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 overall 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.

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.