

capacity was up to 90 percent after a substantial rise from the recession low of 78 percent in early 1961. The record of price stability was equally impressive: average consumer prices in July 1965 were only 6 percent higher than they had been in early 1961, and prices of non-food commodities had risen only 3 percent. Manufactured finished products at wholesale were selling, on average, less than 1 percent above the level at the start of the expansion.

The progress of the economy from early 1961 to mid-1965 owed much to the active use of expansionary fiscal policy. Through reform of depreciation rules in 1962, the initiation of the investment tax credit also in 1962, and the tax reductions following from the Revenue Act of 1964, earners of both corporate and individual incomes enjoyed a one-fifth reduction in their tax liabilities.

Meanwhile, Federal spending on goods and services stayed on a plateau. After mid 1962, there was little change—actually a modest decline—in the dollar total of defense expenditures. Therefore, as a share of our growing GNP, these outlays fell steadily from 9.5 to 7.3 percent. Defense spending was clearly not the fuel propelling the economy toward full employment. Rather the decline in the defense share was a lubricant that greased the wheels. It made possible reductions in taxes at the same time that important new civilian objectives of the Federal Government were being pursued through the President's Great Society programs.

The private investment share of GNP rose to make up for the decline in defense; meanwhile, State and local outlays continued to absorb a growing fraction of our real output; and, contrary to their usual behavior in a period of rapid economic expansion, consumer purchases held their own as a share of GNP.

Given the healthy economic environment in the spring of 1965, policy was aiming to provide further stimulus to complete the advance to full employment. Congress enacted a major reduction of excise taxes, and the first stage took effect in June 1965. A liberalization of social insurance benefits was enacted to take effect retroactively and was scheduled to give the economy a significant stimulus in the fall of 1965. Monetary policy continued to pursue a quiet life, meeting the credit needs of a brisk expansion and contributing to the stability of long-term interest rates that was so unusual for a period of rapid economic advance.

THE PERIOD OF SPEEDUP

The pace of economic advance quickened markedly in late 1965 and early 1966 with defense and business fixed investment leading the way and consumption close behind. GNP, which had been advancing at an average rate of \$11 billion per quarter, rose an average of \$16 billion per quarter between the second quarter of 1965 and the first quarter of 1966. The annual rate of real growth was a phenomenal 7.2 percent. Unemployment started dropping rapidly and, in February, reached what is still the low point of this expansion—3.7 percent of the labor force. But along with the important progress came some disturbing problems—accelerating prices, soaring interest rates, and a shrinking surplus in international trade.

On top of the deliberate fiscal stimuli that were coming into play and the forward momentum of a strong economy close to full employment, the \$2 billion a quarter rise in defense outlays undoubtedly