

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 marketed 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 laborforce, 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 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,

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