions because such decisions are necessarily forward looking and based on anticipations of future profits and sales. On the other hand, market experience does provide incentives and information about recent and prospective developments. And businessmen have increasingly used scientific techniques to rationalize their capital budgets. Business investment programs in the past 2 years seem to have added to capital in the right places and in appropriate amounts, as discussed in Chapter 2. Programs planned for 1966 should continue these trends.

THE IMPACT OF DEFENSE

National defense outlays will be the other major expansionary force this year. The upward movement in defense spending alters a pattern of stability maintained from mid-1962 into 1965. During that period, the national defense establishment was considerably modernized and better equipped; yet over-all defense expenditures were stable or declining. Since the economy was expanding rapidly, the percentage of GNP channeled into defense purchases declined from 9.2 in 1962 to 7.4 in the first half of 1965.

We are not now engaged in wartime mobilization, nor entering such a mobilization period. The present defense buildup is vastly different in size from the mobilizations at the outset of World War II or the Korean conflict. When the United States entered World War II, it had to build a military establishment almost from scratch; and the Korean war followed a period of rather thorough demobilization and de-emphasis of defense. In both cases, the outbreak of hostilities required a fundamental reevaluation of the country's defense posture, leading to vast increases in expenditures.

Ever since the Korean war, the United States has given greater attention to the requirements of military preparedness in an uneasy world. After Korea, defense expenditures dropped sharply from their peak rate of nearly $50 billion, but they have never fallen below $38 billion. In contrast, they had totaled $13 billion in 1949. Since 1953, the country has invested mightily in defense; it has continually rolled over its stock of defense goods and equipment to take advantage of new developments in weapons systems and has maintained general purpose defense capabilities. The Vietnam conflict, therefore, finds us well prepared. The procurement and personnel increases are modest by earlier standards and by comparison with total supply capabilities.

The percentage increase in defense expenditures this year will slightly exceed that in over-all national output. Defense purchases of goods and services, which were 7.5 percent of GNP in the fiscal year ended June 1965, are expected to average 7.6 percent in both fiscal 1966 and fiscal 1967 (Table 7). This contrasts markedly with the buildup after the outbreak of

TABLE 7.—*Defense impact in relation to GNP, Korean war period and current period*

Period and fiscal year	Budget expenditures for national defense (billions of dollars)	Federal purchases of goods and services for national defense	
		Amount (billions of dollars)	Percent of GNP
Korean war period:			
1950	13.0	12.7	4.8
1951	22.5	21.7	7.0
1952	44.0	41.8	12.4
1953	50.4	48.8	13.6
Current period:			
1965	50.2	48.8	7.5
1966 [1]	56.6	53.0	7.6
1967 [1]	60.5	56.5	7.6

[1] Estimates.

Sources: Bureau of the Budget, Department of Commerce, and Council of Economic Advisers.

the Korean war when defense outlays more than tripled in 2 years and rose from under 5 percent of GNP in fiscal 1950 to over 12 percent in fiscal 1952.

The increase in purchases for defense of $6 billion this calendar year represents nearly 13 percent of the increase in GNP. These outlays will exert a broad fiscal stimulus. Indeed, because they directly and immediately add to GNP, defense purchases tend to have a somewhat larger and more rapid economic effect than a tax reduction (or increase in transfers) of the same size, which must be respent before it can stimulate production. Although not as general as most tax cuts would be, even the direct impact of defense is felt throughout the economy. This is evident in the distribution of added defense expenditures among various types of products. About 35 percent of the step-up in defense expenditures for 1966 is for direct personnel costs—pay and allowances—of the increased number of military and civilian personnel. An additional 10 percent of the total increase is for training, food, lodging, clothing, and transportation costs directly associated with the increased manpower. Another 22 percent represents gasoline, ammunition, ordnance, and similar mass-produced production-line items. A further 18 percent can be attributed to large, sophisticated weapons systems, such as aircraft, ships, and missiles.

Defense procurement by itself will not be placing extreme demands on particular industries, although textiles and selected other industries receiving increased defense orders are already experiencing high operating rates as a result of buoyant private demand.

The present Defense Materials System, which has been in effect since the end of the Korean war, will continue to deal with allocation problems. It gives priority to defense and defense-related orders in the event of any conflict with civilian orders for the same materials or for use of industrial capacity, and allots certain categories of controlled materials on the basis of priority. With the economy operating considerably below capacity, these priorities and allocations have been routinely executed in the past without bumping private demands to any noticeable extent. With operating rates now higher than before, there may be some cases where the execution of civilian orders will be somewhat delayed. However, these will be exceptional, and will not be such as to require alteration in our present machinery for materials priorities and allocations.

THE NEED FOR FLEXIBILITY

Economic policy for 1966 is guided by a thorough and realistic assessment of the outlook for the economy and by the objective of maintaining a well-paced advance. Fiscal policies for 1966 have been fashioned in the light of an evaluation of both the strength of private demand and the moderating influence of monetary policy. Clearly, fiscal and monetary policies must be closely coordinated, and effective coordination has prevailed in the past 5 years. The Administration regretted that the discount rate increase last December interrupted that pattern. Consultations between the Federal Reserve and the Administration continue, helping to assure that monetary and fiscal policy together will provide appropriately for sustained and balanced expansion. Both are keenly aware of uncertainties in the outlook and are prepared to respond to emerging developments.

CONTINGENCIES IN 1966

This year, the economy will be moving into new territory as rates of unemployment reach the lowest levels in more than a decade. While prospects are excellent that this course can be safely traversed, there can be no certainty. The defense program introduces an especially important set of uncertainties into the outlook. The budget is based upon a careful judgment of the defense requirements imposed by our commitments in Vietnam and throughout the world. Nevertheless, these requirements could change in the year ahead—in either direction. Finally, private demand is a constant source of uncertainty. Its particular strength in 1965 was a surprise. This buoyancy has been recognized in the forecast for 1966, but the accuracy of such an evaluation cannot be guaranteed.

In considering these uncertainties, it is important to appreciate the internal resistance of the economy to disturbances, as reflected in the record of recent years. To be sure, the economy can be pushed into boom or recession by sufficiently potent forces. But it is a mistake to view the path of economic activity as a tightrope from which one false step would mean spiralling inflation or cumulative contraction. One important sector of the economy, residential construction, lagged behind during most of 1964 and again during much of 1965; nevertheless, its sluggishness was barely noticeable in the aggregate pattern of activity. The strikes in the automobile industry in the fourth quarter of 1964 left a clear mark on the output of that quarter, but had no lasting effect on the vigor of expansion. Nor did the recent strong buildup and subsequent absorption of steel inventories disturb the over-all pace of economic activity.

Production and employment have shown stability in the face of volatile movements in financial markets. The sharp plunge of stock prices in the late spring of 1965 presumably was associated with a marked shift in investors' sentiment; yet spending for goods and services by consumers and business remained remarkably unaffected by the gyration.

Perhaps the clearest recent example of the economy's inherent stability was its response to the deliberate stimulus of tax reduction. The 1964 tax cut was indeed massive, but the response was gradual and the effect in lifting national output was spaced out over many quarters. Meanwhile, labor markets adapted and investment responded to create new capacity which permitted a remarkably balanced, noninflationary advance.

While the economy's own adaptation is the first line of defense, economic policy has a major role to play in countering disturbances. The program outlined earlier in this chapter is designed to meet the prospective needs of the Nation. But major changes in the outlook during the year could require new actions by the Administration, the Congress, and the Federal Reserve System. If military needs should prove to be larger than is anticipated in the fiscal 1967 budget—or if private expenditures should advance sharply so as to endanger price stability—further fiscal or monetary restraints would be necessary to prevent the rise in total demand from outpacing the growth in productive capacity. The President has indicated that he will not hesitate to recommend further tax increases in such circumstances.

On the other hand, a peaceful conclusion of the Vietnam hostilities could point to a reversal of policy actions premised on rising military spending. It would offer the welcome opportunity to encourage private expenditures

795-983 O—66——5

by reducing taxes once again or to add to high-priority Federal expenditures for civilian programs now limited by defense requirements. It could also point toward easing monetary policy.

LONGER-RUN OUTLOOK

In the longer run, defense will not continue to contribute as strongly to aggregate demand as in 1966. The current defense buildup meets an exceptional need and will be reversed as soon as reduction of world tension permits. In the years ahead, moreover, investment will certainly not rise consistently as fast as it will this year. It may even decline as a proportion of GNP. Yet, the factors determining investment do not point to a slump in capital outlays, provided that alert policies preserve the general health of the economy.

Shifting patterns of defense and capital outlays need not throw the economy off its track. The maintenance of steady advance at full employment does not require a growth of demand as strong as that needed to eliminate slack. The economy would face serious inflation if such strong expansionary pressures continued for very long. But continual growth of demand is needed to maintain balance with potential output. Strength in other types of spending will be required to lead that growth in the future.

New sources of strength may be generated elsewhere within the private economy. In particular, later in this decade, more vigor can be expected from residential construction, an important component of private investment which for demographic and temporary reasons has been conspicuously lagging. Moreover, if additional demand is needed, fiscal policy can help through new or expanded productive civilian programs or through tax reduction to support consumer purchasing power.

The prospects for sustained expansion thus continue to be favorable for the longer run. Even so, our ability to counter recession can and should be improved. Long-needed reforms in the unemployment insurance system are one important step that should be taken this year. There is also a good opportunity now to intensify discussion and study of the type of tax action which could best combat the threat of recession. A social consensus on this issue would help to avoid prolonged debate in a time of urgency.

Both in meeting surprises and in laying systematic plans, the lessons learned in the last 5 years will remain relevant. The American economy has demonstrated its capacity for strong growth and its ability to move steadily ahead, as long as a reasonable balance between total supply and over-all demand is maintained. The promotion of such a balance will remain the basic task of domestic fiscal and monetary policies.