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RECONSTRUCTION FINANCE CORPORATION
WASHINGTON

HENRY T. BODMAN
MEMBER OF THE BOARD

January 14, 1948

Dear Marriner:

The enclosed is a copy of a statement made before the Special Subcommittee of the Senate Banking and Currency Committee today in which I make recommendations regarding the future lending functions of the RFC.

I thought this might be of some interest to you.

Sincerely,

Henry

Honorable Marriner S. Eccles
Chairman, Board of Governors of
the Federal Reserve System
Washington 25, D. C.

Enclosure

JAN 14 1948

STATEMENT OF HENRY T. BODMAN, MEMBER OF THE BOARD, RECONSTRUCTION FINANCE CORPORATION, BEFORE THE SPECIAL SUBCOMMITTEE OF THE SENATE BANKING AND CURRENCY COMMITTEE - RFC INQUIRY

It is my understanding that the Committee is interested in obtaining my views on what functions the RFC should have as a lending agency in peacetime.

The RFC has now been through the complete range of economic conditions -- from the depths of depression to the present period of prosperity, full employment and general credit availability. It has acquired a background of experience which should be helpful to the Congress in deciding what its future lending functions should be.

To summarize my general conclusions at the outset, I believe that a government lending agency is needed to cope with emergency situations which involve the national interest; and that the RFC's record effectively demonstrates its ability to perform that function. I therefore believe that RFC should be continued in order that this need may be filled.

This broad conclusion does not, of course, dispose of the many questions raised by your Committee concerning the scope of RFC's operations under varying economic conditions.

These are problems which deserve careful consideration. They involve certain fundamental economic and social questions which necessarily arise when the Government undertakes to lend money collected through taxation to private concerns operated for profit.

The use of public funds is justified only when it promotes the public welfare. When the Government lends money to a business enterprise, the direct benefit which flows to the owners of the business should only be incidental to the attainment of the ultimate objective which is the indirect benefit to the general welfare. Broadly speaking, loans made by the Government would seem justified only when the indirect or public benefit is the primary objective and when, therefore, the direct benefit is subordinate.

For example, this was the case when the RFC was created in the midst of the financial crisis in 1932. By that time the depression had so adversely affected our banking and credit system that we were faced with a national catastrophe.

In an effort to meet this situation, the RFC was formed on the principle that a strong federal lending Agency would serve as a bulwark against further deterioration of the economy.

As you gentlemen have seen from the charts made available to this Committee, the principal activity of the RFC in its early years was the financial assistance it gave to the banks of the country. By 1934, RFC held over \$1.7 billion in loans to and investments in banks and other financial institutions. This program was the outstanding contribution of the RFC during the depression period.

It is important to identify the purposes for which these loans and investments were made. They were made originally in an effort to keep the banks open so that the day-to-day business transactions of the country could be carried on; and, later, to relieve the deflationary pressures

of credit contraction which reflected the condition of the banks themselves, rather than the condition of their borrowers.

The Government stepped into the picture, but not to protect the stockholders of the banks. It acted to protect the public from the consequences of a collapse of the nation's banking and credit system. This indirect benefit was clearly the primary consideration.

After the immediate financial crisis was over, the problem of greatest national importance was that of the staggering volume of unemployment. In these circumstances the RFC Act was amended in 1934 so as to permit it to make loans directly to ordinary business enterprises where they could not obtain credit privately due to the condition of the banks at that time.

It should be recalled that here again the controlling purpose of these loans was not to assist, or enrich, the individual owners of the concerns receiving Government credit. The controlling purpose was an indirect one,-- to enable private concerns to absorb a greater volume of labor in useful productive occupations, and thus to relieve the unemployment situation. There was a definite element of national interest in so doing.

As a result of the general recovery in business, and of the improved liquidity of the banks as time went on, credit became much more generally available and unemployment dropped considerably by 1937. It is significant that, in view of this and recognizing the emergency nature of RFC's activities, the President directed the RFC to discontinue accepting loan applications in 1937. A few months later, however, when the business recession of 1938 began to reach serious proportions, the RFC again entered the credit field.

With the advent of the National Defense program, and later the War program, RFC's powers were greatly expanded in order that it might undertake its tremendously important war functions which were carried out in such a splendid manner. The last Congress, as RFC had suggested, appropriately repealed practically all of the War Emergency powers of the Corporation, including its very broad wartime lending authority. The Congress also continued RFC's pre-war lending authority for one year and, at the same time, provided for the study your Committee is now making as to what the future lending functions of the RFC should be.

One widely held view regarding this question is that, under our banking and credit system, there is a permanent shortage of certain types of credit which the Government, as a normal function, should assume responsibility for overcoming through the lending operations of the RFC.

Another view is that the RFC should be maintained as a kind of Fire Department,— a stand-by organization relatively inactive in good times but ready to come to the rescue whenever an emergency arises. I subscribe to the latter view.

It is difficult, if not impossible, to set up a detailed mechanical formula for determining which loans should and should not be made if this general principle is to be adopted. However, it is possible, and highly important to determine the purposes for which Government credit should and should not be made available in keeping with this view.

For certain types of loans such as those as may be necessary because of floods or other major catastrophes, the question of purpose is easy to decide. However, because of their wide variety, this is not true for other categories of loans, particularly those to the ordinary

business enterprise. To determine the purposes for which such loans should be made is the crux of the problem.

My general recommendations regarding the purposes for which the Government should make business loans from time to time are as follows:

First: The Government would be justified, in a period of financial or economic distress, in making loans to stimulate economic recovery and to overcome a serious unemployment situation. At such times, and where private credit is not available, the granting of loans to individual enterprises results in important and necessary indirect benefits which would be in the national interest.

For the Government, however, to make loans to the ordinary mine-run of business enterprise, in what might be regarded as normal, or prosperous, or boom times, involves certain long-term dangers which, in my opinion, more than offset the possible benefits to be derived. The dangers I see in this are three in number:

- (a) It puts the Government in business on a permanent, rather than on an emergency basis.
- (b) It sometimes tends to subsidize, or give a special benefit to the inefficient or marginal producer at the expense of those able to care for themselves.
- (c) It may result in using money extracted from all of the people for the enrichment of individual owners, or groups of owners of a business enterprise, without corresponding public benefits.

Second: The Government would be justified, even in normal or prosperous times, in making loans in emergency situations.

It is not easy, however, to define an emergency. Everyone faced with financial difficulties thinks there is an emergency. But that is not the kind of emergency we are talking about here. For an emergency to

exist in the broader sense, a definite element of national interest must be present.

More specifically, I would suggest that, except in times of economic or financial distress, the RFC's lending powers should be used only for the purpose of making loans to business enterprises, which, individually, are of importance to the national defense, or otherwise to the national interest.

As an example, in view of the international situation, it may be essential, even under present economic conditions, for the Government to extend credit, in cases where private financing is not possible, to aircraft manufacturing companies which are important to the national defense.

As a further example, if it can be demonstrated that our air transport system can be permanently strengthened through providing it with more modern and efficient equipment, loans for this purpose, where private credit is not available, would seem proper and desirable, irrespective of the state of economy, and would be in the interest of national defense.

A third and somewhat different type of example involves the close relationship between our natural resources and the national defense. It would seem proper for the RFC to be ready to extend credit, not otherwise available, to certain enterprises which would, with such credit, make an important contribution to the development or preservation of natural resources such as timber, oil, and various strategic and critical materials.

As I have indicated in the foregoing, the real problem is to determine the purposes for which, under varying economic conditions, the RFC should be authorized to make loans to ordinary business enterprises operated for profit. If this can be done, the remaining questions concern-

ing the lending policy to be followed by the RFC become relatively easy to answer.

To summarize, my conclusions are:

First: That loans for such broad purposes as "to help in maintaining the economic stability of the country, and to assist in promoting maximum employment and production" should be made only in periods of economic or financial distress, and only when private credit is not available; and

Second: That where the purpose is to finance enterprises which, individually, are important to the national defense, or otherwise to the national interest, it would seem wise for the Government to be empowered to make loans when private credit is not available, irrespective of general economic conditions.

If these principles are adopted, they will provide a clear indication that the taxpayers' money should be lent only in emergency situations when the indirect benefit to the nation as a whole is such as to justify the entry of the Government into the field of supplying credit to private enterprises.

January 19, 1948.

Dear Harry:

Thank you for your letter of January 14 enclosing a copy of your able statement before the Special Subcommittee of the Senate Banking and Currency Committee with regard to future lending functions of the RFC. As you know, I also subscribe to your view and I like the forthright way in which you stated the case.

I am passing the statement along to the Board and staff members who are particularly concerned with our bill S. 408 with which you are familiar.

With best regards,

Sincerely yours,

(Signed) M. S. Eccles

The Honorable Henry T. Bodman,
Reconstruction Finance Corporation,
Washington 25, D. C.

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