C. Sources of Inflationary Pressures in 1966

The sources of inflation will strengthen this year on both the demand and cost sides.

The Council predicts that gross national product will grow 5 percent in real dollars at a time when output is already pushing against capacity and when a number of industries already are at or above the preferred operating rates. Pressures on the labor supply are already strong, and the labor market will tighten even more thoughout the year. Demand for bank credit also continues at exceedingly high levels.

Some private economists are predicting an even greater increase in GNP this year than the Council, which last year badly underestimated the pace of the advance. Forecasters already are raising their sights for the year. If Vietnam spending increases more than anticipated—which is probable in light of the administration's past underestimates—then the economy will be under more severe strain than now anticipated.

Capital spending by business is continuing at a high level, and the volume of fixed investment expenditures in 1966 is expected to run well ahead of earlier projections. Dr. Walter W. Heller recently noted that in 1965 investment for the first time equaled high employment private saving. He said that in 1966 investment "threatens to exceed high employment saving and exert inationary pressures."

Inventory accumulation is gathering speed as a hedge against price increases and as a response to rising sales. In the final quarter of 1965, inventories increased at a seasonally adjusted annual rate of over $10 billion, $2.4 billion more than in the third quarter and the highest increase since the Korean war. For all of 1965, inventories rose by $8.2 billion, almost double the increase for 1964 and the largest annual increase since 1951.

In spite of the increase in the discount rate in December, the rate of increase in money and credit continues at a high level. Bank loans to business rose 20 percent in 1965 after increasing by an average of 7 percent in the preceding 4 years. Consumer credit rose 12 percent, compared with an average of 8 percent in the preceding 4 years. Total private debt rose nearly 10 percent, or slightly faster than the average increase since 1960. Concern about the quality of private credit is voiced in many quarters.

The money supply rose nearly 5 percent in 1965, while money supply and time deposits together rose almost 10 percent. The rate of expansion of credit and money actually increased within the year itself. The increase in the money supply was nearly three times greater in the last 6 months of 1965 than in the first 6 months.

PRESSURES IN DEFENSE INDUSTRIES

Pressures will be especially great in the defense and defense-related industries, which are receiving a flood of new Government orders. As Charles L. Schultze, now Director of the Bureau of the Budget, pointed out in a 1959 Joint Economic Committee study, inflation can originate in excess demands in particular sectors and spread to the rest of the economy through the cost mechanism. The recent sharp increases in demands in the defense industries ultimately could give added impetus to the inflation originating in excess overall levels of demand.

It is true, as the administration claims, that supply problems will be eased as the result of new capacity now being built. However, this overlooks the possibility that the growth of demand will soar even more than the growth in new capacity and particularly in those components of demand where supply is already hard pressed. This argument also fails to recognize that a considerable "shakedown" period is required for new capacity to become efficiently operative.

The greatest demand pressures will be felt on the labor force. The economy is now below the administration's 4-percent interim unemployment goal, although it should be noted that this administration over the past 5 years has added 300,000 to the Armed Forces, 200,000 to Government employment and hundreds of thousands to the munitions industry. The current aggregate unemployment rate conceals tightness within key sectors of the labor market. In February, the unemployment rate was down to 2.6 percent for adult men and 1.9 percent for married men. For the entire full-time labor force, the unemployment rate was 3.3 percent. Unemployment in manufacturing was at 3.5 percent in the final quarter of 1965.

Other signs of a tightening labor market include the fact that in late 1965 the hiring rate was at the highest point in 12 years, while layoffs were at the