BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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STATEMENT OF MARRINER S. ECCLES, MEMBER
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
BEFORE
THE SENATE BANKING AND CURRENCY COMMITTEE CONSIDERING
LEGISLATION TO ABOLISH THE RECONSTRUCTION FINANCE CORPORATION

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear here this morning and give my reasons why I feel that the Reconstruction Finance Corporation should be abolished. I am speaking for myself and not for the Federal Reserve Board. I am speaking as one who has been in Government service for the past seventeen years and who, during that entire period, has taken an active part in helping to solve the problems of maintaining economic stability within the framework of our democratic capitalistic society. I have, ever since the termination of the war, viewed with grave misgivings the continuation and expansion of the Government in the field of private lending. There are sound and indisputable reasons why the RFC should be abolished. With your permission I shall present, as briefly and directly as possible, what I consider the most important reasons.

Inflation and Its Control

Throughout the postwar period, and particularly since the Korean invasion, the country has experienced a most serious inflationary development. This was brought about by too much money and credit in the hands of the public relative to the goods and services available in the market. The RFC, instead of liquidating its outstanding credits during this period, added to inflationary pressures by extending its lending activities and those of its affiliate, FNMA. Inflation has greatly depreciated the purchasing power of the dollar, and as a result the cost of living has increased approximately 45 per cent since the end of the war. This has been a most serious and unjustified development, and should not have been permitted; this inflation has worked a grave injustice upon large numbers of our people; it has injured most the aged, the pensioners, the widows and the disabled -- the most helpless members of our society. Inflation diminishes our incentives to work, to save, and to plan for the future, and in so doing undermines the very foundations of our free democratic society.

With a rapid increase in defense expenditures immediately confronting us, prevention of further inflation will be difficult. If it is to be avoided, all of us must support fiscal, monetary, and credit measures essential to its control. With full utilization of our manpower and raw materials, it is imperative that the Federal cash budget be maintained on a pay-as-you-go basis. This is necessary to assure the transfer of funds from the civilian economy to the Government to pay for the goods and services that are transferred. Otherwise, more funds will accumulate in the hands of the public than there are goods and services available for the public to buy. Such a condition will lead to further inflation. To prevent such a development, taxes have already been raised and will have to be raised further to keep pace with the increase in defense expenditures.

However, the success of an anti-inflationary program depends on more than a balanced budget. Despite the existence of a substantial budgetary surplus since Korea, a very rapid growth of bank credit has intensified inflationary pressures. As taxes increase, efforts to offset the resulting reduction in incomes give rise to increased demands for all types of credit, thereby tending to minimize the effects of a balanced budget. For this reason, an adequate program of credit restraint is essential to the success of a pay-as-you-go tax program.

Such a program of credit restraints has been developed, including control of consumer credit through Regulation W, of real estate mortgage credit through Regulation X, and of business credit through the Voluntary Credit Restraint Program provided for in the Defense Production Act of 1950 and under the supervision of the Federal Reserve Board. The need of further legislation to curb the growth of bank credit is being considered. Most important of all, the monetary and fiscal authorities have just recently reached an accord with reference to the management of the public debt that may go far toward curbing bank credit expansion, providing a balanced budget is maintained. All of the measures so adopted have received endorsement and support in congressional and financial circles, as well as by the general public.

Government Lending Inconsistent With Anti-Inflationary Program

The Government is obviously very inconsistent when it acts to balance the Federal budget and restrain credit expansion to prevent inflation, while at the same time continuing in force and effect lending activities of Government agencies such as the RFC. There is no logical justification for restricting the flow of good private credit, and at the same time permitting and encouraging the granting of unjustified and unsound loans by Government agencies to the private economy.

We must recognize that the conditions under which the RFC came into existence were very different from those prevailing at the present time. It was established in the depths of the greatest economic depression in our history for the purpose of providing emergency financial assistance to banks and other financial institutions. Subsequently, its authority was broadened to include loans to nonfinancial business concerns under certain conditions. Because there were many weaknesses in our economic system in the early thirties, no one seriously questioned the need for a temporary Government agency designed to assist the country in an economic emergency which was forcing all financial institutions, as a matter of self-preservation, to liquidate all outstanding credits.

We have long since recognized and corrected many of the weaknesses that brought about our economic collapse in the Thirties. We have greatly strengthened our commercial banking system and provided for insurance of bank deposits; we have provided for regulation and supervision of security flotations and the operation of the organized securities exchanges; and the Government has recognized by statute its obligation to assist in the maintenance of maximum employment and has provided extensive social security for a large number of the people. In addition, we have improved our techniques and gained valuable experience in the use of monetary, credit, and fiscal policies for purposes of achieving and maintaining economic stability. For these and other reasons, the necessity for continuing the RFC as an emergency financial institution no longer exists.

The problems confronting the country today are the very opposite of those which confronted the country when the RFC was first established. In our present situation, the operations of the RFC, as well as those of FNMA, in continuing to put additional funds into the spending stream only intensify the already difficult problem of curbing credit expansion. Having long since outlived its usefulness to the economy, the RFC should be abolished without further delay.

<u>No Need for Direct Government Financing</u>

There is no real place in a private enterprise economy for direct Government lending to the private economy, any more than there is a place for direct Government ownership of the means of production. Government participation in either activity is socialistic in nature and will, if continued and expanded, weaken and ultimately destroy the private free enterprise system. The Government's function is to regulate and supervise the activities of private enterprise in the public interest, and not to own and operate tax-free financing or production organizations in competition with those that are privately owned and operated and are taxed. We might feel differently about the RFC if our private financing facilities and resources were unable to provide the credit required to utilize as fully as possible the labor and materials available in the economy. But such is not the case at the present time.

There are located throughout the United States more than 14,000 commercial banks, over 600 life insurance companies, more than 500 mutual savings banks, and nearly 6,000 savings and loan associations. In addition, there are numerous mortgage companies, sales finance companies, industrial loan associations, and other financing institutions. Each and every one of them, operating with funds obtained from private sources and in competition with numerous other institutions, is engaged in extending credit, in accordance with self-surviving and profit motive lending and investment policies, to meet all of the legitimate needs of a private enterprise economy. The very fact that these financing institutions are competitive and derive their earnings from the loans and investments which they make is in itself an assurance that the necessary credit requirements of the economy are being, and will continue to be, met. The combined resources at the disposal of these institutions are enormous; as of December 31, 1950, the commercial banks, life insurance companies, mutual savings banks, and savings and loan associations alone held over 290 billion dollars of loans, investments and other assets, and they are adding billions of dollars to these assets every year.

To continue the existence of the RFC in competition with our private financing institutions is completely indefensible if we really believe in our private enterprise economy. This is because the RFC's only source of funds is the Federal Treasury, while the Treasury's only source of funds is the private economy through tax collections or by borrowing to meet a budgetary deficit. Using these funds to make loans that cannot be secured in a free market means in effect that the RFC is employing funds obtained from the entire public in making questionable loans for the benefit of a select few. It is obviously unfair for the Government to subsidize with credit those business concerns which cannot stand on their own feet, but nevertheless are competing for sales and profits with concerns that have to obtain the funds they use in the private market. In other words, privately financed business concerns are called upon to provide indirectly through the Government part of the funds used by their competitors who receive RFC loans.

As the Government does not own the business enterprises which it finances by means of direct or guaranteed loans, any profits from their operations accrue to the private owners. But, if the loan eventually proves to be a loss, either in part or in whole, the Government, and ultimately the taxpayer, suffers the amount of such loss. There have been conspicuous examples of borrowers from RFC who made great profits through the use of the taxpayers' money, as well as of borrowers who incurred substantial losses at the expense of the taxpayers. If we are going to be Socialistic in some of our economic activities, it had better be by going into business directly where the profits as well as the losses accrue to the taxpayer, instead of indirectly through providing unjustified credit where only the losses accrue to the taxpayer. I am vigorously opposed to either form of Socialization.

The RFC obtains its funds without cost from the taxpayer and pays no taxes of any kind on its operations, while privately owned and operated financing institutions must raise their capital in the private market and pay in interest and dividends whatever is required. They must also pay their share of local as well as Federal taxes. Quite obviously, a company operating with an abundance of free capital on a tax-free basis during a period of inflation can make its earnings appear to be much better than a careful analysis of the facts would warrant.

Perhaps the argument most frequently heard in support of the RFC's continuance is the aid which it provides to small businesses, which presumably are unable to obtain financial assistance from any other source. However, if we examine the reports of the RFC we find that while the number of loans made to small businesses is large, the dollar volume of such loans is small relative to the total amount of loans granted or outstanding. In other words, the bulk of the funds loaned by RFC have gone to large, rather than small, businesses. Moreover, it is the considered opinion of experts in the field of small business financing that what small businesses need primarily is managerial and technical assistance rather than more money. To encourage inefficient utilization of financial resources by small business is wasteful, extravagant and in the end unproductive. The RFC does not have the specialized facilities required to provide adequate managerial and technical assistance to small business, and it should be left to private enterprise to develop them, as well as to supply whatever capital and credit are needed, especially under present conditions.

RFC Lending Subject to Political Pressure

One of the most striking facts brought to light during the recent investigation of the RFC is the extent to which its lending activities have been subject to political influence. The RFC is designated to make or guarantee loans to credit-worthy borrowers who cannot secure credit on reasonable terms from customary sources. Under this arrangement heavy political pressures have been brought to bear by and on behalf of borrowers who expect to benefit from the credit. The problems of a public lending agency, as compared with a private one, are immeasurably increased by such pressures. If only sound and justifiable loans were granted, there would be great criticisms of the RFC by the would-be borrowers and their political representatives. If it does grant questionable loans in response to political requirements, then, as the recent investigation has shown, it will be bitterly criticized by the public. So long as there is a Government lending agency like the RFC there will be great and undeniable demand for unsound and unjustified credit. This will put all members of Congress under more or less political pressure to assist applicants in receiving such credit. I should think in these circumstances members of Congress would be the first ones to want to liquidate the RFC and be relieved of the pressures which only add to their responsibilities and can serve no useful public purpose.

Aside from the economic considerations which I have enumerated there are strong collateral reasons for abolishing the RFC. It has already been demonstrated that where a Government agency has wide discretion in loaning large amounts of funds to the voting public, its ethical and moral standards deteriorate over a period of time as a result of inevitable political pressures. This has the unfortunate effect of tending to destroy the confidence of the people in their Government.

Credit for Defense Purposes

In letting defense contracts, priority should be given to those prime contractors or subcontractors who have the necessary skill, productive facilities, and financial resources. However, it may be found necessary, as in World War II, to facilitate defense production by giving some contracts to those who do not have adequate financial resources and cannot obtain them from private financing institutions. In such cases, some Government help may be essential, but it should be provided in the form of a Government guarantee of private credit and not by a direct Government loan. Such guarantees would be most effectively handled under a single program, such as that authorized by the Defense Production Act of 1950. This provides for guarantee of loans by eight agencies engaged in defense activities, using the Federal Reserve Banks as fiscal agencies in arranging the guarantees. This is the same as the Regulation V program which was used so effectively in World War II. Under this regulation the Federal Reserve Banks and their branches throughout the country gained extensive experience in authorizing guarantees on 8,800 loans, amounting to over 10 billion dollars. The net result of the V-loan operation was a net profit of 24 billion dollars from the loan guarantee fees charged, after deducting all expenses and losses.

Under the V-loan program, a defense contractor or subcontractor engaged in defense production who is unable to obtain the necessary credit may apply for a guaranteed loan to his local bank or other private financing institution. The local Federal Reserve banks, acting as fiscal agents for those Government agencies which are loan guarantors, review and recommend action to be taken on loan applications. Upon approval by the guaranteeing agency, the private banks advance the full amount of the loan and a fee is paid covering the guaranteed portion of the loan. The guarantee fee ranges from 10 to 40 per cent of the interest rate on the loan, depending upon the percentage of the loan guaranteed. In practically every case the banks carry 10 per cent or more of the loan without a guarantee. Not only is the financing decentralized, but the local banks have a real interest in the loan and can be depended upon to give it necessary supervision. The requirement of approval by the guaranteeing agency assures that credit extension is being concentrated in those industries essential to the defense effort.

The existence of the V-loan program to provide essential defense credit makes unnecessary the continued existence of the RFC for this purpose. This is particularly true at a time when heavy inflationary pressures require the diversion of working capital and credit from non-defense to defense purposes as goods and labor are transferred, rather than try to super-impose defense credit on top of the existing volume of outstanding credit.

In conclusion, I should like to say that the evidence, both from an economic and a political standpoint, strongly supports the view that the liquidation of the RFC is long overdue.