

The rise of military production came in an economy whose total output was rising rapidly, so that while the value of defense production rose by about 40 per cent, it rose by only about 26 per cent as a proportion of total output.

The defense build-up was superimposed on an economy in which there was some slack, but not very much, and the slack was already being reduced by the expansion then under way. The defense build-up immediately accentuated inflationary tendencies which were already in evidence. The increased production and incomes resulting from the defense expansion caused further expansion of private investment in plant and equipment and in consumption expenditures. Even though real output continued to rise at a substantial rate—5.9 per cent from the second quarter of 1965 to the second quarter of 1966—it could not keep up with the acceleration of spending, and the rate of price increase jumped.

The absorption of resources for defense was not so large as to slow down significantly the rate of growth of the supply of non-defense goods and services. However, the real output available for non-defense use could not grow as rapidly as non-defense demands were growing, especially as these demands were being stimulated by the defense program itself. Some of the demands could not be met in full, and this raised a problem of priorities—of which demands should be met and which should not. This problem was not met explicitly and positively, at least at first. It was met negatively. The failure to take steps to restrain consumption and government non-defense expenditures made it almost inevitable that real investment and net exports (the excess of U.S. exports of goods and services over U.S. imports) would be squeezed down. The impact on net exports came first, partly because the booming, inflating U.S. economy sucked in more imports and partly because the Vietnam operations themselves increased overseas expenditures.

In the second half of 1965 total private fixed investment—in business plant and equipment and in residential structures—continued the rise that had been under way before the Vietnam build-up began. However, after the first quarter of 1966, investment ran into a growing insufficiency of savings, which was later accentuated by the absorption of part of the savings to finance a growing government deficit. The pressure of investment demand against the supply of savings available for private investment caused interest rates to rise. Higher interest rates restrained total investment, but some kinds of investment were held back more than others. Between the first quarter of '66 and the first quarter of '67, total fixed investment (excluding inventory) declined from \$94.5 billion to \$90.2 billion (1958 prices, annual rates) and from 14.9 per cent to 13.8 per cent of the real final product. But until the first quarter of 1967 this decline was entirely concentrated in residential construction which fell from \$22.3 billion to \$16.8 billion. Other fixed investment, mainly business plant and equipment expenditures, rose both absolutely and relative to available output throughout 1966. While wage and other cost increases were a factor, the larger part of this decline in construction resulted from the greater sensitivity of residential construction to interest rate increases and from the institutional structure of the financial system, which tended to divert funds from housing as savings become scarcer. In the fall of last year the government made an attempt to shift part of the impact of the shortage of savings on to plant and equipment expenditures by suspending the tax credit for business investment. Partly because of this, but partly also because profits had levelled out and for other reasons, business investment declined in the first quarter of 1967. Indeed, the prospective rate of growth of private investment was so reduced that the government restored the investment credit in the spring of 1967.

In sum, it may be said that while the Vietnam effort was not so large as to cause any severe hardship in real terms in the domestic economy, the consequences of the policy actions and inactions of the build-up period up to early 1967 were a degree of inflation and a concentration of the real impacts on fixed investment and on net exports. Obviously, these impacts were not desirable.

On any reasonable assessment of the growth of public and private demands for output in the remainder of 1967 and 1968, the supply of saving available to finance private investment after financing a Federal deficit of about \$15 billion will leave little room for increases in private investment from current levels. The competition of a large Federal deficit with rising demands for saving to finance private investment will tend to make interest rates high and this will have the effect of holding down private investment.

In the first half of 1967, however, monetary and credit developments have been very expansive. Federal Reserve credit has expanded at a 15 per cent rate per annum since December 1966 in contrast with a 10 per cent annual rate from 1964