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The Crunch of 1966— Model for New Financial Crises?

*The events of 1966 show that a
major financial crisis can happen again*

HYMAN P. MINSKY

For the millions of Americans old enough to remember it, the Bank Holiday of 1933 was grimly misnamed. Those ten days, with the doors of the nation's banks locked and its businesses standing still, marked the climax of the prolonged debt-deflation that began with the stock-market crash of 1929. This period of financial instability was the initial phase of the Great Depression, which lingered on until the defense and war efforts of the 1940s. In response, the Roosevelt Administration undertook thorough reforms of the American banking and financial system—reforms designed to guarantee that a financial crisis of these dimensions could never occur again.

In the period following the Great Depression, the strength of the reformed financial system was not really tested. But then, in late summer of 1966, the stability of the U.S. financial system was once again in jeopardy. Fortunately, in 1966 the financial pressures were kept within manageable bounds—the crisis turned out to be only a mini-crisis, as befits an era of mini-skirts. Thus it seemed that the defenses erected in the 1930s had passed their first serious test.

Nevertheless, the events of 1966 are a warning: They show that a financial crisis, carrying the seeds of a deep depression, can happen again. Thus, we need to examine the forces that created and resolved the mini-crisis of 1966, and to explore some of its repercussions.

The financial community's label for the crisis that reached its climax in the late summer of 1966 was the "Crunch," a colorful way of describing intense pressure upon banks and other financial institutions—pressure for cash or, to put it another way, for liquidity. However, more was involved than just pressure for cash. On Wall Street, in late August of that year, the atmosphere was one of controlled panic. That the panic was controlled represented an act of faith—everyone felt sure that *this* time, in contrast with the 1930s, the Federal Reserve would step in and prevent a cash stringency from escalating into a fully developed panic that would shake the entire economy. But although Wall Street was confident that the Federal Reserve would act, it was still uncertain throughout August as to how—and how soon—this intervention would come. Nobody was sure what losses he or his organization would have to face before the pressure was relaxed.

As it turned out, the price wrung from the financial community was sufficiently high, both in money and in fear and uncertainty, to cause a major restructuring of desired portfolios. Throughout 1967, commercial banks, life-insurance companies, savings banks (meaning here both savings and loan associations and mutual-savings banks), and nonfinancial corporations all preferred distinctly more conservative asset and liability positions than they held during the euphoric boom period just before the Crunch. Cash flows have been used to acquire liquid assets, and the desire for liquidity has led some businesses to raise funds in the capital market in order to improve balance sheets rather than for investment in plant and equipment. As a result, the mini-crisis of 1966 led to a mini-recession in 1967; the economy slowed down, despite strong expansionary pressures generated by steeply rising Federal defense-spending for the war in Vietnam. In fact, had it not been for this increased defense-spending, the employment repercussions of the 1966 crisis might have been grave indeed.

The fundamental economic law behind the Crunch is this: The only way to break an inflationary investment boom set off by an evaporation of uncertainty is to reintroduce uncertainty. This is what the Crunch did. In short, the Crunch was both an instrument of policy and a result of that policy.

What Triggered the Crunch?

To see how the Crunch developed, it is necessary to recall the political and economic climate of 1966. Today, in the gloom of late winter 1968, with the country heavily burdened by an unpopular war, civil disorders, and sagging confidence in the quality of national leadership, it is hard to remember the optimism and pride that ruled America's thinking as recently as two years ago. The contribution of eco-

nomics to this modern era of good feeling was the belated achievement of a consensus that the Keynesian New Economics really worked. It was felt that if the policy prescriptions of the New Economics were applied, business cycles as they had been known would be a thing of the past. The accepted view was that businessmen and householders need no longer fear a "haircurling depression." From then on, the perfected tools of economic policy would "fine-tune" the economy so that, period by period, it would stay on a course of sustained growth. Seven good years would be succeeded not by seven lean years, but always by seven more good ones. The resulting rapid and sustained growth would make all good and desirable goals compatible: Americans would be able to have tax reductions *and* the Great Society.

Because of this confidence, there was a swing away from portfolios designed to protect against unfavorable economic conditions. As soon as the belief became dominant that business cycles had been eliminated and that steady growth was assured, the country embarked upon an unprecedented investment boom. This boom was partly financed by portfolio changes designed to decrease liquidity, since having ready cash—or having securities readily convertible into cash—was under these circumstances of lesser importance.

Investment Boom in the Sixties

An unprecedented investment boom made the mid-1960s soar. In 1966, the dollar value of physical assets purchased by nonfarm, nonfinancial corporate business was \$73.8 billion, almost twice the \$37.0 billion of 1961. When the investment boom accelerated in 1965 and 1966, business began to rely heavily on external financing. In the years 1961 through 1964, roughly 3 to 6 percent of corporate investment was financed with net external funds; in 1965, about 11 percent of investment was financed from outside sources; and in 1966, the figure had climbed to more than 20 percent. (See Table I.)

This vast demand for external financing generated stresses and strains throughout the financial system.

To obtain the funds they wanted, corporations borrowed a great deal from banks and issued a huge number of bonds—both public offerings and direct placements (offered to large-scale lenders, such as insurance companies and educational institutions). Because the demand for financing was so intense, interest rates climbed steadily during 1965 and 1966 despite developments that should have helped stabilize them—namely rapidly increasing supplies of money and bank credit.

The rapid rate of increase of money and bank credit during this period was due to two factors, which we can label as the traditional and the innovational elements in the developing picture. The traditional element was a rapid increase in the reserves of member commercial banks at the Federal Reserve Banks. The innovational element was that the efficiency of reserves was being increased due to the very rapid growth of negotiable certificates of deposit ("CDs").

The reserves of member banks consist mainly of deposits by member commercial banks at their district Federal Reserve Bank. To a large extent, changes in the amount of such deposits are determined by the Federal Reserve System. The favorite instrument of the Federal Reserve for affecting the volume of such deposits is "open-market operations." If the Federal Reserve wants to increase member-bank reserves, it will purchase U.S. government debt in the very active market in which banks, other financial institutions, and ordinary business corporations participate; if the aim is to decrease reserves, then the Federal Reserve sells U.S. government debt. As the U.S. banking system is a fractional reserve banking system, commercial banks need keep only a fraction of such reserves against their demand-deposit liabilities. Their other assets held against deposits are earning assets, which are bank loans and investments, that is, bank credit.

Foreshadowing some of the story to follow, we can note that open-market operations are not the only Federal Reserve operation by which the reserves of member banks can vary. Another way is by member-bank borrowing from the Federal Reserve at the "dis-

TABLE I—Investment and Internal Sources of Funds—Nonfarm, Nonfinancial Corporate Business 1961-1966

Year	Purchase of Physical Assets		Internal Sources of Funds Billions of \$	Net External Funds Billions of \$	Net External Funds as a Percentage of Purchases of Physical Assets
	Billions of \$	Growth Rate %*			
1961	37.0	- 5.6%	35.6	1.4	3.8%
1962	44.7	20.8	41.8	2.9	6.5
1963	46.7	4.5	43.9	2.8	6.0
1964	52.2	11.8	50.8	1.4	2.7
1965	61.9	18.6	55.3	6.6	10.7
1966	73.8	19.2	58.6	15.2	20.6

Source: Table B-69 p. 294: 1967 Economic Report of the President.

* Value year t ÷ value year t-1 x 100 - 100

count window." The discount window was an important source of total bank reserves in earlier days; however, during the period under discussion the discount window was not much used. As will be pointed out, this abstention from the discount window, even though interest rates were such that borrowing from the window seemed profitable, was one of the special characteristics of this period.

Negotiable certificates of deposit, which have been called the "new instrument" of the 1960s, are evidence of large (minimum \$100,000) time (interest-earning) deposits at commercial banks that cannot be withdrawn until a stated due date—typically 90 days, 180 days, or one year after deposit. However, as leading Wall Street investment banking houses make a secondary market (buy and sell) in these certificates of deposit, any owner of such a deposit can obtain cash by selling in this market prior to the due date of his certificate. Almost always anyone with idle funds can purchase a CD from the market with a desired number of days, less than the minimum of 90 days for which banks issue such certificates, to maturity. As certificates of deposit are time deposits, by Federal Reserve regulations the emitting bank need keep a smaller fraction of reserves against these deposits than against demand deposits. Thus if banks can get depositors to shift funds from demand deposits to certificates of deposit, the amount that can be lent or invested increases. During the period of rapid bank-loan expansion in the mid-1960s, money-market banks were able to sell such CDs in increasing volume, which enabled them to increase loans at a faster rate than reserves were increasing.

These CDs compete with Treasury bills and open-market commercial paper for the temporarily idle funds of large-scale enterprises such as corporations, other financial institutions, and state and local governments. However, whereas there is no ceiling on the interest rates that these competing instruments can buy, there is a ceiling, set by the Federal Reserve System, on the rate that banks can pay on their newly-issued CDs. Whenever other money-market rates rise above this ceiling, banks cannot "sell" new deposits, and as a result of runoffs of maturing deposits they face a de-



"I say, don't you think we've cooled the boom off enough?"
(Drawing by Alan Dunn; © 1966 The New Yorker Magazine, Inc.)

crease in their ability to lend. In December 1965, when this was threatened, the Federal Reserve responded by simultaneously raising the ceiling rate on CDs to 5.5 percent and the discount rate (the rate at which the Federal Reserve lends to member banks) to 4.5 percent.

December 1965, when the Federal Reserve raised allowable interest rates on CDs to protect the commercial banks that had them outstanding, is a good place to start on detailed examination of the events leading up to the Crunch. An investment boom was in full swing, and the rise in interest rates following the Federal Reserve action did not "cool" the boom. Between December 1965 and April 1966, the reserve base of member banks and the money stock grew at the rapid annual rate of 6.8 percent. Since time deposits (heavily CDs) grew even more rapidly, bank credit grew at an 8.0 percent annual rate. But in spite of this, the interest rates for financing private business continued to climb. For example, the yield of prime (highest quality) commercial paper rose by 63 basis points (63/100 of a percentage point), and the yield of Aaa (highest quality) corporate bonds rose by 25 basis points.

TABLE II—Money and Bank Credit—Annual Rates of Change for Various Periods December '65-November '67

	Dec. '65 to April '66	April '66 to July '66	July '66 to Dec. '66	Dec. '66 to Nov. '67
	Percentage rate of change per year			
Reserves of Member Banks	6.8	2.6	-4.3	11.4
Money Stock	6.8	-3.0	1.0	7.0
Time Deposits	9.5	10.7	4.2	16.6
Bank Credit	8.0	8.0	1.5	12.4

Source: Federal Reserve Bank of St. Louis, *Monetary Trends*.

TABLE III—Interest Rates—First Week in Selected Months Plus Peak and Trough Rates January 1966–November 1967

	Jan. '66	Apr. '66	July '66	Sept. '66	Peak '66	Jan. '67	Trough '67	Nov. '67
3-Month Treasury Bills	4.53	4.51	4.47	5.07	5.52	4.80	3.41	4.57
Federal Funds	4.63	4.65	5.42	5.35	Sept. 23 6.00	5.31	June 9 3.45	4.05
Large CDs	4.80	5.30	5.60	5.75	Sept. 9 5.90	5.70	July 21 4.25	5.30
Prime Commercial Paper	4.75	5.38	5.58	5.88	Oct. 14 & 21 6.00	6.00	April 7 4.63	5.13
Long-Term Government Bonds	4.44	4.54	4.69	4.87	Oct. 7, '66— Jan. 6, '67 4.87	4.46	May 19— June 23 4.37	5.35
Corporate Bonds Aaa	4.73	4.98	5.10	5.44	Aug. 26, Sept. 2 5.44	5.38	Feb. 3 5.00	5.95
					Sept. 9		Feb. 10	

Source: Federal Reserve Bank of St. Louis, *U.S. Financial Data*.

In April, by decreasing the rate at which it purchased government securities in the open market, the Federal Reserve slowed down the rate of growth of the reserve base, and with it the money supply. Between April and July, the reserves of member banks grew at only a 2.6 percent annual rate, and the money stock actually declined at a rate of 1.4 percent. However, time deposits at commercial banks grew at a rate of 10.7 percent annually—so that bank credit grew at an accelerated rate of 8.6 percent. Interest rates also continued to rise.

It was at this point that CDs—the *Wunderkind* new instrument of the 1960s—began to cause difficulties. Toward the end of June 1966, the price of large CDs carrying the ceiling rate of interest went to a discount in the secondary market (the return on "used" CDs became greater than the largest return allowed on new CDs). This effectively stopped the increase in the volume of such CDs outstanding, and beginning in August the amount outstanding began to fall rapidly. This change in the trend of CDs outstanding combined with a decline in member-bank reserves—between July and December of 1966, member-bank reserves fell at an annual rate of 4.3 percent—slowed down the rate of increase in bank credit.

In December 1965, at the same time it had put a ceiling of 5.5 percent on CDs, the Federal Reserve placed a maximum of 4 percent on the interest commercial banks could pay on passbook savings deposits—the typical savings account kept by householders. Since this rate was considerably lower than the rates offered by savings and loan associations and mutual-savings banks, commercial-bank savings deposits were not a threat to the savings banks.

Late in the second quarter of 1966, the savings institutions felt the squeeze when some Eastern banks, struggling to attract new deposits, started promoting *small*, household-sized CDs at the ceiling interest rate of 5.5 percent. These household CDs posed a serious threat to the savings and loan associations—particularly in California, where a large portion of the deposits were from out of state—and the mutual-savings

banks, mainly concentrated in New York and New England. In July 1966, the previously rapidly growing savings and loan associations experienced an unprecedented \$1.5 billion decrease in deposits.

The Savings-Bank Squeeze

Throughout the rest of the year, a major concern of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board—three arms of the peculiarly decentralized central bank of the United States—was to protect the savings institutions. Savings institutions have mortgages as their principal asset, and the standard American mortgage is a long-term, fully amortized, fixed-interest contract. Hence, most savings institutions were locked into assets that reflected past interest rates. For example, the New York savings banks were under pressure to pay interest rates competitive with the 5.5 percent that New York commercial banks were willing to pay on their household CDs, but the savings banks' portfolios consisted mainly of mortgages that yielded substantially less than 5 percent.

Not only were these banks technically insolvent—the market value of their mortgage portfolios was substantially lower than the face value, so that their deposit liabilities exceeded the market value of their assets—but they were making running losses, since the returns on their portfolios were well below the cost of borrowing money plus operating costs.

Another trouble spot in the savings-bank picture was California. Interest rates on California mortgages had long been high enough so that, on the surface, the California savings institutions seemed able to meet commercial-bank-rate competition for deposits. During 1966, however, when the rise in competing interest rates slowed the flow of money to the California savings institutions, elements of weakness in their mortgage portfolios became apparent. Over the July 4 weekend, the Federal Home Loan Bank Board—the regulating and deposit-insurance agency for savings and loan associations—stepped in and arranged for the quiet take-over of a threatened institution by one that

was considered sound. Such discreetly managed takeovers, rather than public closings and liquidations, constituted the pattern preferred by the deposit-insurance agencies throughout the rest of the year. The power of deposit insurance to prevent explosive instability was tested for the first time in 1966, and it passed with honors. Events that would have triggered "runs" in the past occurred without causing any major deposit withdrawals.

In turn, these pressures upon the savings banks swiftly affected the market for housing. Not only did savings banks raise the interest rate, increase the down payment, and shorten the duration of new mortgages, but they also decreased their commitments to acquire future mortgages. Generally, the savings banks make financing commitments to speculative builders in the fall of the year for the following spring. The savings banks' shaky position in the late summer and fall of '66, however, assured decreased commitments and poor "new starts" for housing in the spring of '67.

In addition, the cash squeeze hit the insurance companies, adding to the trouble in the housing industry and putting additional pressure on commercial banks. Many life-insurance policies guarantee the policyholder borrowing rights at 5 percent. As interest rates rose, life-insurance companies experienced a sharp rise in the exercise of these rights. Further, the loan demand was reinforced by the need for ready cash to meet stock-market margin calls following the sharp decline in August. The result of this pressure on the life-insurance companies was that they, too, radically decreased their mortgage take-out commitments for the following spring—a move that further weakened the home-building industry. In addition, as prior commitments to acquire mortgages and corporate bonds became current, many life-insurance companies resorted to borrowing from commercial banks.

Thin Market for Municipals

Another element in the developing crisis centered on the market for municipal securities ("municipals" is the market term for state and local bonds). Banks are required to pledge collateral against the deposits of state and local government units. The usual collateral is U.S. government debt. By mid-year 1966, commercial banks had very little in the way of government debt that had not been pledged as collateral for such deposits. The combination of a decrease in the reserve base due to Federal Reserve action, the rundown of CDs due to the interest-rate relations, the lack of unpledged U.S. government debt, and the strong business-loan demand led many banks to try to obtain cash reserves by selling some of their municipals. As a result, the price of municipals fell sharply.

The effect on new issues of municipals was disas-

trous. Commercial banks normally take about one-third of the new issues of municipals, but as the Crunch developed, they withdrew from the market. By the end of August, the market for municipals was "disorganized," to say the least. The yield on high-grade municipals reached 5 percent—and income from municipals is tax-exempt—but even at such rates the market was thin.

Let us now follow the movement of interest rates that were not under "ceilings." Between the first week in July and the first week in September of 1966, the three-month Treasury bill rate rose by 60 basis points; prime commercial paper rose by 30 basis points. This rise in money-market rates, which apply to relatively short-term notes, was paralleled by increases in the longer term capital-market rates: Government bonds rose by 18 basis points, and the highest-grade corporate bonds rose by 34 basis points. (See Table III.)

Meanwhile, despite these rising interest rates, investment continued to boom. It is a phenomenon of the American economy that, as long as interest rates remain within a range that is compatible with institutional stability in the American setting, business investment is not likely to be greatly inhibited—or stimulated—by fluctuations in interest rates.

Throughout this period the Federal Reserve, while maintaining the discount rate at 4.5 percent, allowed but a slight increase—some \$300 million during the first half of 1966 (out of the total member-bank reserves of \$23 billion)—in borrowings by member banks at the discount "window." In theory the discount window serves as a source of funds to member banks so that they do not need to pay much more than the discount rate for funds. It also serves as a safety valve against too great a build-up of pressure for liquidity. In practice, the discount window is administered by the various Reserve banks, and the rules guiding the administration of the window are mysterious if not devious.

During July and August the window was so tightly administered that even though banks were paying up to 1.5 percent more than the discount rate for reserves, member-bank borrowings at the Federal Reserve, on the average, did not increase. In particular the money-market banks believed that the discount window was effectively closed to them: As liquidity pressures were building up, the safety valve that the discount window in principle represents was not allowed to function.

By the end of August 1966, the disorganization in the municipals market, rumors about the solvency and liquidity of various savings institutions, and the frantic position-making efforts of money-market banks confronting a discount window that was apparently closed generated a controlled panic. It was clear that the next move was up to the Federal Reserve.

Because of the shortage of cash in 1966, savings banks raised interest rates and down payments on mortgages. This discouraged homebuyers, and many speculative builders stopped work.

The Resolution

There are a considerable number of instruments of control at the disposal of the Federal Reserve Board. Conversely, at any time there are many interdependent variables and constraints upon Federal Reserve actions. At this time perhaps the most urgent constraint came from the savings banks. In order to protect them from losing deposits and incurring even greater operating losses, the Federal Reserve ruled out the possibility of raising the ceiling rate on CDs or the discount rate, as had been done in December 1965. In other words, although the intent was to constrain business investment, the orthodox solution of across-the-board increases in interest rates could not be applied.

Thus, the Crunch developed with some rates fixed—at effective ceilings—and others free to vary. Had the Federal Reserve taken the course of expanding the reserve base, which, through the banking process, would have increased available credit, the investment boom could have been financed without significant increases in interest rates. But that course would have meant that the Federal Reserve would quite literally have become an engine of inflation.

It is not necessary to approve the timing or the details of the Federal Reserve's constraining action in order to recognize that the situation developing in 1966—which was due to a rapidly exploding demand for financing from the private sector, combined with expansionary economic forces unleashed by the war in Vietnam—was such that sooner or later the Federal Reserve would have had to undertake a policy of active constraint.

A money panic is ephemeral, compounded of a combination of real cash shortages and a precautionary demand designed to protect against awesome, unknown contingencies. As was true for some of the money panics of the 19th century, the 1966 crisis evaporated when the authorities sent out a letter.

On September 1, the president of each of the twelve district Reserve banks sent every member bank in his district an identical letter stating that loans were available at the discount window to banks whose policies corresponded to Federal Reserve objectives. In particular, funds were available to finance current holdings of municipal securities for banks that could show that they were constraining expansion of business loans. In addition, the letter stated that the Federal Reserve recognized "that banks adjusting their position through loan curtailment may need a longer period of discount accommodation than would be required for the disposition of securities." The import of the letter was

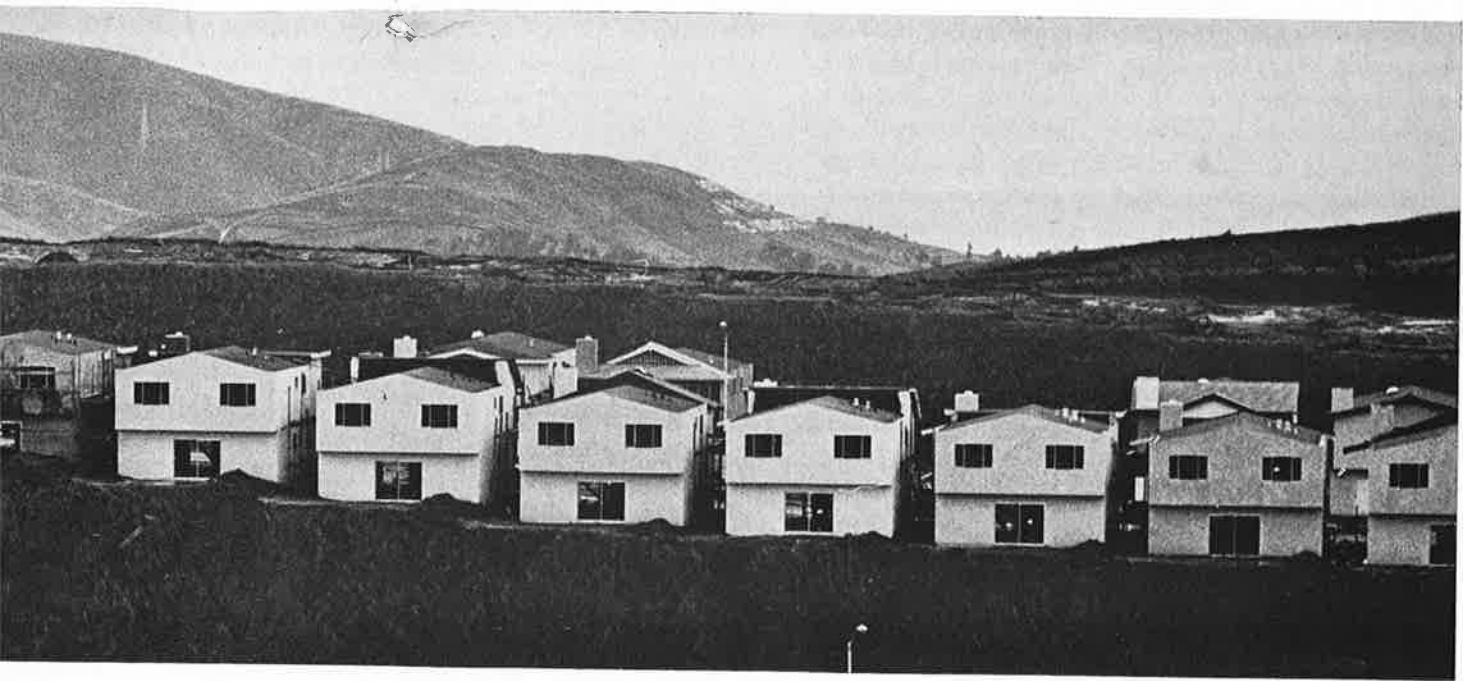


that the Federal Reserve acted to bolster municipal securities. By allowing municipals to be used at the discount window, it set a firm floor to their price and quite suddenly made what had been an illiquid asset liquid. As the money-market banks had been actively trying to restrain expansion of business loans even before ceiling-rate CDs went to a discount at the end of June, each bank considered itself eligible for such accommodations. The Federal Reserve's discount window, which had been assumed to be closed, now appeared provisionally open: The safety valve was allowed to work.

During the first week in September, a slight "peak" (about \$100 million) occurred in borrowings at the Federal Reserve. Thus, although statistically little had been changed by the September 1 letter, the psychological elements of the mini-panic had been dissipated. More important than the extent to which the window was actually used was the fact that once discounting was available, there was no further need to hoard reserves against future crises.

Other events combined with the letter to ease the pressure in financial markets. Congress passed a law, effective in late September, permitting the Federal Reserve to discriminate by size when it set ceiling interest rates on time deposits. Simultaneously, Congress granted the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board the power to set ceiling and differential interest rates on deposits at institutions under their jurisdiction. The authorities immediately set a 5 percent ceiling on time deposits of less than \$100,000 at commercial banks, effectively checking their competition with the higher-paying savings institutions.

Furthermore, the Administration requested that the



investment tax credit be put aside. To the financial community, this move signaled that a larger share of the effort to control inflation was to be made through fiscal policy—by means of adjustments in taxation and spending. Presumably, this would permit the Federal Reserve to relax some of its monetary constraints upon banks and other financial markets.

Throughout the rest of the year, the Federal Reserve continued to restrict expansion of the reserve base and bank credit. However, in spite of this constraint, liquidity pressures eased—and even more quickly than they had developed. Borrowings by member banks at the Federal Reserve fell from a peak of almost \$900 million to about \$500 million by the year's end. A further fall to \$200 million occurred by March of 1967. The three-month Treasury bill rate fell by 72 basis points between the September peak and the first week in January. Over roughly the same period, the yield on long-term government bonds fell by 41 basis points. (See Table III.)

The Aftermath

The Crunch worked. The investment boom was broken. Gross private domestic investment decreased at an annual rate of 26.0 percent between the fourth quarter of 1966 and the second quarter of 1967. In large part, this drop signaled a halt in inventory accumulation, but equally significant was the fact that it was accompanied by no growth in the volume of business investment in plant and equipment. This was in sharp contrast with the rapid increases in 1966. (See Table I.)

In December 1966, the Federal Reserve switched to an expansionary monetary policy, which was main-

tained for most of 1967. Through November of 1967, the reserves of member banks grew at an annual rate of 11.4 percent, and bank credit grew at an annual rate of 12.4 percent. (See Table II.) Large-denomination certificates of deposit reached a trough of \$15.4 billion in mid-December of 1966. By December 1967, the amount outstanding exceeded \$21 billion—a significant increase over the \$18.5 billion of August 1966.

Normally, with the money supply and the reserve base increasing rapidly, the gross national product static or growing slowly, and private investment dropping swiftly, interest rates would fall. Certainly, money-market and capital-market rates would normally be below the peak they reached when the economy was growing rapidly and the Federal Reserve Board was imposing monetary constraint. And, in fact, in December of 1967 short-term rates *were* below the levels they had reached during September and October of 1966. But each rate was well above its post-Crunch trough. For example, the rate for three-month Treasury bills rode a roller coaster: from a peak of 5.52 percent on Sept. 23, 1966, to a trough of 3.41 percent on June 9, 1967, to 4.92 percent in early December of 1967.

The most significant post-Crunch developments, however, took place in the market for long-term government and corporate bonds. In December of 1967, both these rates were well above their Crunch peak. For example, Aaa corporate bonds reached a peak yield of 5.52 percent in September 1966, and a trough of 5.00 percent in February 1967. In early December the rate of return on such securities was 6.13 percent.

The climb in these interest rates was due to a huge outpouring of corporate bonds in 1967. These issues

were not the result of any rapid expansion of business investment. Quite the contrary; business investment did not change, or declined. However, an institution with a long-term debt to pay is more liquid than one with an equivalent amount of short-term debt; its cash needs in the near future are smaller. Furthermore, in the fall of 1966, corporations were made aware that banks can be unreliable sources of financing, and many wished to decrease their dependence upon bank borrowings. That is, the pressure in the long-term bond market in 1967—and it was acute, with many new issues yielding well over 6.00 percent—in substantial part reflected a desire on the part of business to rectify balance sheets rather than to finance any burst of new investment.

Through 1967, the economy was sustained by a sharp increase in Federal spending, especially for defense. As a result, a hefty government deficit was racked up—in part due to the decline in tax revenue stemming from the decline in corporate profits. Government debt fed into the portfolios of banks, financial institutions, households, and ordinary businesses increases their liquidity. The combination of government expansion sustaining total demand, government deficits feeding liquid assets into portfolios, and the use of long-term debt by corporations is now satisfying the increased preference for liquidity that developed after the 1966 Crunch. But once this preference is satisfied, conditions will be ripe for another take-off of investment demand.

The events of 1966-67 show that in the intensely financial American economy—despite the precision ministrations of the New Economics—investment booms and liquidity crises are still possible. Business cycles remain very much part of the picture, even though the 1966 Crunch led to no more than a mini-recession rather than a true depression. The modest overall impact was the result of the offsetting rapid increases in Federal spending in Vietnam. Without them, it is very likely that an event such as the Crunch of 1966 would have had serious employment repercussions. Because of the accident of Vietnam, there is a danger that the Crunch's lesson about the perils attending stretched liquidity positions may soon be forgotten.

The period covered here closes before any serious impact from the devaluation of the British pound could become manifest. The next chapter in the history

of America's financial system, most likely will center on the way in which the precarious international position of the dollar is resolved. The current emphasis upon defending the dollar can very well lead to economic policies that generate continuing constraint on financial markets. If this constraint takes place in the midst of strong expansionary pressures from business, then liquidity-stretching financial changes will occur to offset at least part of the constraint. Under these circumstances we will not have to wait another 30 years before the authorities' ability to handle a liquidity stringency is once again tested.

On the other hand, constraint on financial markets may be so severe that strong expansionary pressures from business do not develop. In such a relatively stagnant economy, financial instability of the type discussed here is not an issue. Thus the alternatives before us may be either to stagnate—albeit at a high level—or to live with the danger of recurrent Crunches.

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