The Federal Reserve is responsible, however, for forcing a huge contraction in bank certificates of deposit that created very real dangers for the orderly functioning of the financial markets. The crunch, as it has come to be called, has had pervasive and continuing effects upon the credit demands of business corporations and upon the willingness of banks to enter into new credit commitments.

On the other hand, Federal Reserve policy in 1967 was responsibly adjusted to the limits within which it could be effective given the total demand for credit and money. Net credit raised by nonfinancial sectors of the economy rose to a record high of $82 billion, some $10 billion more than the previous record set in 1965. Yet, funds raised by private borrowers were less than in 1965, and also less than in 1966, in spite of the much higher dollar level of economic activity; the difference was Federal Government borrowing.

If the Federal Reserve had attempted to squeeze more out of the private sector in order to finance the huge Government deficit, the consequences for interest rates, for the ability of the credit markets to function, and for the economy could have been most upsetting.

Guidelines for Policy

The guideline for Federal Reserve policy most often proposed is in terms of some target rate of growth in money supply, usually defined as demand deposits and currency in circulation. In an operational sense, this is not the most useful guideline since it is not as much subject to direct Federal Reserve influence as either credit flow or interest rates. While changes in money supply are influenced by Federal Reserve policy, the influence tends to be at a second remove rather than at the direct point of entry of the central bank into the economic process.

Again, 1966 and 1967 experience is illustrative. The failure of money supply to grow in the last half of 1966 resulted primarily from more intensive use of demand deposit balances occasioned by the difficulty many business concerns and individuals encountered in getting access to credit.

While part of the phenomenon no doubt represented voluntary economizing on money to take advantage of the high rates of return available on short-term investments, most of it probably was an involuntary repsonse to credit tightness.

The unusually large rate of growth in money supply in 1967 was due partly to the rebuilding of cash balances to desired levels once credit was again available. More importantly, however, it was a backlash effect from the 1966 credit crunch.

In an effort to build good will with their banks to help assure access to credit in the event of another 1966-type crunch, most business concerns increased their compensating balances—usually with some encouragement from their banks. As a consequence, demand deposits increased proportionately more in New York and other money centers than elsewhere; that is, at banks the bulk of whose deposits are from business concerns.

Monetary analyses often seem to imply that the Federal Reserve is able to regulate money supply growth to whatever target it might choose. In this analysis the Fed creates reserves, the banks create