The Honorable Joseph S. Clark,
United States Senate,
Washington 25, D. C.

Dear Senator Clark:

In your letter of June 24 you asked for my comment on a number of questions. I am happy to comment, and hope that my responses will be useful to you and your Committee.

1. Do you agree that "tighter credit conditions affected unevenly different sectors of the economy and different types of businesses"?

2. Is an uneven effect of credit and monetary policy bad for the economy as a whole?

These questions are closely related and I shall try to answer them together.

In an economy as broad and as interdependent as ours, the effects of tighter credit tend to be pervasive--more so, I think, than is commonly realized. One of the immediate effects is to increase the cost of credit thereby tending to reduce the volume of borrowing. It also increases the rewards for savings thereby increasing the amount of loanable funds available. These influences spread throughout the economy in a relatively short time.

To take one example, if individuals decide to save more or borrow less by reducing their purchases of durable goods, these decisions affect several very large and important industries in the country--industries which include both giant manufacturers and relatively small dealers, as well as companies that customarily depend heavily on borrowed funds and those that rely more extensively on internal financing. The decisions also affect the availability of loanable funds to a variety of lenders and hence their ability to meet their customers' demands. In short, these decisions affect in one way or another the countless saving, spending, lending and borrowing activities that make up our daily economic and business life.

One cannot say that every activity, every sector, every member of every sector in the economy is evenly affected by tight credit conditions. Neither can one determine the extent to which one sector is affected relative to another. There is unquestionably some unevenness in the effect of general monetary restraints, but the alternatives--unrestrained inflation or a harness of specific direct controls--would in my opinion be immeasurably more uneven in their discriminatory effects.

3. In general, do higher interest rates and a reduced supply of credit in relation to demand pose more serious problems for small businesses than for large businesses?

It is difficult to say whether, and if so to what extent, tight credit conditions by themselves have a disproportionately adverse effect on small businesses. So far as short-term bank credit is concerned--and small businesses rely heavily on this type of credit--the information we receive from surveys suggests that the supply of such credit has not diminished over the past two and one-half years. While interest rates on small loans of banks generally are higher than rates on large loans, the increase in rates on small loans has been less than that on large loans over this period. Small businesses have also had an increased volume of internal funds and this may have moderated their needs for borrowed funds. According to F.T.C.-S.E.C. data for manufacturing corporations, the profits of small companies increased substantially in 1956, compared with a decline for large companies.

The financing problem of small businesses lies, in our judgment, in the field of long-term debt and equity capital. To some extent, higher interest rates and a supply of credit short of demand for its use may intensify this problem.

It is in boom times that the demands for the goods and services of small, as well as large, businesses are at their peak. It is then that businesses are tempted to overestimate their future growth, to overextend themselves, and to lay the seeds for trouble when final demand is less pressing. Some small businesses, without the research and technical advisory services available to many larger firms, are particularly vulnerable to such miscalculations. The fact that business enterprises may be restrained in their expansion by reluctance on the part of investors to make all of the capital they want available to them is one of the "checks and balances" in our economic system which helps to prevent uneconomic use of our resources.

4. On the basis of such factual information as may be available to you, what additional volume of credit to small businesses would be necessary to maintain their fair share of the total quantity of credit available?

So far as I know, there is no factual information available that would permit a satisfactory judgment as to the amount of credit that represents small business' "fair share". If one accepts the premise that the impersonal judgment of the market place, while economic in the broadest sense, does not always satisfy desirable social objectives, then one must set up different criteria for allocating available credit. This might result in further involving the Federal Government in financial activities beyond the scope of its ordinary responsibilities. Moreover, these criteria would have to be very general and would have to be geared to the broad social objectives desired rather than to any particular dollar or percentage amounts. This would be a most difficult task and I do not believe it would be as effective as the judgment of the market place.

5. If this additional volume is greater than the lending authority of the Small Business Administration, how can the supply of credit for small businesses be increased?

7. Is it feasible to increase the supply of credit available to small businesses solely through the lending program of the Small Business Administration?

I can also answer these related questions together. Since I feel that it is extremely difficult to determine the "fair share" of the aggregate credit pool that small businesses should receive without the guidance of the market place, I find it equally as difficult to say whether the Small Business Administration can adequately fill any gap that may exist between the "fair share" and the amount of credit currently available to small firms.

As I indicated in my testimony, if there is such a gap, every effort should be made to encourage private organizations to fill it.

6. Could the Board of Governors of the Federal Reserve System take steps to increase the supply of credit for small businesses through policy statements or advice to member-institutions?

The Federal Reserve System has studiously avoided interfering with the operations of its member banks in allocating the available supply of credit to particular sectors or individual members of the economy. This allocation is best left to market forces and to the decisions of our numerous, widely scattered, and locally oriented commercial banks. The Federal Reserve concentrates on influencing the over-all quantity of money and credit and on trying to keep their growth consistent with the maintenance of orderly economic progress.

8. When the Congress attempts to alleviate the uneven effects of policies which restrain credit, it is frequently said that such attempts are inflationary. If the Congress decides that such direct lending programs are essential, cannot the Federal Reserve System take action through open market operations or other means to offset any inflationary tendencies which might otherwise result?

The Federal Reserve would, of course, do everything within its power, through open market operations or other means, to offset any inflationary tendencies that might arise from direct Government lending programs. Such offsetting action is very difficult to accomplish, however, and might prove relatively ineffective, at least in the short-run, due both to the problem of measuring the potential inflationary effects of particular lending programs and the fact that the effects of offsetting action would be delayed. The most appropriate way to counteract this type of inflationary pressure would be through fiscal policy, that is, by financing any new specialized lending programs by taxation.

Sincerely yours,

Wm. McC. Martin, Jr.

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