Chapter 1

Extending the Record of Prosperity

THE UNITED STATES in 1966 enjoyed the benefits of the fullest employment in more than a decade. The unemployment rate reached a 13-year low of 3.9 percent. At that level, demand finally matched supply in most labor markets, a situation which economists define as essentially "full employment."

Real incomes of all major groups registered sizable gains. Expansion continued for the sixth straight year. For the third successive year, growth exceeded 5¼ percent, a record unparalleled in our postwar experience.

By any standard, then, 1966 was a big year for the economy. Gross national product (GNP) expanded by a record $58 billion in current prices and reached $740 billion. As in the 2 preceding years, a major advance in business fixed investment was a key expansionary force. And the rising requirements of Vietnam added $10 billion to defense outlays. State and local spending and inventory investment also rose strongly.

As a result, 1966 was in some respects too big a year, especially in the early months. Spurred by the defense buildup, total demand—public and private— forged ahead at an extraordinarily rapid rate in late 1965 and early 1966. Strains developed in financial markets. Demand outstripped supply in several sectors which were already near full utilization. As Chapter 2 explains, many of the new orders simply added to backlogs and put upward pressures on prices. Some of the excess demands were met by imports, reducing the U.S. foreign trade surplus and retarding progress toward equilibrium in the balance of payments, as Chapter 5 indicates.

After years of stimulating demand, policy was called upon to restrain the economy. The need for restraint was recognized at the start of the year. Monetary policy assumed a restrictive stance. In anticipation of large increases in private expenditures and defense outlays, tax policies were applied to curb private demand. In 1964 and 1965, an expansionary tax policy had stimulated the economy; but in March 1966, restrictive tax changes were enacted at the President's request. Excise tax cuts were postponed, and income tax payments were accelerated. Moreover, the President's budget program in January stringently held down nondefense outlays. These measures produced a Federal surplus in the national income accounts budget and a net restrictive fiscal impact in the first half of 1966, despite the strong advance in defense spending.

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But the magnitude of the task was not fully appreciated at the beginning of 1966. As private demand and Vietnam requirements exceeded forecasts, policy was adjusted to the new developments. Monetary policy tightened further, causing a major cutback in homebuilding. In September, the President proposed additional selective fiscal measures to alleviate excessive demands for funds and for capital goods.

The initial restraining measures, reinforced by the previously enacted rise in payroll taxes, began to take effect in the spring. By the closing months of 1966, it was clear that the brakes had worked. The economy had shouldered the burden of active hostilities without the need for cumbersome and inefficient controls and without losing its basic health and stability. It was shown that policy could work both ways; it could restrain the economy, much as it had been able to provide stimulus during the preceding 5 years. In particular, the power of tight money as a tool of restraint—as well as its uneven impact—was demonstrated beyond any reasonable doubt.

As 1967 opens, inflationary forces set in motion during the period of overly rapid expansion are still alive, although their strength is waning. But now there is also a renewed challenge to sustain expansion; any further slowdown would be undesirable.

A healthy advance of demand in pace with the growth of potential output would permit gradual restoration of price stability. It would also promote a recovery in our foreign trade balance, thereby aiding the pursuit of equilibrium in the balance of payments. The fiscal program for 1967 is designed to meet these objectives and to assure that the easing of monetary conditions, presently underway, can be extended.

ACHIEVEMENTS OF AN EXPANDING ECONOMY

Last year's record of economic gains added in length and strength to the remarkable uninterrupted expansion that began early in 1961 (Table 1). This advance can be viewed in many dimensions. Prosperity has conferred its benefits on nearly every sector, industry, and region in almost every year.

EMPLOYMENT GAINS

Of all its facets, the growth of employment may be of greatest significance. Increasing numbers of Americans have obtained opportunities to earn secure livelihoods and to contribute to the material welfare of society.

Employment in 1966

Employment gains in 1966 were the largest of any year in the expansion. Civilian employment increased by 1.9 million, and 400,000 persons were added to the Armed Forces. The civilian unemployment rate fell from 4.6 percent in 1965 to 3.9 percent in 1966, the lowest since 1953. During the year, the seasonally adjusted rate remained essentially on a plateau, fluctuating between 3.7 and 4.0 percent. The number of persons unemployed

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TABLE 1.—*Changes in economic activity since 1961*

Measure of economic activity	Percentage change per year					
	1961 to 1966	1961 to 1962	1962 to 1963	1963 to 1964	1964 to 1965	1965 to 1966 [1]
Production:						
Gross national product, constant prices [2]	5.4	6.6	4.0	5.3	5.9	5.4
Personal consumption expenditures	5.2	4.9	4.4	5.8	6.0	4.9
Business fixed investment	9.7	9.2	4.4	10.6	13.1	11.2
Residential structures	(3)	10.2	4.2	−.8	−2.0	−10.8
Government purchases of goods and services	4.2	7.0	2.0	1.6	2.5	8.0
Federal	3.3	9.9	−.8	−2.9	(3)	10.9
State and local	5.2	3.5	5.5	6.6	5.4	5.0
Industrial production	7.3	7.8	5.1	6.4	8.4	9.0
Prices: GNP deflator	1.8	1.1	1.3	1.6	1.8	3.0
Employment:						
Total civilian employment	2.2	1.8	1.4	2.2	2.6	2.6
Nonagricultural payroll employment	3.4	2.9	2.0	2.9	4.2	5.1

[1] Preliminary.
[2] Includes change in business inventories and net exports of goods and services, not shown separately.
[3] Less than .05 percent.

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

dropped by 500,000 in 1966. Nearly all groups shared in the reduction, the only exceptions being nonwhite females in two age groups, 14–19 and 45 years and over. Although employment in both of these groups expanded, the increase was not enough to keep pace with the rapid growth of these groups in the labor force.

The expansion in the demand for labor extended to every nonagricultural sector of the economy. The most remarkable gains were in manufacturing where the number of jobs rose 1 million from 1965 to 1966. Since most manufacturing employment consists of high-productivity, high-wage jobs, the gain contributed to a major advance in real income. Employment in trade and services and State and local governments also expanded substantially, rising by about 1½ million workers in 1966.

The mirror image of the rapid increase in nonagricultural jobs was a remarkable decline of 400,000 in agricultural employment in 1966. This decrease of 8¼ percent was the largest percentage drop on record, as higher-paying nonfarm job opportunities attracted farmers and hired workers out of agriculture.

Labor Supply

The labor force expanded by 1.8 million workers last year, nearly 500,000 more than demographic trends alone would have indicated. In particular, a larger fraction of women and teenagers participated in the labor force.

Low unemployment encourages entry into the labor force. Some people, especially women and teenagers, who would be interested in working if jobs were plentiful, do not actively search for jobs when they believe none are available. At such times, these persons are considered neither as employed

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nor unemployed, and are not counted in the labor force. When job opportunities improve, they enter the labor force, seeking and frequently finding jobs. The evidence of 1966 suggests that nearly 500,000 of "hidden unemployed" or "discouraged workers" entered the labor force. Probably, additional workers, who did not respond fully to improved job opportunities last year, will enter the labor market if it remains buoyant.

The Record Since 1961

The number of unemployed today is about 2 million lower than 6 years ago. Over the same period, nearly 9 million additional Americans have gained employment. Millions more moved into higher paying, more secure, and better jobs, and out of declining areas and low-wage industries. The benefits of full employment have extended far beyond the important gains in real income and material welfare. By reducing poverty and hardship, the opportunities for productive employment have contributed to human dignity and self-esteem and to freedom of choice.

The decline in unemployment in a vigorous and buoyant economy has changed the diagnoses and the proposed remedies for our labor market problems. Allegations that a substantial fraction of the labor force lacks the motivation to work have been refuted by the facts. Proposals to cut unemployment by artificially shortening the workweek, or by instituting practices deliberately designed to hold down productivity, are no longer seriously advanced.

The marked decline in unemployment in the past 6 years has been shared by nearly all groups. In some instances, improvement has been dramatic. Only one-third as many Americans were unemployed for 15 consecutive weeks or longer in 1966 as in 1961. Over the same period, the unemployment rates for nonwhite adult males, blue collar workers, and married men fell by more than half.

Many of the previously hard core depressed areas are no longer suffering from high unemployment. In early 1961, 101 of the Nation's 150 major labor market areas were classified as areas of substantial unemployment, with rates in excess of 6 percent. Today, there are only 8 labor market areas in that category. There are now 66 areas that have unemployment rates of less than 3 percent; for most of 1961, there were none.

Of course, some groups have gained less than others. Unemployment remains high among nonwhites, teenagers, and, especially among workers with few skills and little training. As Chapter 3 indicates, inexperience, inadequate education, and racial discrimination unfortunately penalize these groups, placing their members at the end of all too many hiring lines.

PRODUCTIVITY

Productivity increases during the expansion have been excellent. The slow growth in the number of adult male workers was often cited as a reason for expecting bottlenecks in the labor market and a sluggish productivity

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performance during the expansion. However, from 1961 to 1966, the average annual growth of private output per man-hour was 3.5 percent, exceeding the long-term trend of a little over 3 percent a year.

One factor making for good productivity performance in recent years has been the high level of business investment expenditures. As a result, capital has not been a bottleneck to the expansion of production and employment in most areas and industries. Moreover, high investment rates have helped to modernize the capital stock and thereby speed technological progress.

In large part, however, the above-normal growth of productivity is typical of economic recoveries. A slack economy does not make full use of its capital stock or overhead labor. As activity expands, both are utilized more efficiently and productivity increases. But this cannot go on indefinitely. In 1965 and 1966, average use of plant and equipment approached "preferred" rates, and overhead labor had to be expanded. As a result of these factors and need for major, rapid adjustments in the composition of employment, growth of productivity slowed in 1965 and 1966 to just under 3 percent, slightly below the long-term trend.

GAINS IN REAL INCOME

Advances in employment and productivity have generated unprecedented gains in the real income and the standard of living of the American people. Farmers, wage earners, businessmen, and professional workers have all shared in the impressive advance. Real disposable income per capita—the best single measure of consumer welfare—has risen by 24 percent over the past 6 years, matching the increase in the preceding 13 years.

Gains have been particularly rapid in recent years. In 1964 and 1965, real disposable income per capita increased by 5 percent a year—the equivalent of more than 2 extra weekly paychecks annually. Despite the disturbing rise in consumer prices in 1966, real disposable income per capita continued to grow strongly—by 3½ percent. The higher incomes of 1966 included a 12 percent increase in social insurance transfer payments, which aided some of the needier groups.

Since 1961, there have been impressive advances in each type of income as well as in total income, as shown in Table 2. Through 1965, the growth of corporate profits outpaced GNP and most other types of income. In 1966, however, profits rose in line with GNP and less rapidly than employee compensation.

The full story of the welfare gains from economic expansion cannot be conveyed by any array of statistics. Other data—such as the rapid growth in the number of families owning durable goods and the greater percentage of families enjoying adequate diets and medical facilities—could be presented to document various trends. But they all add up to the single story

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TABLE 2.—*Changes in measures of income since 1961*

Measure of income	1961	1965	1966 [1]	Percentage change per year [1]	
				1961 to 1966	1965 to 1966
	Billions of dollars				
Compensation of employees	302.6	392.9	433.3	7.4	10.3
Corporate profits:					
Before taxes	50.3	75.7	81.8	10.2	8.1
After taxes	27.2	44.5	48.1	12.1	8.1
Disposable personal income:					
Current prices	364.4	469.1	505.3	6.8	7.7
1958 prices	350.7	430.8	451.5	5.2	4.8
	Dollars				
Farm income per farm:					
Current prices	3,389	4,493	4,955	7.9	10.3
1966 prices	3,684	4,632	4,955	6.1	7.0

[1] Preliminary.

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

that sustained prosperity means more comfort, more freedom, and more security for the overwhelming majority of Americans.

THE REALIZATION OF ECONOMIC POTENTIAL

A major economic accomplishment of 1966 is that the United States made essentially full use of its productive potential. Gone were the chronic underutilization of resources, general excess supply in labor markets, and wastefully idle industrial capacity that had blemished the performance of the economy for a decade. Because of the excessive unemployment and idle capital in previous years, the Nation sacrificed the opportunity to consume and invest a large amount of the output that it was capable of producing. At the trough of the recession in the first quarter of 1961, the "gap" between actual and potential GNP amounted to $57 billion (1966 prices). From 1958 to 1965, the cumulative gap totaled $260 billion (Chart 1).

Five years ago, when unemployment was 6 percent of the labor force, there was clearly an excess supply of labor. Nobody could be sure where balance between supply and demand would be reached. The Council of Economic Advisers, among others, judged that an unemployment rate near 4 percent would (with the existing structure of labor markets) yield approximate balance between the supply and demand for labor. Other experts argued, however, that the economy would run into substantial and significant labor bottlenecks when unemployment fell to 5 percent. Another group contended optimistically that a sufficient expansion of aggregate demand might push unemployment down as low as 3 percent without creating excess demand pressures. The experience of the past year provides a partial answer, suggesting that the 4 percent judgment was nearest to the mark. In 1966,

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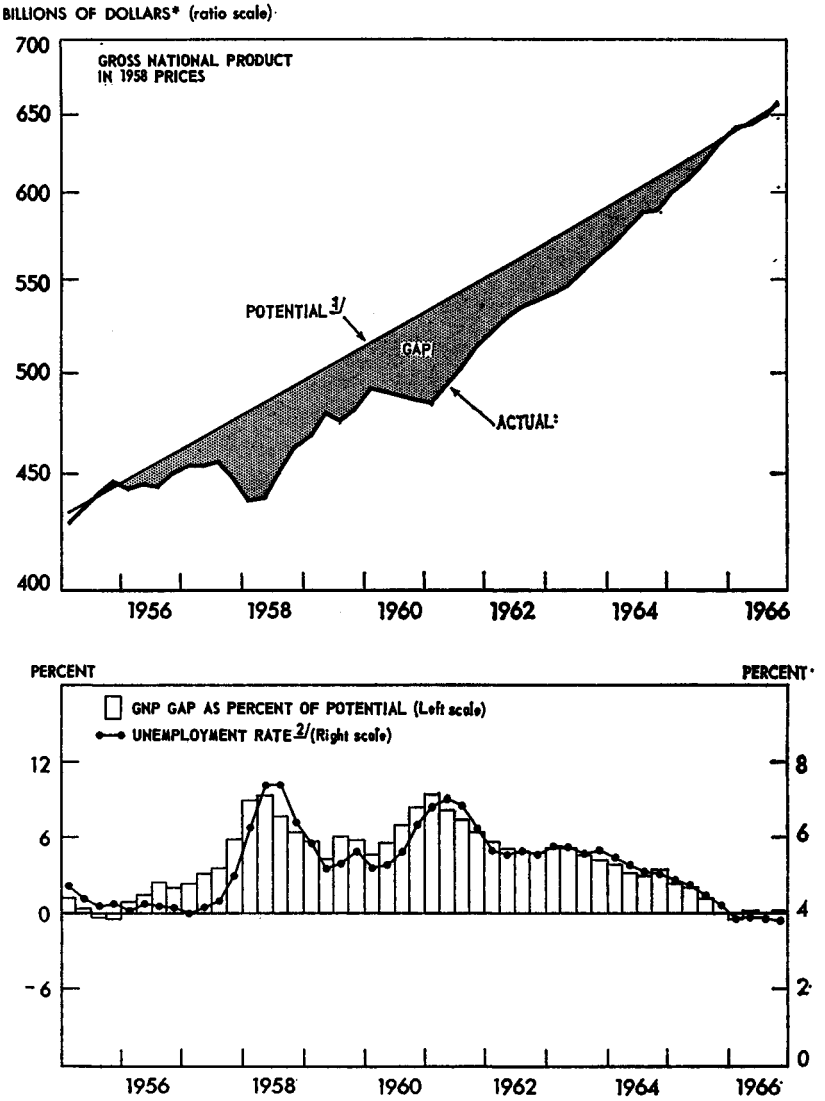
Chart 1

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, 3¾% FROM 1962 IV TO 1965 IV, AND 4% FROM 1965 IV TO 1966 IV.

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

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

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labor markets were generally in balance, although there were shortages of certain labor skills and a few remaining pockets of unemployment. The areas of shortages seemed largely to reflect the speed of the economy's advance rather than the level of utilization attained. With the return of a more moderate advance, those pressures have begun to subside.

The economy caught up with its economic potential in 1966. But total demand must continue to rise to keep pace with a growing potential GNP. Indeed, primarily as a result of faster growth of the labor force, potential output itself has been accelerating somewhat. From the mid-1950's into the early 1960's, it advanced by about 3½ percent a year. More recently, the rate of growth moved up to 3¾ percent a year; and at present, it seems to be advancing at an annual rate of about 4 percent.

The growth of potential stems from three principal determinants: the rise in the labor force; changes in annual average hours worked per man; and the growth of average output per man-hour—that is, of productivity. Because of the low birth rates during the depression of the 1930's and World War II, the working-age population expanded slowly in the 1950's. However, high postwar birth rates have recently led to accelerated growth of the labor force from 1¼ percent annually in earlier years to 1¾ percent.

Under steady full employment conditions, longer vacations and shorter workweeks would lead to an annual decline of about ¼ percent in hours worked per man, thereby reducing the growth in total man-hours to about 1½ percent a year.

Labor productivity in the private economy has grown at a trend rate somewhat over 3 percent a year during the postwar period. But, since the method of measuring productivity of Government workers ignores any change in their efficiency, the trend rate of increase in output per man-hour in the total economy is just over 2½ percent a year. Thus, with GNP per man-hour advancing at that rate and total man-hours at about 1½ percent, potential output advances at 4 percent.

The Nation's economic potential may grow even more rapidly in the future if the trend advance of productivity quickens. Two recent developments, in particular, could speed the growth of productivity. First, the current investment boom has led to a significant modernization of our capital stock. About one-third of manufacturing equipment in use today is less than 3 years old, compared with one-fourth at the beginning of 1964. When much of our capital stock is new, the production process will incorporate many of the latest technological advances. However, new investment does not confer its productivity benefits immediately. Projects must first be completed and, even then, there are important start-up and break-in costs until new plant and equipment work smoothly. Hence, much of the productivity bonus of the recent capital boom may still lie ahead. Second, the use of active manpower policies can make a significant contribution to the improvement of the quality of the labor force, and thus to productivity.

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Manpower policies may also increase growth rates over the long run by lowering the level of unemployment consistent with price stability. In fact, significant further reductions in unemployment will depend primarily on manpower programs, particularly those aimed at disadvantaged groups, as discussed in Chapter 3.

The closing of the gap in 1966 was a great achievement. But it necessarily means that the 5½ percent rate of advance of real output registered in recent years cannot be matched in the near future. That rapid expansion was possible because idle resources were ready and able to make a productive contribution. The growth of employment outpaced the expansion of the civilian labor force; many new employees were put to work on previously idle or underused machines; improved utilization rates yielded a bonus of extra gains in productivity. But now that full employment has been essentially attained, output cannot continue to rise faster than productive capacity.

STRAINS AND RESTRAINT IN A SURGING ECONOMY

The major theme of recent economic developments is the continuation of progress. But there is also a secondary theme of problems and imbalances, many of which can be traced back to mid–1965, when the sudden increase in defense requirements for Vietnam led to a marked acceleration in economic activity. By the time measures of fiscal and monetary restraint took hold and slowed down the economy, significant problems had developed—an interruption of price stability, a deterioration in international trade performance, acute pressures in financial markets, and sharply divergent movements among the various sectors of the economy.

THE ECONOMY IN MID-1965

As of mid-1965, the economy was advancing steadily and healthily toward full employment. GNP had risen by $11 billion a quarter, on the average, for the preceding 2 years; the annual rate of real growth over that period had been 5½ percent. Unemployment was down to 4½ percent of the civilian labor force, and the average operating rate of manufacturing capacity was up to 89 percent. The price record showed few blemishes: average consumer prices in July 1965 were only 6 percent higher than they had been in early 1961, and prices of nonfood commodities had risen by only 3 percent. Prices of manufactured finished products at wholesale had advanced by 1 percent in 5 years.

Expansionary fiscal policy had contributed actively to the record of 52 months of advance. The reform of depreciation rules and the investment tax credit, both initiated in 1962, encouraged business to expand and modernize plant and equipment. Furthermore, as a result of these measures and the much larger tax reductions granted by the Revenue Act of

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1964, both corporate and individual income recipients were enjoying an average reduction of one-fifth in their tax liabilities. Monetary policy continued to meet the credit needs of a brisk expansion and thereby contributed to the relative stability of long-term interest rates that was unusual for a period of rapid economic advance. Meanwhile, Federal spending on goods and services was essentially level after mid-1962. As a share of the growing GNP, defense purchases fell steadily from 9.2 percent in 1962 to a post-Korean low of 7.3 percent by mid-1965. Defense spending was clearly not the fuel that was propelling the economy toward full employment. But neither was the decline in the defense share permitted to retard the growth of total demand; some economic stimulus was provided by spending on new Federal civilian programs, and major reductions in taxes encouraged private spending.

New stimulative policies were being prepared in the spring of 1965 to complete the advance to full employment. Congress enacted a major phased reduction of excise taxes, in line with the President's proposals, and its first stage took effect in June 1965, cutting taxes by $1¾ billion (annual rate). A liberalization of social insurance benefits, designed to help the aged, was enacted to take effect retroactively. The larger benefits were to be financed by a payroll tax increase at the beginning of 1966. Meanwhile, the liberalization of benefits was expected to give the economy a significant stimulus in the fall of 1965 when an anticipated liquidation of steel inventories might otherwise have threatened a slowdown. The retroactive portion, which was disbursed in September, amounted to $900 million. Thereafter, annual benefits were raised by about $2 billion.

SPURT IN ECONOMIC ACTIVITY

The economic environment was significantly changed by the expansion of defense requirements. On July 28, 1965, the President requested additional funds for defense and indicated that further increases would be required in January. Military outlays, at an annual rate, rose by nearly $2 billion a quarter in late 1965 and early 1966 (Table 3). Defense orders expanded very rapidly, spurring demands for labor and inventories by contractors.

Yet the defense buildup itself was not enough to account directly for the acceleration in the over-all economic advance. Rather, it reinforced the previously planned fiscal stimuli and the forward momentum of a strong economy close to full employment. Furthermore, the expansion of defense spending contributed to a significant change in the climate of opinion. The Vietnam buildup virtually assured American businessmen that no economic reverse would occur in the near future. The impact on business attitudes was intensified by unwarranted fears that the Vietnam conflict might have consequences like those of the Korean conflict: direct controls, excess profits taxes, and a huge jump in prices of raw materials.

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TABLE 3.—*Changes in gross national product during two periods since mid-1965*

[Billions of dollars, seasonally adjusted annual rates]

Expenditure category	Change	
	1965 II to 1966 I	1966 I to 1966 IV [1]
Gross national product	48.3	37.9
Personal consumption expenditures	28.8	18.8
Durable goods	5.9	−.2
Nondurable goods	12.5	6.8
Services	10.4	12.2
Gross private domestic investment	10.8	3.5
Fixed investment	9.6	−2.0
Business fixed investment [2]	9.1	4.7
Residential structures	.5	−6.7
Change in business inventories	1.3	5.5
Net exports of goods and services	−2.2	−1.2
Government purchases of goods and services	10.7	16.9
Federal	6.3	10.6
National defense	5.5	10.9
Other	.9	−.4
State and local	4.4	6.3

[1] Preliminary.
[2] Nonresidential structures and producers' durable equipment.

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

Sources: Department of Commerce and Council of Economic Advisers.

The increase in defense spending swelled an already strongly rising tide of business investment expenditures. From the second quarter of 1965 to the first quarter of 1966, business spending for new structures and equipment rose by $9 billion. Defense, investment, and social security liberalization, in combination, speeded the growth of disposable income. Consumer spending responded strongly, growing by $29 billion over this three-quarter interval. All in all, GNP advanced at an average of $16 billion a quarter. Real output grew at a phenomenal annual rate of 7.2 percent, and industrial production rose at an annual rate of 9.7 percent.

Unemployment fell from 4.7 percent to 3.8 percent of the civilian labor force during this period. New orders for durable manufactured goods rose markedly (12 percent), with orders for electrical machinery (20 percent) and defense products (19 percent) increasing especially rapidly.

The surge in demand for goods and labor created pressures on prices in many areas. From October 1965 to July 1966, the annual rate of advance for industrial wholesale prices stepped-up to 3 percent. Prices of industrial crude materials moved sharply upward—at an annual rate of 8 percent from October to April. At the consumer level, demand pressures raised prices of services and nonfood commodities and combined with special supply factors in agriculture to push up food prices. These price movements and their consequences are discussed in detail in Chapter 2. All in all, the economy exceeded reasonable speed limits in the period from mid-1965 through the first quarter of 1966.

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MODERATION IN THE PACE OF ADVANCE

After years of providing stimulus to the economy, policy changed direction at the turn of the year. Monetary policy accounted for a major share of the restraint during most of 1966. As described in detail below, the Federal Reserve restrained the growth of credit supply in the face of extremely strong demands for borrowing by business. With intense competition for funds, interest rates rose sharply. Institutions which supply mortgage funds to the homebuilding industry lost deposits both to the commercial banks and to the market for new corporate securities. As a result, residential construction was starved for funds, and the sharp decline in this sector was one of the principal moderating influences during the second half of 1966.

Fiscal policy also responded effectively. Although the special defense costs necessarily swelled Federal outlays and were highly stimulative, restrictive actions were taken in other areas. Increases in nondefense purchases were held to $300 million from 1965 to 1966. Several restrictive tax measures were proposed in January 1966, and were enacted in mid-March. These included a reinstatement of some of the earlier excise tax reduction, restoring about $1 billion to the annual rate of Federal revenues; and a system of graduated withholding for individual income taxes that drew off $1½ billion (annual rate) from disposable income beginning in May. These new measures followed the $6 billion increase in payroll taxes that took effect at the start of 1966. In addition, revenues were increased in the spring by unusually large payments on 1965 income tax liabilities.

The national income accounts budget for the Federal sector shifted from a deficit at an annual rate of $1½ billion in the second half of 1965 to a surplus at an annual rate of $3 billion in the first half of 1966. (As explained in the Appendix to this Chapter, Federal fiscal policy is discussed throughout this Report in terms of the national income accounts budget.)

These monetary and fiscal actions helped to bring the rate of over-all economic expansion in line with the growth of capacity. After the first quarter of 1966, gains in GNP slowed to an average of $12½ billion a quarter, no longer outstripping the growth of potential GNP. The unemployment rate leveled off, as employment gains essentially matched the growth of the labor force. Manufacturing output actually rose less than the growth of manufacturing capacity, and average operating rates at year-end were below the 91 percent that had been reached in the first quarter.

The change of pace was first clearly noticeable in the spring. Fiscal restraint appreciably slowed the growth of disposable income in the second quarter and contributed to a marked slowdown in consumer spending. During the summer, consumer demand perked up again. But homebuilding, which had declined moderately in the second quarter, was hit hard by the shortage of mortgage financing and took a sharp plunge, holding down the increase in economic activity.

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Business demand for capital goods, on the other hand, continued to expand rapidly during the spring and summer. Although tight money, rising costs of machinery and construction, declining prices of common stock, and appeals for voluntary restraint had moderating effects in particular firms and industries, total business investment forged ahead. In August, both the Commerce-SEC anticipations survey and the National Industrial Conference Board appropriations survey confirmed the vigor of the capital boom. Commercial construction was the only type of business investment that showed weakness; it was restrained by the shortage of mortgage funds.

The capital boom, in fact, was proving too vigorous. In view of the growing backlogs of orders, shortages of certain types of skilled labor, rising prices in capital goods industries, and acute pressures of business credit demands on financial markets, there was a clear need to moderate investment demand. On September 8, the President asked Congress to suspend, until January 1, 1968, the 7 percent tax credit on investment in machinery and equipment and accelerated depreciation provisions on new buildings. At the same time, he initiated a program to reduce nondefense spending.

The Commerce-SEC survey in November showed that only moderate further increases in plant and equipment spending were planned through the second quarter of 1967. It also revealed that the actual increase in capital outlays in the third quarter was somewhat smaller than the planned advance reported in August; this was the first downward revision of plans in 3 years. The results of the survey no doubt reflected several factors, including the moderation of economic expansion, the financial pressures on business, and the suspension of the investment tax incentives. Even though orders for machinery and equipment continued to outrun shipments through December, there were favorable prospects that the pressures of excess demand on capital goods industries would be lessened in the months ahead.

RETROSPECT

Despite the moderation after the first quarter, expansion for 1966 was more rapid than virtually anyone expected at the outset. At the time it was presented last January, the Council's forecast that GNP in 1966 would rise strongly by $46½ billion was somewhat above the typical forecast of private economists. Yet it turned out to be $12 billion too low. In part, the underestimate reflected the difference between the predicted real growth of nearly 5 percent and the actual rate of 5½ percent. In addition, the over-all price deflator rose by 3 percent—about 1 percentage point more than projected.

The primary sources of the underestimate were in Federal defense purchases and business fixed investment. While both had been expected to be key sources of strength, they were even stronger than anticipated. As the prospective duration of Vietnam hostilities and the intensity of our military commitment exceeded those assumed in the budget, Federal spending

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for defense in the calendar year ran above last January's estimate by $4 billion. Spurred in part by defense outlays, expenditures on plant and equipment topped the Council's expectations by $2 billion to $3 billion. State and local purchases and inventory investment also were above the projections, while homebuilding and net exports fell below the estimates.

As it became clear that public and private demand was exceeding expectations, the desirability of further increases in taxes came under public discussion. Continuing and careful consideration of this issue within the Administration, sharpened by the increasing strain on financial markets, led to the fiscal program of September 8. In retrospect it is clear that, after March, monetary and fiscal policy in combination provided adequate total restraint. It may be debated whether a better balance of demands and policies would have been achieved if a program of additional fiscal restraint had been undertaken earlier in order to relieve the pressure on monetary policy. It may also be argued that the capital boom could have been cooled off sooner if the investment tax credit had been suspended earlier in the year. The question of whether a different timing or different magnitude of fiscal actions might have produced a more favorable balance in 1966 will long interest and challenge analysts of economic policy. But the main lesson is clear from the record: economic policy was used effectively to restrain the economy during 1966, much as it had been used during the preceding 5 years to stimulate demand.

THE PATTERN OF OUTPUT

In contrast to the reassuring balance of the expansion from 1961 to 1965, the advance in 1966 was uncomfortably uneven among sectors. The nature of these imbalances is illustrated by Chart 2, which shows the shares of GNP absorbed by various types of expenditures since 1954.

It is striking that the portion of GNP devoted to Federal purchases in 1966 was much the same as in earlier years. Indeed, despite the sharp growth of defense outlays, Federal expenditures represented a smaller share of national product than in any other post-Korean year except 1964 and 1965. The share of defense purchases was 8.1 percent, also lower than in any year from 1954 to 1963. State and local government purchases continued their secular rise as a share of GNP.

The share of private domestic and foreign investment in 1966, 16 percent of GNP, was quite typical for a full-employment year. Private investment exceeded private saving at full employment, leaving room for moderate surpluses in government budgets (national income accounts basis).

UNEVEN SHARES IN INVESTMENT

Although the share of investment in GNP was normal, the pattern of the major investment components was unusual when compared with other post-

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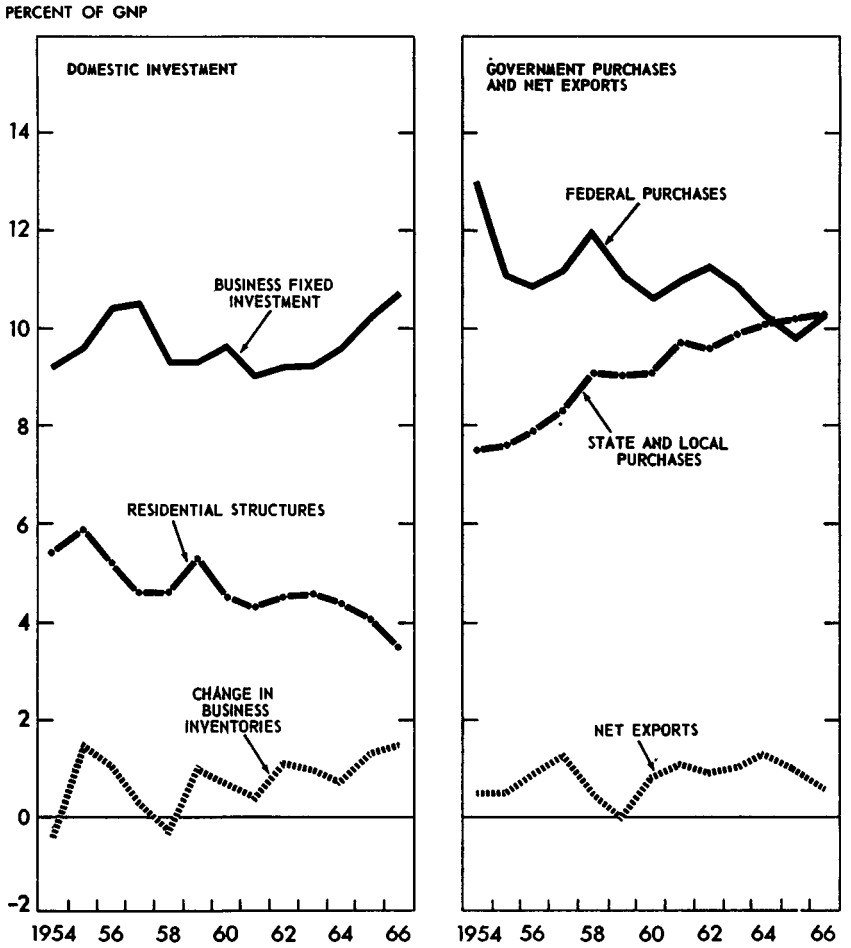
Chart 2

Selected Shares of Gross National Product



SOURCE: DEPARTMENT OF COMMERCE.

Korean years. Business fixed investment was at a record high of 10.7 percent of GNP, surpassing its previous peak of 10.5 percent in 1957 and considerably above its post-Korean average of 9.8 percent. Because of the scarcity of mortgage funds, housing starts fell steadily from an average of 1.5 million units in the first quarter of the year to 1.0 million in the fourth; at 3.5 percent, the share of residential construction was at a post-Korean low. Inventory investment, at 1.5 percent, matched its previous post-Korean high of 1955. Excess demand at home generated a spurt in demand for goods from abroad, pulling down the share of net exports to the lowest level since 1959.

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The record share of business fixed investment in 1966 occurred despite the need for a much greater volume of external financing at unusually high borrowing costs. Incentives to invest were provided by a continuation of the forces that had spurred business to expand and modernize facilities in 1964 and 1965: growing sales, orders, and profits, and high operating rates. These were further strengthened by the rise in defense spending.

INVENTORY INVESTMENT

A high rate of inventory investment in relation to GNP during 1966 reflected many of the same factors that stimulated business fixed investment. Inventory-sales ratios generally crept up after years of stability or decline. Nonfarm stocks expanded by 8 percent over the year, considerably above the rate of growth of real output or sales. Inventories rose especially rapidly in durable goods manufacturing; these stocks grew by nearly $7 billion during the first 11 months of 1966. Within durables, goods-in-process inventories rose by about $4 billion over the period, reflecting, in part, the build-up of defense and business equipment in the pipeline.

The long production times that are essential for many durable goods were largely responsible for the growth of stocks of goods-in-process. From the time a company begins to build an airplane or a machine, it may take 6 months or a year to produce a finished good and complete a shipment. While the piece of equipment is being fabricated, the value of the completed portion shows up in inventories of goods-in-process. Thus, if orders rise sharply for items with long production times, inventories grow; the ratio of inventories to shipments also tends to increase until shipments can catch up.

In late 1965 and in 1966, orders for business equipment and defense hardgoods rose sharply, and shipments did not keep pace. The economic impact of this step-up in orders was not fully reflected in Government purchases or in business fixed investment; some of it showed up as inventory investment. The impact of defense orders on inventories cannot be quantified precisely. But it can be estimated by two approaches: one uses data on progress payments made by the Department of Defense, and the other rests mainly on the statistics of defense-oriented industries. Both approaches suggest that, from the beginning of the fourth quarter of 1965 through the third quarter of 1966, defense contractors and their suppliers added about $2 billion to their stocks as a result of defense orders.

MONEY AND CREDIT

The composition of output and the pace of advance last year were much influenced by financial and credit developments. In 1966, monetary policy moved to the center of the stage. Previously, it had played a significant role in support of an active fiscal policy to stimulate economic expansion.

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PROMOTING EXPANSION, 1961 TO 1965

From 1961 through 1965, Federal Reserve policy permitted a sufficient expansion of credit to accommodate expanding demands for funds at only moderately rising interest rates. As in any period of economic advance, greatly increased credit was demanded by consumers to purchase homes and durable goods, businesses to finance investment in plant and equipment and inventories, and State and local authorities to support their expenditures. In 1965, the net flow of new credit to these groups was $66 billion—nearly double the amount in 1961 (Table 4).

The pattern of credit flows had several outstanding characteristics. The volume of corporate security issues actually declined; with the very rapid growth of corporate profits, internal funds nearly kept pace with the expansion of business investment until mid-1965 (Chart 3). Also, the volume of security issues was held down by the ready availability of bank loans to business.

The share of commercial banks in total lending rose by nearly one-third from 1961 to 1965, while the share of thrift institutions (savings and loan associations and mutual savings banks) declined by nearly one-third. Following a series of upward adjustments by regulatory authorities in the maximum interest rates allowed on time and savings deposits, commercial banks competed aggressively for time deposits and acquired funds to meet growing demands for loans. They developed and made effective use of some new financial instruments, especially the negotiable certificate of deposit (CD). Because these certificates, unlike ordinary time deposits, can be readily sold, holders can earn interest on idle deposits without sacrificing liquidity. These innovations helped to hold down long-term interest rates in the face of

TABLE 4.—*Net funds raised by domestic nonfinancial sectors, 1961–66*

[Billions of dollars]

Type of credit	1961	1962	1963	1964	1965	1966		
						Total [1]	First half	Second half [1]
							Seasonally adjusted annual rates	
Private domestic nonfinancial sectors	33.9	44.2	50.2	55.6	66.0	58.7	70.0	47.8
Consumer credit	1.7	5.5	7.3	8.0	9.4	7.0	7.8	6.2
Bank loans [2]	2.2	4.8	5.4	6.5	13.6	7.4	11.4	3.7
State and local obligations	4.9	5.0	6.7	5.9	7.4	5.7	6.4	5.1
Corporate securities	7.1	5.1	3.6	5.4	5.4	10.9	13.6	8.2
Home mortgages [3]	11.4	13.0	15.2	15.7	16.0	12.3	14.4	10.2
Other [4]	6.7	10.9	12.0	14.2	14.2	15.4	16.1	14.6
U.S. Government	7.7	7.9	5.0	7.0	3.5	7.4	9.0	5.8

[1] Preliminary estimates.
[2] Bank loans not elsewhere classified.
[3] Mortgages on 1- to 4-family homes.
[4] Acceptances, commercial and finance company paper, U.S. Government loans, and mortgages on multifamily dwellings and on farm and commercial land and buildings.

Source: Board of Governors of the Federal Reserve System.

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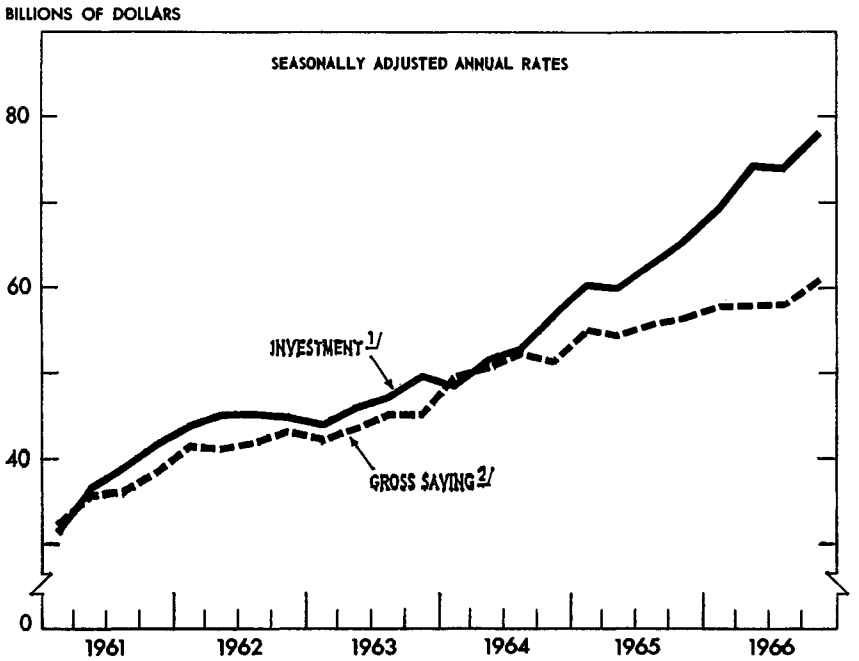
Chart 3

Investment and Gross Saving of Nonfinancial Corporations



1/FIXED INVESTMENT PLUS CHANGE IN INVENTORIES.
2/CORPORATE PROFITS AND INVENTORY VALUATION ADJUSTMENT, LESS PROFITS TAX ACCRUALS AND DIVIDEND PAYMENTS, PLUS CAPITAL CONSUMPTION ALLOWANCES.
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

growing credit demands, and supported continued expansion of economic activity.

SHIFT TO RESTRAINT

Conditions changed dramatically in the closing months of 1965. The rapid rise of business investment far exceeded the growth of corporate cash flow. This widening gap, shown in Chart 3, was the major driving force behind the rising demand for credit that continued into the first half of 1966. Given the intensity of this demand, monetary policy could have prevented an increase in interest rates and a tightening of credit availability only by creating bank reserves at an extremely rapid rate. Such a policy would have contributed to inflation by removing financial limitations on the surging demands for goods and services. Under the circumstances, it was desirable to curb the growth of credit. The appropriate degree of restraint had to take into account the volume of pressure on financial

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markets and the magnitude of the upward movement in interest rates that could be tolerated.

In December 1965, the Federal Reserve signaled the forthcoming tightening of monetary policy by increasing the discount rate from 4 percent to 4½ percent. At the same time, the maximum allowable interest rate on time deposits of commercial banks was raised from 4½ to 5½ percent. During the first half of 1966, business demands for credit rose rapidly. Supplies of credit did not keep pace, as the Federal Reserve held the expansion in bank reserves somewhat below that of 1965, when credit demands were rising less strongly.

In order to maintain the good will of valued business customers, banks made every effort to satisfy the mounting demands for business loans. They obtained additional loanable funds by increasing their borrowings from the Federal Reserve, reducing their investments in securities, bringing back funds from their foreign branches, and attracting additional time deposits through higher interest rates. As a result, they were able to expand business loans at an annual rate of about 20 percent in the first half of 1966, even more rapidly than the 18 percent increase in 1965.

Corporate demands for credit were so strong that even this extraordinary increase in bank lending provided less than half of the external funds raised by corporations. To finance their investment expenditures, firms began to issue large amounts of new securities. Sales of securities by the Government, particularly Government agencies, were also large during this period.

The large volume of corporate and Government securities could be sold only at much higher yields. After November 1965 interest rates on high-grade securities increased sharply (Chart 4). As in the past, the rise in market yields, relative to the rates paid on deposits, permitted security issues to absorb a larger proportion of total household lending (Chart 5). As in other periods of tight money and rising security yields, funds deposited in financial institutions declined relative to funds provided directly to the security markets.

COMPETITION AMONG FINANCIAL INSTITUTIONS

Commercial banks competed strongly and rather successfully to hold their own as the total flow of funds into depository institutions declined. By raising yields on CD's, the banks attracted corporate time deposits in large volume. In addition, through the expanded use of savings certificates and other types of nonnegotiable certificates of deposit, they induced an increasing flow of household time deposits.

The impact of the increased direct flow of savings to security markets fell heavily on the thrift institutions. Thrift institutions continued to receive the deposits of the steady savers who represent a major part of their clientele.

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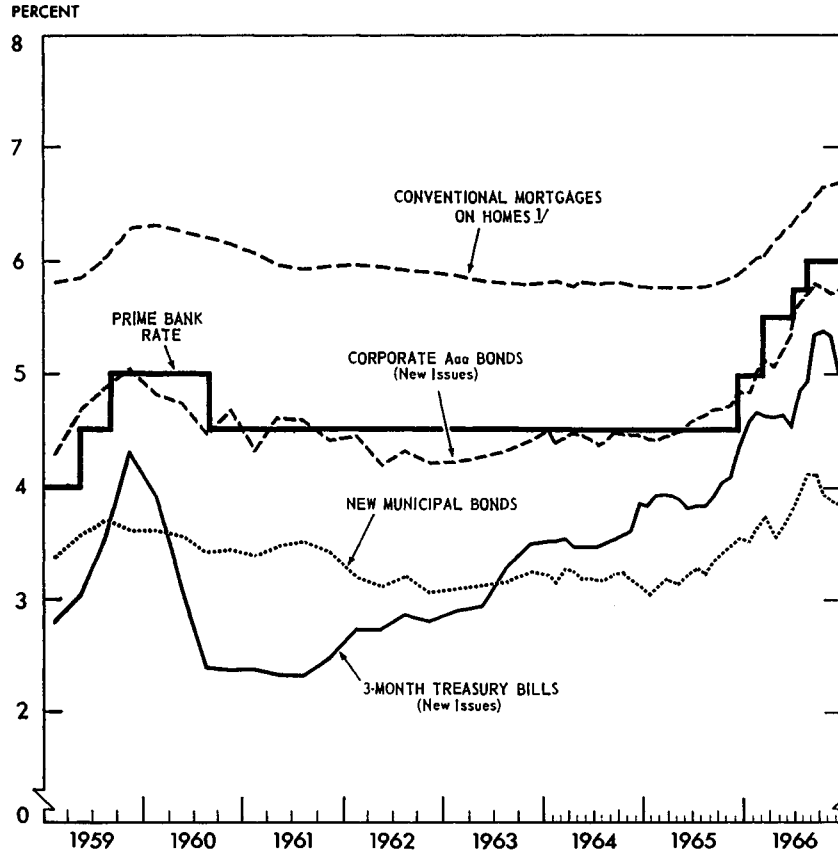
Chart 4

Selected Interest Rates



1/NEW AND EXISTING HOMES THROUGH 1960 I, AND NEW HOMES ONLY THEREAFTER.
NOTE.-DATA PLOTTED ARE QUARTERLY THROUGH 1963, MONTHLY THEREAFTER.
SOURCES: FEDERAL HOUSING ADMINISTRATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE, AND TREASURY DEPARTMENT

Indeed, the gross inflow to savings and loan associations actually was larger in 1966 than in 1965. But, funds of interest-sensitive depositors (so-called "hot money") were withdrawn and invested in higher-yielding securities. These withdrawals dominated the net inflow. By mid-1966, the net inflow had fallen to a rate less than one-fourth that of 1965.

Unlike banks, thrift institutions were unable to prevent withdrawals effectively by raising interest rates paid on deposits. Because the portfolios of these institutions were invested primarily in mortgages (assets with a fixed yield and a very slow turnover), they had relatively little flexibility in adjusting the rates paid on ordinary deposits. Nor have thrift institutions made effective use of special savings certificates, which—like bank CD's—offer

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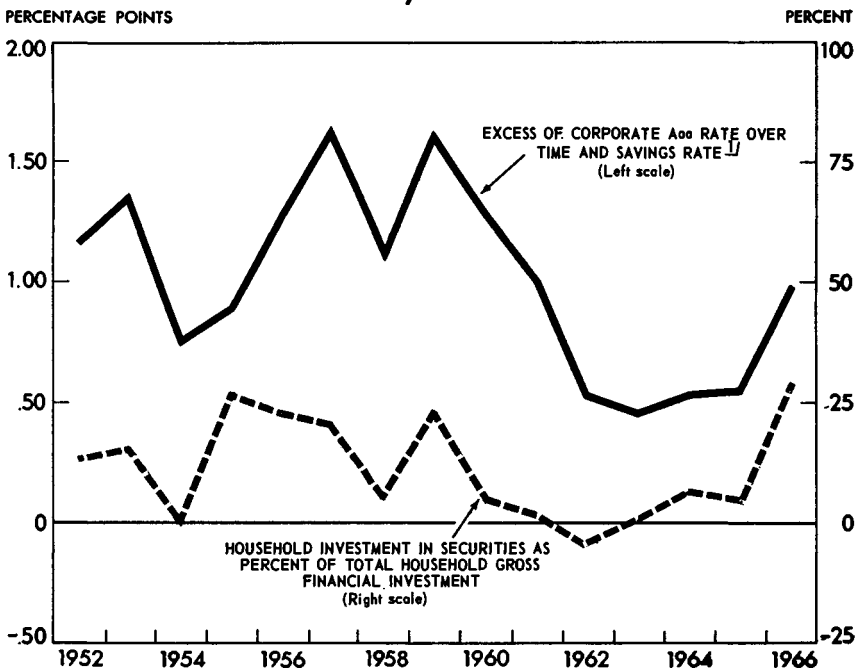
Chart 5

Interest Rate Differentials and Household Security Purchases



1/EXCESS OF CORPORATE Aaa BOND RATE (NEW ISSUES) OVER WEIGHTED AVERAGE OF INTEREST RATES PAID ON TIME AND SAVINGS DEPOSITS AND SHARE ACCOUNTS AT COMMERCIAL BANKS AND SAVINGS INSTITUTIONS.

SOURCES: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION, FEDERAL HOME LOAN BANK BOARD, AND COUNCIL OF ECONOMIC ADVISERS.

higher interest rates marginally without increasing the yield to all depositors. If they had tried to remain competitive with banks by raising the rates paid on all deposits, their expenses would have risen much more rapidly than their income.

With a greatly reduced inflow of funds, thrift institutions had to curtail mortgage lending sharply in 1966. Net acquisitions of residential mortgages decreased by 25 percent in the first two quarters of 1966. This reduction occurred despite significant Government aid: the Federal National Mortgage Association purchased nearly $4½ billion of mortgages (annual rate) during the period, and the Home Loan Banks provided funds to offset deposit losses of savings and loan associations. In the third quarter, only $9.4 billion (annual rate) went into residential mortgages—more than 40 percent below the amount provided a year earlier. The net flow into home mortgages from savings and loan associations was virtually zero. The result of all this was the marked decline in residential construction described earlier.

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In the first half of the year, Federal Reserve policy restrained bank lending only moderately but placed other financial institutions under severe pressure. If monetary policy had been applied more restrictively to banks by providing a smaller increase in reserves through open market operations, banks would have sold more securties and bid more aggressively for time deposits. In that event, pressure on thrift institutions would have been even more extreme than it was in fact. In view of this, monetary policy was tempered by the intense competition among financial institutions.

ACTIONS TO REDUCE FINANCIAL PRESSURES

The Federal Reserve acted after midyear to curb this intense competition. In July, interest rate ceilings were lowered on selected types of time deposits, and reserve requirements on time deposits were raised.

Banks were also put under pressure during the summer as market interest rates rose further and those on CD's moved up to the permissible 5½ percent ceiling, curtailing the ability of banks to retain corporate time deposits. Meanwhile the Federal Reserve tightened its open market operations, reducing nonborrowed reserves by $300 million between July and August. Interest rates rose sharply and, by late August, all sectors of the financial markets were under severe pressure. Banks, faced with a declining reserve base and unable to obtain corporate funds through CD's, were obliged to slow down their lending. Thrift institutions, fearing a loss of funds, sharply curtailed new mortgage commitments.

In September, the Administration, the Congress, and financial regulatory agencies all took actions to improve the balance of demands for both funds and goods.

The Federal Reserve, on September 1, asked member banks to cooperate in moderating the rate of lending to business and spelled out its own current policies regarding lending to member banks. Banks that cooperated in holding down business loan commitments and refrained from liquidating securities would be permitted to borrow funds from the Federal Reserve for somewhat longer periods than usual, while making necessary adjustments. The Federal Reserve further increased the reserve requirement on time deposits.

The President's proposal for temporary suspension of tax incentives to investment was designed to reduce corporate demands for long-term funds. The Administration also buoyed financial markets by indicating that Federal agencies would hold down stringently their issues of securities in the financial markets, even for purposes of refunding maturing issues.

On September 21, the President signed a bill allowing Federal regulatory authorities to impose new interest rate ceilings on time and savings accounts. In order to restrain excessive rate competition among different types of financial institutions, the agencies involved announced new interest rate regulations on the same day that the bill was signed.

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The interest rate that commercial banks were permitted to pay on deposits of less than $100,000 was reduced from 5½ percent to 5 percent. A 5 percent interest rate ceiling was also imposed on the deposits of mutual savings banks. Because the rates paid by savings and loan associations varied widely among different parts of the country, the regulations governing these institutions were considerably more complicated, but in general the ceilings were set somewhat above the comparable ones for commercial banks.

The flow of funds into mortgages was also supported by another piece of legislation signed the same month, which increased the lending ability of the Federal National Mortgage Association by a total of $4.8 billion.

These various actions reflected widespread concern over the uneven impact of monetary policy actions and changing credit demands on different sectors of the market.

SIGNS OF RELAXATION

Since September, financial conditions have improved considerably. The moderation in the pace of economic activity began to be reflected in less intense demands for credit. As inflationary pressures abated, monetary policy responded promptly to the changing economic climate, and nonborrowed reserves resumed their growth in November and December. Moreover, the Federal Reserve in late December rescinded the September letter requesting banks to restrict business loans.

After touching in late August and early September the highest levels in more than 40 years, interest rates fell steadily. By the end of the year, most major interest rates on securities were appreciably below their earlier peaks. The Treasury bill rate fell to about 4¾ percent, from more than 5½ percent in September. Rates on new issues of high grade corporate and municipal bonds declined by about one-half percentage point.

The reduction in market interest rates and in the ceilings on rates of depository institutions has begun to restore balance among financial intermediaries. Mutual savings banks gained deposits at an annual rate of more than 6½ percent in the latter part of 1966. Savings and loan associations took longer to recover, but by December there was definite improvement. In the first 11 months of 1966, the net inflow of funds was 72 percent below a year earlier. In December, however, a substantial net inflow of $1.7 billion exceeded that of December 1965.

Commercial bank credit fell from August to October, bottomed out in November; in December it rebounded at an annual rate of 9 percent, returning to its August level. However, bank lending continued to be conservative at year end, as many banks felt a need to rebuild their liquidity position before expanding their loan commitments.

As a result of the moderation in economic activity and the flexible response of monetary policy, a welcome movement toward easier monetary conditions began to emerge as 1966 closed.

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EVALUATION OF MONETARY RESTRAINT

The credit squeeze of 1966 had an impressive and beneficial restraining effect on over-all demand. Its side effects were equally impressive but far less beneficial.

These side effects explain in part why relaxation of credit conditions is and has been an objective of policy. The cause of equity was not served by the arbitrary redistribution of income produced by very high interest rates or by the adversity experienced in the homebuilding industry. Moreover, the stability of financial markets was at times endangered. While the insurance of deposits and the powers of "lenders of last resort" gave full protection against any recurrence of the financial panics experienced in previous generations, the liquidity of portfolios was impaired by rapidly rising interest rates.

Last August, monetary policy was probably as tight as it could get without risking financial disorder. Any further increase in over-all demand could not have been effectively countered by general monetary policy. In such a situation, the flexibility of over-all stabilization policy is impaired. It is desirable for both fiscal and monetary policies to be operating from positions where they can move freely either way—toward stimulus or restraint in the event of unanticipated developments.

The main effect of tight money on over-all activity worked primarily through the mortgage market, curtailing homebuilding and other mortgage-financed construction. In December, expenditures for residential structures were $7 billion (annual rate) below the first quarter level. Homebuilding had been on a plateau during most of 1965 and was rising moderately at the start of 1966. Demand conditions for housing looked fairly encouraging as excess supplies of new housing (especially apartments) that had earlier appeared in certain areas were reduced moderately during 1965. In the absence of tight money, residential construction might have risen slightly further or retreated modestly during the course of 1966; the decline that actually occurred is a reasonable estimate of the impact of the change in credit conditions. By similar reasoning, the performance of commercial and other mortgage-financed types of construction suggests an impact of perhaps $1 billion or more. Monetary restraint probably also had some modest effect on expenditures for producers' durable equipment and consumer durables, but the amount is not evident in aggregate data.

All in all, it seems reasonable—perhaps even conservative—to estimate that credit-financed expenditures may have been held down directly by as much as $8 billion at year-end as a result of tight money, compared with what would have happened had monetary policies continued supportive, as during 1964 and most of 1965. This direct impact of $8 billion on GNP is roughly as great as the estimated direct impact from a 10 percent surcharge on personal and corporate tax liabilities. (By restraining incomes, both tax increases and tight money have further indirect "multiplier" effects on GNP.) Thus, when monetary restraint is taken into account, it becomes

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clear that the combined impact of monetary and fiscal policy was markedly restrictive.

PROSPECTS AND POLICIES FOR 1967

As 1967 begins, over-all demand is reflecting the restraint of last year's monetary and tax actions. Excessive demand is not now a serious threat. The economy's advance is being stimulated by a continuing rise in Federal defense and State and local purchases. In the private sector, significant increases should be registered in consumption. Modest advances are indicated for business fixed investment and for net exports, which reversed a long decline in the fourth quarter of 1966.

Data on housing starts and permits for the closing months of 1966 provide encouraging, although not conclusive, evidence that homebuilding activity has touched bottom. But the recovery of homebuilding will take considerable time, and the effects of last year's monetary restraint will still be felt for many months. Interest rates on securities have declined; but revitalized flows of funds into banks and thrift institutions have just begun. Financial institutions are relaxing their lending policies only gradually as they rebuild liquidity. Interest rates on bank loans and mortgages have not yet reflected the easing in financial markets. Finally, construction expenditures will take place only after contracts are placed and work is initiated.

Inventory investment is bound to be considerably below the unusually high rate in the closing months of 1966. The rate of accumulation in the fourth quarter was about double that required to keep stocks advancing in pace with the trend growth of sales. As in the earlier months of 1966, much of the latest advance in inventories seems to have taken place in goods-in-process held by industries producing defense and business equipment; the buildup may continue but probably at a diminished rate.

Thus, the economy faces a transition to a lower rate of investment in inventories. The strength elsewhere in the economy offers important evidence that the inventory adjustment need not cumulate into an excessive slowdown of activity. The over-all assessment does suggest, however, that private demand is not likely to be particularly buoyant in the first half of 1967 and that a stimulative stabilization policy is appropriate to support steady expansion during this period.

FISCAL PROGRAM FOR 1967

The budget will be appropriately stimulative in the first half of 1967. The annual rate of deficit (national income accounts basis) is expected to be more than $5 billion, compared with a $2½ billion deficit rate in the second half of 1966. Although nondefense spending has been held down, both the special costs of Vietnam and further increases in transfer payments for Medicare will add substantially to Federal outlays. Revenues will continue

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their normal growth in the first half of 1967; but, unlike 1966, no significant net changes in tax payments will result from recent legislation. An increase in payroll taxes of $1½ billion (annual rate), which went into effect at the beginning of 1967, will be nearly offset by the effect of the system of graduated withholding on income tax collections. As a result of this system, which was instituted last May, an additional $1 billion in personal taxes was collected during 1966. Reflecting this, net final payments this spring on personal tax liabilities for 1966 are expected to be correspondingly smaller.

By midyear, construction should be recovering with the stimulus of monetary ease; and inventory investment should be leveling off at a moderate rate. In combination, these two sectors should significantly strengthen over-all private demand. A shift toward restraint in fiscal policy is appropriate at that time to assure that demand does not outrun capacity, that movement toward restoration of price stability is maintained, and that monetary policy does not have to be tightened again.

In line with this set of aims, the President is asking the Congress to enact, as of midyear, a 6 percent surcharge on personal and corporate income tax liabilities with an exemption for low-income families. The tax will remain in effect for 2 years or as long as the unusual special Vietnam costs continue. The form of this proposed temporary tax increase parallels the conclusion of the Subcommittee on Fiscal Policy of the Joint Economic Committee that ". . . a uniform percentage addition to . . . corporate and personal income tax liabilities . . ., to be effective for a stated period, best satisfies criteria for shortrun stabilizing revenue changes." Once fully in effect, the surcharge will drain off an estimated $5.8 billion (annual rate) of private incomes—$3.9 billion from individuals and $1.9 billion from corporations.

On the expenditure side, defense purchases will continue to rise but at a diminishing rate during the course of the year. Transfer payments in the second half of 1967 will exceed the rate in the first half by $4½ billion, reflecting primarily the proposed increase in Social Security benefits. The President is requesting benefit liberalization amounting to $4 billion (annual rate) to begin by midyear, to support the needs of the elderly. The liberalization will be followed by an increase in the payroll tax base at the beginning of 1968. Reflecting the income tax surcharge, normal revenue growth, and increased expenditures, the rate of budget deficit will be reduced to about $3 billion in the second half of the year, and the budget is expected to be approximately in balance in the first half of 1968.

ECONOMIC OUTLOOK

With Congressional enactment of the President's key fiscal proposals, GNP for 1967 is expected to reach $787 billion, given the $740 billion now estimated for 1966. In the nature of economic forecasting, the projected advance of $47 billion must be viewed as the midpoint of a range of possible outcomes, rather than a precise estimate.

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Like any quantitative forecast, the estimated rise of $47 billion is meant to convey important qualitative judgments. The advance will be considerably less rapid than the record increase of $58 billion in GNP in 1966. Healthy forward motion will nevertheless be maintained. Real output should expand nearly in line with the 4 percent growth of potential. As explained in Chapter 2, the price record should improve; over-all prices may increase slightly more than 2½ percent. Finally and most important, the Nation should continue to experience substantially full employment in 1967. The unemployment rate should be essentially the same as in 1966, when it averaged 3.9 percent. After allowance for an increase of more than 300,000 in the Armed Forces, the civilian labor force should expand by about 1¼ million, and civilian employment should approximately keep pace.

Outlook by Sectors

A more balanced composition of output is expected in 1967, reflecting the aims and effects of policy. Neither business fixed investment nor inventory investment will, or should, be strong stimulating forces. On the other hand, housing should gain as the year develops, and defense outlays will continue to provide economic stimulus.

Business Fixed Investment. After increasing by an average of 13½ percent annually over the past 3 years, business fixed investment should expand much more slowly in 1967. Evidence of this is already provided in the November survey of intentions for plant and equipment spending. Investment should increase only slightly from its level in the fourth quarter of 1966, and should show a rise of about $3 billion from 1966 to 1967. This pace would be a welcome respite, permitting pressures on capital goods industries to abate. The ratio of business investment to GNP should decline slowly to a more sustainable level near 10¼ percent by year end.

Business Inventories. Inventory investment was at a record high last year, partly because of the rise in goods-in-process stocks of industries producing business and defense equipment. Any further buildup of these stocks will be small. Stocks in most areas are expected to rise in line with steady and moderate advances in sales. Inventory investment for 1967 may be about half the $11½ billion rate experienced in 1966. Most of the decline to a sustainable rate should occur in the first half of the year, with a leveling off thereafter.

Homebuilding. As monetary policy continues to ease, housing starts should begin to rise above their current depressed level. Additional help should come from actions of the Federal Home Loan Bank Board (FHLBB) and the Federal National Mortgage Association (FNMA). Because of the lag between mortgage commitments and construction expenditures, activity should begin to increase very gradually in the first half of the year and gain considerable momentum in the latter part. Demo-

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graphic factors and low vacancy rates point to latent strength in homebuilding, which should become evident during the course of 1967.

Residential construction expenditures are expected to increase by about $5 billion to $6 billion from the fourth quarter of 1966 to the fourth quarter of 1967. Even so, for the year as a whole, they would still be about $1 billion below the 1966 average.

Government. State and local government purchases, which grew by 10 percent, or $7 billion in 1966, should expand in 1967 by about $8 billion in response to growing needs and strongly increasing revenues. The increase in Federal purchases from 1966 to 1967 is expected to be $12 billion, mostly for defense. But the rate of advance will taper off during the course of the year.

Net Exports. As the growth of imports moderates and exports show strength, net exports should expand throughout the year, rising about $1 billion from 1966 to 1967.

Consumption. The fiscal program for 1967 will have a direct impact on after-tax incomes of households and thus on their consumption outlays. The growth in transfer payments will increase disposable income, while the proposed surtax on individual incomes and the payroll tax that just took effect will restrain it. The more moderate growth expected in employment and the net effect of these policy measures will hold the growth of disposable personal income in 1967 somewhat below the gain in 1966.

This advance in disposable income should make possible a gain in consumption of more than $30 billion in 1967, compared with a rise of $33½ billion in 1966. In real terms, the expected gains in consumption and disposable income in 1967 are expected approximately to match those of 1966. The saving rate in 1967 should remain close to the 1966 level of 5¼ percent, a little below the average of recent years.

Flexibility

The program and the outlook for 1967 provide good prospects for a growth of demand that keeps pace with capacity. But the experience of 1966 is a clear reminder that surprises can develop and that policy must be alert to them. This year, the risks are on both sides: demand could grow too sluggishly or too strongly. A balance of risks is a necessary feature of a full employment economy moving ahead essentially in line with potential.

In the first half of 1967, there are forces which could make for sluggish private demand, but a sizable stimulus from fiscal policy will help to clear the hurdles. Then, in the second half, housing should move up strongly, the rate of inventory investment should stop declining, and transfer payments will rise. Indeed, with these developments, private demand could once again move ahead rapidly, perhaps even too rapidly. But, by that time, the President's tax program will be moderating the advance.

At any time in the year, the outlook for plant and equipment demand could be upset if the recent signs of moderation should prove illusory or

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if a sharp and pronounced decline should occur. Either development could call for a response by stabilization policies.

Cessation of hostilities in Vietnam would be the most welcome surprise that could develop in 1967. It would challenge economic policy to smooth the transition—and policy will be ready to meet the challenge. On the other hand, an unexpected increase in outlays required for defense would have important consequences, pointing toward further measures of restraint, particularly from fiscal policy.

A firm set of attainable objectives, a program that fits the present outlook, alertness to changing circumstances, and flexible and well-coordinated use of policy instruments are the necessary means for maintaining full employment and achieving a sustainable advance in 1967.

IMPROVING STABILIZATION TOOLS OVER THE LONGER RUN

The tools of economic stabilization now at our disposal can cope quite effectively with the problems that lie immediately ahead. Over the coming years, however, there is a continuing need to sharpen and improve these policy tools—as well as the institutional framework within which they operate—so that short-term policy can respond efficiently and flexibly to economic fluctuations and simultaneously promote progress along a path of sustainable long-term growth.

USES OF MONETARY POLICY

As a stabilization tool, monetary policy has some distinct advantages. Policy changes can be made quickly in response to changing signals. Furthermore, as was evident in 1966, a restrictive monetary policy can reduce aggregate demand fairly promptly and very sharply.

But there are also distinct limitations on the uses of monetary policy. As demonstrated in 1966 its impact on different sectors of the economy can be highly uneven, both in magnitude and in timing. Moreover, if monetary policy is used repeatedly and in large doses to restrain inflation, it may be difficult to avoid a long-term upward trend in interest rates. And the scope for monetary policy may at times also be limited by balance of payments considerations.

The uneven impact of changes in credit conditions is unavoidable to a certain extent. Monetary policy inevitably has its principal effect on those sectors that are particularly dependent on credit. But the special vulnerability of some sectors to tightening is also importantly related to certain structural characteristics of our financial institutions. Over time, there should be scope for reducing the uneven impact of monetary policy through various modifications in these institutional arrangements. This is particularly true with respect to homebuilding.

In the postwar period, changing monetary conditions have contributed to several major swings in residential construction. This particularly sensi-

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tive reaction to monetary conditions reflects the reliance of mortgage financing on institutional rather than open market sources of credit and its special reliance on one particular type of institution, namely savings and loan associations. The most recent example of this sensitivity, reviewed earlier, was in 1966, when the associations suffered major withdrawals of funds.

Until 1957, savings and loan associations were largely sheltered from competition with commercial banks. Bank interest rates for time deposits were fixed at a low level, and most banks were not interested in competing for savings funds. At that time, however, a series of increases was initiated in the administrative ceilings on the interest rates that banks could pay on time deposits. This led to a gradual narrowing in the differential between rates paid by the associations and by the banks; and the share of deposits going into savings and loan associations declined, even though the total amount advanced rapidly, at least until 1966. Given the respective legal limitations on the portfolios of banks and of thrift institutions, such a shift gradually tended to curtail the flow of funds to the mortgage market. There is every reason to believe that thrift institutions will continue to face strong competition from banks, and must hereafter operate in a very different environment from that prior to 1957.

The supply of mortgage funds might be better protected in future periods of tight credit conditions if techniques could be devised to give the mortgage markets new and better forms of access to the open capital markets, either directly or through the thrift institutions. A number of possible arrangements are now under discussion in the industry. With such arrangements, funds would be available only at competitive rates; but they would be available. At present, some access is obtained indirectly, when banks, insurance companies, and savings banks sell bonds in periods of tight money in order to buy mortgages. FNMA secondary market operations and FHLBB advances to savings and loan associations also provide an indirect link between mortgage financing and the national capital market.

Some additional stability in the flow of funds to the mortgage market could also be achieved through changes in the practices of savings and loan associations. They could partially stabilize their mortgage lending activity in the face of fluctuations in deposit flows if they held secondary reserves as commercial banks normally do. They can also place themselves in a better position to hold on to interest-sensitive deposits in a period of tight credit by issuing special instruments, like CD's, returning a higher yield to investors. Comprehensive authority to issue such instruments has been granted only recently and should be of additional help in the future. In particular, the associations reduce their exposure to abrupt changes in deposit flows by issuing such instruments for longer maturities.

It would also be desirable to strengthen thrift institutions by legislation permitting the Federal chartering of mutual savings banks. Such institutions would have powers to invest in corporate securities and con-

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sumer loans as well as mortgages. While broadened investment privileges of federally chartered mutual savings banks might initially divert some funds from the mortgage market, such chartered banks would improve the efficiency of thrift institutions, strengthen them in competition with banks, and thereby ultimately benefit the mortgage market.

If the ability of the thrift institutions to compete with commercial banks can be strengthened, continuous reliance on interest rate ceilings on savings accounts may no longer be desirable. But there could still be occasions when rate ceilings would serve a genuine need. This contingency could be provided for in either of two ways: (1) through standby authority to impose rate ceilings under particular circumstances; or (2) through permanent ceilings set sufficiently high that they would become effective only in unusual instances. Pending agreement on the most suitable form of permanent legislation for regulating rates, the present legislation (which expires in September) should be continued for a limited period.

The kinds of financial innovations sketched above could increase the scope for the active use of monetary policy as a tool of stabilization. With such changes, a restrictive monetary policy might have a broader and less uneven impact.

There are, however, other possible limitations on the use of monetary policy. There is the danger that under some circumstances, employment of the monetary instrument for short-run stabilization purposes can produce an upward ratcheting of interest rates which could interfere with long-term economic growth.

Indeed, in the postwar period, cyclical movements in rates have been superimposed on a distinct upward rate trend. Every period of business expansion has brought new postwar peaks in interest rates. Of course, rates were abnormally low at the start of the postwar era, reflecting the unusually large liquid balances of businesses and households. But this initial situation cannot explain the continuing upward trend in rates since the mid-1950's. During each period of economic expansion in the 1950's, credit was tightened sharply to restrain demand. The resulting increases in interest rates were not fully offset during the subsequent mild recessions. With each advance, expectations became adjusted to the new level. Rigidities retarded declines, once higher rates were built into the deposit and loan practices of financial institutions.

But an upward ratchet of interest rates is not an inherent or necessary result of a flexible monetary policy. There is now a welcome opportunity for monetary policy to demonstrate its reversibility in a period of prosperity; indeed, that opportunity has already begun to be converted into reality.

A variety of approaches can also be used to reduce some of the obstacles to a flexible use of monetary policy which may be imposed by balance of payments considerations, as discussed more fully in Chapter 5.

Monetary policy is an indispensable tool; and there is important scope for making it more useful. But the measures that can be taken to this end can-

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not fully overcome its inherent limitations. It needs, and has, a powerful ally in fiscal policy.

NEED FOR FISCAL FLEXIBILITY

In any over-all stabilization program, fiscal policy must play a major role. Fiscal policy is generally more even in its impact than monetary policy. Its effects tend to be more readily predictable and less subject to time lags. Fiscal policy, too, can be used with a great deal of flexibility.

In principle, a fiscal program for short-term stabilization can involve adjustment of budget expenditures, of tax rates, or of both. A limited amount of discretionary expenditure variation within a given year can be very useful to deal with unanticipated economic developments. But most economists now agree that the selection of appropriate expenditure levels for various public programs in the budget should be made in light of the relative merits of alternative programs, and of the benefits of added public expenditures, compared with private ones, at the margin. Although the timing of some Federal expenditures can be flexibly adjusted, only gradual changes can be made in other programs without compromising their efficiency, at least to a degree. For such reasons, it is preferable to emphasize changes in tax rates (suitably coordinated with changes in monetary policy) for stabilization purposes, and to take full account of the possibilities of tax and monetary adjustments in determining patterns and levels of public expenditures.

A change in tax rates can have a powerful impact; but it usually need not be applied in heavy doses. A large downward adjustment in tax rates was needed in 1964, because fiscal policy had been permitted to tighten unduly over a period of many years. But if active fiscal policy is pursued continuously, only small adjustments in tax rates at any given time should be needed in most peacetime situations. Willingness to consider making such small adjustments frequently would contribute substantially to the effectiveness of stabilization policy and to efficient planning of Government programs. Indeed, this willingness seems already established: in each of the past 6 years, Presidents Kennedy and Johnson have called for significant changes in tax laws. Annual tax changes have, in fact, become the rule rather than the exception.

The very fact that tax rates are less stable than in the past helps to make for a more stable economy. Far from being a source of increased uncertainty—as is sometimes alleged—the flexible and coordinated use of stabilization policies should enable both business firms and individuals to make their economic decisions in a climate of greater confidence. A knowledge that policies are alert to changing developments should help to reduce the important uncertainties about possible fluctuations in sales, profits, and employment opportunities.

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Appendix

The Federal Budget, National Income Accounts Basis

Throughout this Annual Report, Federal receipts and expenditures and budget surpluses or deficits are referred to in terms of the national income accounts (NIA) budget. This is a set of accounts devised by the Department of Commerce, as part of the national income statistics, to register the way that Federal fiscal transactions affect the income stream.

The principles followed in the NIA budget are relatively simple. In the first place, this budget is comprehensive and records all Federal transactions that directly alter private spendable income including that of State and local governments. It incorporates the fiscal transactions of all Federal agencies, regardless of the legal arrangements applying to these agencies. Thus, the accounts include operations of trust funds and other Government-owned agencies as well as regular Government departments.

Second, Federal transactions are counted at the time that they add to or subtract from private spendable income, which often is different from the time when funds are actually withdrawn from or deposited into Treasury accounts.

Third, all transactions involving loans or exchanges in assets are excluded. The Government engages in numerous lending and swapping transactions involving billions of dollars a year. These are extremely important to the operation of the economy, but they are not to be regarded as fiscal transactions because they do not affect disposable incomes directly.

In following these principles, the NIA budget differs in several important respects from the more familiar administrative budget. The administrative budget is the traditional vehicle for the management and control of most of the Federal programs which operate through regular Congressional appropriations. But it does not, and was not designed to, reflect even approximately the economic impact of fiscal policy.

For the calendar year 1966, the NIA budget was essentially balanced with a tiny surplus of $0.2 billion. But, in the administrative budget, expenditures outran receipts by $7.3 billion. The main elements accounting for this very large difference are shown in Table 5. Particularly important were Federal net loans and the net surplus of trust funds.

Trust funds. The administrative budget generally excludes both the revenues and expenditures of Federal trust funds. These funds include the

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TABLE 5.—*Relation of two measures of Federal budget surplus or deficit, calendar year 1966*

Description	Billions of dollars
Surplus or deficit (−), national income accounts budget	0.2
Plus: Seigniorage	.9
Excess of taxes received over taxes accrued	1.4
Miscellaneous adjustments (net)	1.0
Less: Excess of cash payments over goods received	1.0
Net loans and financial transactions	6.6
Surplus, Federal trust funds	3.2
Equals: Surplus or deficit (−), administrative budget	−7.3

Sources: Bureau of the Budget and Department of Commerce.

various Social Security, hospital insurance, and Medicare funds, unemployment insurance, railroad and civil service retirement funds, the highway trust fund, veterans life insurance, and many others. Most transactions of trust funds directly affect the private income stream. Both expenditures and receipts are very large, approximately $40 billion. Moreover, the funds can be in substantial surplus or deficit in any year. In calendar 1966, they showed a net surplus of $3.2 billion. That surplus is properly reflected in the NIA budget, although ignored in the administrative budget. A third measure of Government financial transactions—the consolidated cash budget—corresponds in this respect with the NIA budget.

Timing. In business accounting, which provides the framework for decision-making by firms, purchases and sales of goods and services are typically recorded when liabilities are incurred rather than when cash changes hands. The NIA budget generally follows the same procedure. On the revenue side, withholding of personal income taxes is counted as a collection when the taxes are actually taken from the paychecks of employees rather than when employers pay the Government; excise and sales taxes are counted when the sales of taxable goods are actually made; and corporate income taxes are counted when they accrue. Similarly, on the expenditure side, Government purchases of goods from businesses are recorded at the time of delivery rather than at time of payment. In this respect, both the administrative budget and the consolidated cash budget differ from standard business accounting treatment by adopting a cash basis for the timing of transactions.

In 1966, cash collections of taxes exceeded accruals by about $1.4 billion, while cash disbursements for goods and services exceeded deliveries by $1.0 billion.

Seigniorage. The NIA budget and the administrative budget also differ in their treatment of Treasury profits on coinage operations (seigniorage), which amounted to $0.9 billion last year. When the face value of new coins minted exceeds the cost of metal used to produce them, the profit is counted as a receipt in the administrative budget. But it is not a Government receipt in the NIA budget, because the increase in Treasury cash bal-

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ances which results is a purely internal Government bookkeeping entry which does not reduce or drain off private purchasing power.

Lending. A further and vital difference between the NIA budget, on the one hand, and the consolidated cash and administrative budgets, on the other, involves the treatment of lending, loan repayment, and sales of financial assets. Such financial transactions are excluded from the NIA budget because they do not change the net worth or incomes of private parties, but only their liquidity. The reasoning follows the same line applied above to tax accruals and profits on coinage. Just as businesses do not regard themselves as becoming poorer at the time they actually pay taxes they already owe, neither do they consider repaying a Government loan as a current expense. Nor conversely, do their incomes rise when they obtain loans from the Federal Government. Yet, in the administrative budget a new Federal loan increases the deficit as much as an outlay that directly raises private income, and sale or repayment of the loan diminishes it just as much as a tax payment.

To be sure, many Federal loan transactions have important effects on private spending. But they work in a less direct way than the income-generating transactions. They channel funds at low costs to various activities deemed to be of particular social or economic importance, such as exports, college, housing, and farm production. Given the level of tax revenues, when the Government lends more, it must also borrow more. The net impact of a Federal loan financed by Government borrowing is that Government liabilities—Treasury and agency issues—are substituted for private debts.

Such substitution is likely to improve the terms and lower the interest rates available to some borrowers. But other borrowers may be displaced, depending on credit conditions and monetary policy. Federal lending is best regarded as an aspect of monetary, credit, and debt management policy—not of fiscal policy. When it lends borrowed funds, the Government is acting as a financial institution, much like private financial institutions. Borrowers from private financial institutions also increase their liquidity. They acquire cash by incurring debts. They are, indeed, better off for the opportunities to borrow, and they may spend more as a result; but they do not regard the borrowing as an addition to their incomes.

In the past year, the Federal Government was a net lender, partly because of the scarcity of funds in private financial markets. The difference between the two budgets on this account amounted to $6.6 billion.

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