

As a result of the extra defense expenditures and orders, and of the sharp psychological reaction of private spenders to the prospect of a continuing defense buildup, we experienced a period of hectic economic advance in late 1965 and early 1966. The economy was exceeding reasonable speed limits and the brakes had to be applied.

They were applied—both through monetary policy and through the tax measures recommended by the President in January 1966 and promptly enacted by the Congress in March. The overall pace of economic advance was brought down to a reasonable rate by the spring and summer of last year.

But business investment demand forged ahead, seemingly immune to the restraining policy actions. The capital boom called forth ever-larger doses of restrictive monetary policy, placed intolerable burdens on financial markets, generated strong upward pressures on wages and prices in capital goods industries, and contributed to a huge upsurge in imports.

The President's fiscal program of last September 8 turned the tide of interest rates and financial pressures. The capital boom was finally brought to a halt by a combination of forces—the suspension of tax incentives which Congress enacted last October, the direct and indirect impact of tight money, the more moderate pace of overall economic activity, and the related relaxation of inflationary psychology.

The brakes worked. Inflationary pressures were brought under control. But the natural consequence of the restraining policy measures was a period of economic advance at a slower-than-ideal speed.

In the fourth quarter of last year, demand leveled off but production continued to increase. In particular, many manufacturing firms stepped up their output, looking for a further growth of their markets which did not materialize.

As a result, there was a massive accumulation of inventories of unsold goods in the closing months of 1966, which led to cutbacks in industrial output early this year.

The inventory adjustment dominated our economic performance in the first half of 1967. This is illustrated in chart 1, which shows recent quarterly movement of total gross national product, and of "final sales"—that is to say, gross national product excluding inventory investment.