Budget (NIA) would continue to be an expansionary factor, but the increase in deficits would decline.

The NIA budget is a better instrument for considering the interrelationship between budgetary and economic developments. Transactions in financial assets, e.g. purchase or sale of mortgages, are not directly shown. Furthermore, none of the budget concepts reflects the government insurance and guarantee of private loans. Financial transactions and insurance and guarantee programs each differ from direct spending in their economic effect. Their effect is reflected in residential construction or other items appearing in the private sector of the accounting system. The Government's role in bringing about these effects is, however, not indicated in the national income and product accounts. A substantial increase in direct loans is estimated for fiscal 1967, an even larger one for fiscal 1968, especially for programs in the field of housing and urban development. Thus the role of these indirectly stimulating activities of the Federal Government seems to be on the rise (see Appendix Table 2).

It is not possible to add together direct Government spending, direct financial capital transactions, and guarantees and insurance programs of the Government. The economic effect of each of these measures requires different methods of estimation.

Without going into technical details I conclude that the Federal Government's operations as envisaged in the Budget and Economic Report are likely to add to purchasing power and over-all demand especially during the second half of this calendar year and the beginning of next year, if the proposed surcharge on income taxes is not adopted. Even if adopted, I believe there would still be some net expansionary effect emanating from the Federal Government's operations.

II. Recessionary Tendencies in the Private Sector

For judging the appropriate fiscal and economic policies for next year much depends on the interpretation that is given to the recessionary tendencies which are observable in the private sector of the economy. Since they have already been discussed at great length at these hearings I do not need to repeat the factors of strength and weakness which are now observable. The level of economic activity is very high, but the outlook for unemployment is still too large, although low in contrast with most of the recent period. Nevertheless, the existence of recessionary tendencies is generally recognized.

We have experienced an extraordinary period of recovery from 1960 to 1965 with an increase in total production of goods and services by 26% (constant 1958 prices). Actually, the increase in final demand in the private sector was somewhat larger than that in the public sector (see Appendix Table 3). In 1966 the steady recovery growth changed into a boom under the simultaneous impact of a rapid rise in Federal expenditures, particularly for the war in Vietnam, and in fixed business investments. The Government used only very mild fiscal restraint to dampen the boom; the monetary authorities felt that the main responsibility for preventing inflation and a deterioration of the balance of payments rested on their shoulders. They stepped hard on the monetary brake. The effect at the end of 1966 was that growth in final demand in the private sector came to a virtual halt, while demand in the public sector continued to increase (see Appendix Table 3).

There are two different interpretations of these recessionary tendencies.

The first attributes the recessionary tendencies mainly, if not exclusively, to the effect of the restrictive monetary and credit policy. Lack of expansion in private demand with a simultaneous rise in military procurement in process of production resulted in a spectacular increase in business inventories. We are in a period in which the large inventories have a dampening effect on production. This explains the temporary slowdown in economic activity. However, the relaxation in credit restraint which is now under way and the expansionary impact of Government activities will make themselves felt before long. Therefore, an increase in activity and possibly the pressure of demand inflation are likely to be resumed, perhaps by the middle of calendar 1967. This appears to be the projected shape of economic development used for rationalizing the July 1, 1967 effective date of the proposed surcharge on the income tax in the face of present recessionary tendencies.