TREASURY DEPARTMENT

Washington,

ASSISTANT SECRETARY

December 28, 1938.

Dear Marriner:

I have read with interest your letter to Senator Byrd.

There is one point which you make which puzzles me. On page 4 you discuss the question of debt and state:

> "In connection with the question of debt, you also make the curious statement that some day the whole amount must be repaid. Such a statement reflects a misunderstanding of the fundamental nature of our capitalist economy. Debts and obligations of various kinds are but the other side of investment, and if we ever tried to liquidate the whole amount of them, or even any substantial fraction, we would precipitate a crisis so severe that general economic paralysis would result. When there is contraction of total debt, private and public, we have deflation. We have never had prosperous conditions without an accompanying expansion of debt, either private or public, or both."

While I do not question the accuracy of the statements, I wonder if you do not over-emphasize the "indebtedness" aspects of investment at the expense of the equity ownership aspects. Certainly in private finance outright unemcumbered ownership is urgently to be desired, and as long as new profitable investment in a given company occurs either in the form of plowed-back earnings or of new acquisitions of equity capital, you have a thoroughly healthy situation. Further, if a private company does not consciously strive to create equity it is almost certain to get into trouble sooner or later. This process may involve the reinvestment of earnings or it may involve financing which retires debt and substitutes capital stock, but in any case it is a process which is typical and essential for the success and stability of private capitalistic enterprise. I do not believe that this process is deflationary in character, as obviously it can occur during periods when the total volume of debt, private and public, is increasing. In other words, I think that the total new investment figure is the one which we should emphasize rather than the total debt figure, and that we should strive to throw our influence in the direction of equity creation and ownership rather than debt creation and ownership.

Carrying the thought over into the field of public finance, a government cannot very well finance itself through the sale of common stock, at least few governments operating in a capitalistic economy have done so openly. Nevertheless, governments do go through a process of creating equities or cushions when they take advantage of periods of excess revenues and retire indebtedness which has been incurred in periods of deficit financing. This process likewise can, and probably does occur during a period when the total debt, private and public, is increasing. It can also occur during a period when total investment is increasing while total indebtedness is decreasing.

Sincerely,

Wayne

Honorable Marriner S. Eccles
Chairman, Federal Reserve System
Washington, D. C.

January 3, 1939.

Honorable Wayne C. Taylor
Assistant Secretary of the Treasury
Washington, D. C.

Dear Wayne:

I have yours of December 28, 1938, commenting upon my recent letter to Senator Byrd and raising a question respecting the discussion on page 4 of my letter, relating to debt.

Your particular question was whether or not, in stating that prosperous conditions are coincident with an expansion of debt, either private or public, or both, there is an overemphasis of the debt aspect of investment and a corresponding neglect of the equity ownership aspect. You argue that prosperity is related more closely to the total volume of investment than to the total volume of debt, and that it would be preferable if we could have an expansion in investment and at the same time a contraction of debt. If such a development could be brought about, it would be desirable, I agree, but while your proposition seems theoretically correct, I know of no period in the economic history of this country when we have had prosperity without an increase in total debt. And it seems to me that we have less ground for expecting the occurrence of such a situation in the future, since the investment of savings funds has been restricted more and more by laws and regulations to investments in the form of obligations, rather than of equities. Our savings today are largely in the form of assets of insurance companies, investment trusts, endowments, fiduciary trusts and, of course, in savings deposits in commercial banks, mutual savings banks and other thrift institutions. With few exceptions such funds are invested in obligations since under applicable laws and regulations, national or State, they are largely prohibited from going into equities. With these forms of savings denied access to equity investment, about the only savings left are business profits, either corporate or individual, which might be plowed back into the business. The volume of such funds is relatively small. Furthermore, we know from the behavior of corporations in the recent past, that a great portion of such profits are used to retire corporate debt or to buy existing facilities of competitors, neither of which increases equity investment.

Turning now to periods when equity investment was increasing substantially, namely during the late '20's and again in 1936, such increase was accompanied by, if not generated by, a pronounced increase in total debt.

Applying this thesis to the problem of public finance, I recognize that in the '20's it was possible to make a rapid reduction of the Federal debt, while private investment was increasing. Let us not be misled, however, by this circumstance, because if we look below the surface we find that while the Federal debt was decreasing, the public debt of States, counties and municipalities was increasing by a greater amount. Furthermore, the apparent high prosperity of this period was due in no small degree to our large foreign trade, which was sustained by the unhappy process of lending billions to foreign governments, municipalities and corporations, the proceeds of which were used in great measure to buy American products.

I would welcome a situation in which the Government debt might be reduced in order to compensate for a rapid increase in other debt and in private investment, but I am not sanguine that this can occur, least of all in the immediate future. And I am thoroughly convinced that the present volume of Government spending is not too large--in fact, it may be somewhat too small, to generate a volume of total consumption sufficient to induce productive enterprise to expand its plant, an essential prerequisite to relatively full employment and the increase of national income to the point where the Government can balance its budget. As to the possibility of the Government retiring its debt, I believe this can only take place with safety when it is desirable as an offset to an otherwise too rapid expansion of private debt and investment.

Sincerely,

M. S. Eccles
Chairman

LC/fgr