June 30, 1950

Governor Eccles:

Suggest that you read this draft over the week-end and possibly we could have an opportunity to discuss it together with Mr. Youngdahl and Mr. Schmidt on Monday.

R. A. Y.

Attachment
(Draft of RFC statement)

DRAFT
June 29, 1950.

Considerations of the role and scope of Reconstruction Finance Corporation activities inevitably must raise a number of important questions. These questions range from the broadest judgments of the kind of economic system that we are striving to develop or maintain to more narrow considerations regarding the terms and methods of operation of a Government lending agency.

One of our major objectives, private and Government, ~~in this country~~ is to achieve and maintain high and rising levels of production and employment. We want, however, to do this within the framework of a free enterprise democratic economy. The general problem is that of assuring the spending of enough money by the people and by Government to take off the markets the steadily rising production of the labor force that is increasing in productivity as well as in numbers.

The Role of Credit in the Economy

Businesses and individuals as a group spend a part of their incomes on current consumption and save the rest. The part that is saved must be returned to the income stream by being invested either directly or indirectly in new capital goods or houses. If it is not, incomes and employment will decline. Then the flow of money from producers, including both business and agricultural enterprises, to consumers and back again to producers is interrupted. When that happens markets are reduced or lost which means that the incentives to produce, to employ people, and to pay out incomes are also lost.

This process of consuming, saving, and investment in capital goods and housing involves millions of consumers and producers and no single enterprise or individual need consume or invest all of his current income as it accrues. This is because the credit system provides a mechanism for taking up the slack and for directing funds to those who want to use them from those who wish to save them. In the broadest sense then what we are examining when we consider the role of Government in the private credit ~~arrangement~~ field is whether our entire credit mechanism as we have it serves properly and adequately the function of transmitting funds from those who wish to save into hands where they will be used for consumption or investment.

A further general point needs emphasis here, however. We are interested in maintaining and increasing the flows of income by insuring the adequate continuing flow of savings into investment. It is possible, however, to over-invest. That is, decisions to invest by millions of individuals and businesses may aggregate more than the sum which individuals and businesses as a group may wish to save. This will produce inflation in some degree.

Clearly then, what we seek is a balance with the savings of the economy finding full outlet in investment but the excessive investment that produces inflation. Demands for funds for investment purposes cannot properly be considered as necessarily good in themselves. We are too used to thinking only in terms of developing a greater volume of investment demand. Experience in recent years should have taught us that investment volume can be too large as well as too small. We should have learned that all suggestions for providing a mechanism for filling the last vestage of demand for investment funds are not automatically to be taken as desirable. We can have at some times a problem of allocating scarce saving among investment demands just as at other times we can have a problem of stimulating investment to levels that will utilize the volume of our savings. Measures which are good at one phase of the business cycle may be very bad in another phase and an emergency mechanism set up for the depression of the 1930's may have no place in an economy of the 1920's, the '40's and in 1950.

Credit Allocation in Prosperity

At the present time one of the threats to a sustained high level of activity in our economy is that credit is too easy to get -- is being generated too rapidly. Our banks, our life insurance companies, our savings banks and savings and loan institutions and all the other credit granting groups have a tremendous volume of funds to lend. They are making these funds available on extremely liberal terms. In lending these funds, moreover, they are under competition from Government agencies, such as the Reconstruction Finance Corporation, who seem to have money to lend to anybody, to any business enterprise, commercial or agricultural, and to home buyers. The evidence developed in these bearings before your Committee indicates the degree of liberality with which Government money is being loaned. Indeed it seems scarcely possible that the terms could be liberalized ~~much~~ any further and still regard many of these extensions of credit as loans rather than gifts or subsidies.

Banks and other private-credit-granting institutions, under the pressure of competition in part from the Government credit agencies themselves, are also lending today on an extraordinarily liberal basis. The evidence we have from the upward pressure of prices indicates that more money is going into the investment area than there is matched by available capacity to produce investment goods. Our credit should be becoming more scarce, with credit terms more strict. This is the mechanism by which the volume of funds available for investment would ordinarily be brought into balance.

This mechanism, if it is to operate successfully, must inevitably cut off some credit during periods of full utilization of our resources. The borrowers who are not able to meet the more rigid credit standards would be the ones to feel the brunt of the restraints, but all would be encouraged to economize on the use of credit. The existence of unsatisfied borrowers in periods of prosperity should not be regarded as evidence that there is anything wrong with the economic and credit system. It is rather evidence that we have in operation a mechanism of credit allocation which is working just as we have mechanisms in operation that allocate among competing claimants our limited quantities of zinc, lumber, corn, or automobiles. There is a certain top limit to our capacity for producing commodities and no one suggests that we operate our system in a way that will try to distribute more than there is. With full utilization of economic resources, there is also a limit to the amount of credit that can be granted without inflation, cheapening the dollar. If we set up a procedure for satisfying every claimant for credit -- satisfying these credit demands by Government lending when private credit is fully utilized -- we merely stimulate inflation.

The Federal Reserve System has been charged by Congress with the responsibility for regulating or influencing the volume of private credit. It has as its objective so to regulate this credit that the volume of investment will be neither deficient or excessive for maintaining high and rising levels of production and employment. When the Federal Reserve, in order to restrain the granting of credit in a period of high level activity, increases the cost and limits the availability of credit, there will inevitably be businesses and individuals who are not able to obtain all of the financing they would like to have. This action by the Federal Reserve System, however, is taken in the general public interest and benefit and not with a view either of inconveniencing or accommodating specific borrowers and lenders. But ~~The~~ the action is virtually devoid of benefit for economic stability if unsatisfied borrowers are privileged to call upon the Federal Government through its credit agencies for funds made available on an extremely liberal basis. We have here an action taken by one instrumentality of the Government in the interest of economic stability offset, perhaps completely, by another instrumentality of the Government. The private-credit-granting institutions can hardly be blamed for objecting to action restraining their lending activities, even in a period of inflation, when the applicants which they were obliged to turn away are taken care of by a Government agency.

The Reconstruction Finance Corporation is a lending agency set up originally to meet the emergency of the depression. The situation for which the agency was created has long since passed. The time for liquidation of this emergency agency, or at a minimum, arrangements for the suspension of its lending activity, is long overdue.

Credit Measures for Counteracting Depression

During periods when the level of investment is deficient from the standpoint of maintaining a high level of economic activity, availability of private credit in general can be expanded by measures under control of the Federal Reserve System. However, the degree of risk associated in such times with the granting of a broad group of credits to home owners, to businesses, and to other borrowers may be greater than our private credit granting institutions can accept. Our institutional arrangement in this country is such that we will generally have a heavy flow of savings into our banks, into our life insurance companies, into pensions and personal trust funds, and into other institutional forms even in a period of depression. The nature of the problem which Government must face then is to facilitate the channeling of these funds into productive areas and thus prevent them from remaining idle and prolonging depression.

In the last depression the problem was met in the real estate sector by Government mortgage insurance which reduced the risks of lending and stimulated the flow of savings into this area. This insurance system, moreover, sought to maintain our private enterprise institutions and not to substitute for them a system of Government credit.

If, in the future, circumstances should be such that we need to stimulate overall volume of investment it would be desirable to do this in the field of business credit through a comparable system of loan insurance by Government. Extensive reliance on direct Government lending is a long stride toward statism.

The Small Business Problem

There is evidence that the financial requirements of one important segment of the business population -- that of small business -- are not being fully met. Careful analysis of the evidence suggests that the unsatisfied requirements are actually primarily for equity capital.

The suggestion has been made that the Reconstruction Finance Corporation should attempt to fill this gap by making long term credit more readily available to small businesses. Many small businesses, certainly, would prefer to get long-term debt financing rather than outside equity funds. They strongly resist the dilution of management authority for reasons that are easily understood. And they naturally tend to prefer debt financing even when true risk capital is needed, since although suppliers of debt capital may share fully the risks involved in the enterprise, they do not share accordingly in profits should the venture prove successful.

There is grave danger, however, to both borrower and lender in attempting to fill a need for equity capital with credit. There is a further danger, moreover, in having the Government step in to supply that credit.

One reason why small businesses have trouble in getting equity capital is that present laws cut down the volume of small business earnings available for reinvestment. Another is that these same tax laws discourage the investment of savings in high risk, small business enterprises. Having the Government supply debt funds to small businesses is a poor substitute for a thorough going revision of our present tax laws.