RECONSTRUCTION FINANCE CORPORATION ACT

The remarkable dispatch and efficiency with which Congress has recently enacted the Reconstruction Finance Act attracts unusual attention to it, and in itself is a commentary on the serious breakdown of our present system of economy. In the light of widespread reports of the benefits to be derived from its assumed ability to arrest deflation and promote business recovery, it will be distinctly worth while to indicate, in a general way, the object for which it was created, and the lines along which it is likely to operate.

In brief, administration of the law intends to:- (1) eliminate the danger of serious runs on strong liquid banks by frightened depositors, and hence make it possible for these banks to aid deserving borrowers more fully; (2) to insure the credit of major railroads; (3) to strengthen insurance companies, many of which have been seriously endangered by the inroads of policy-holders' loans and the shrinkage in their bond account; (4) to stabilize a highly disorganized bond market by removing the pressure resulting from forced liquidation; (5) to prevent the collapse of real estate mortgages.

These ends are to be achieved through the loan of funds at the discretion of the Board of Directors to banks, trust companies, savings banks, Federal Land Banks, Joint Stock Land Banks, Federal Intermediate Credit Banks, insurance companies, building and loan associations, mortage loan companies, agricultural credit corporations, etc., and to the railroads when they are deemed unable to obtain funds on reasonable terms either through banking channels or from the public. There are two special provisions in the law. One sets aside a sum not less than $50,000,000, nor more than $200,000,000, to be placed at the disposal of the Secretary of Agriculture for loaning, at his discretion, to farmers in need of credit for their ordinary farm operations in 1932. The other allocates a sum not to exceed $300,000,000 to aid depositors of failed banks. From this we can readily perceive that the funds of the Corporation will ultimately be used for providing commercial banking facilities for individuals and firms unable to obtain accommodation at the present time, and for the carrying of long term fixed capital investments.

Then, in order to make a critical analysis and thus be in a position to properly appraise the ultimate possibilities and practical dangers adhering to the project, we must study carefully the source of the capital to be employed.

The share capital ($500,000,000) is to be provided by the Treasury. In addition, varied obligations - none of which may run longer than five years - are authorized to the amount of $1,500,000,000. These obligations are not eligible for rediscounting at the Reserve banks, nor may the Reserve institutions purchase them in the open market. However, the Treasury may buy them in unlimited amounts, and in order to do so may sell its own obligations, which, of course, are eligible for rediscounts. Secretary Mellon has already announced an offering of treasury notes, the major portion of which will be used to set up the share capital of the new corporation, and since they are short term will be rammed down the throats of the banks and, where necessary, of the Federal Reserve banks. As to the remainder of the capital, the Corporation may simply issue its obligations and hand them over to the Treasury for cash, or it may issue and sell its obligations to the general public. It is the method by which this latter capital is obtained that, in our opinion, will ultimately determine the value of the plan.

One of the most unfortunate and serious developments of the depression has been the steady growth of hoarding and the piling up of inactive bank balances. In a measure far greater than the size of these withdrawals, this has acted as a deterrent to the shifting of labor and capital from over-expanded industries to underdeveloped industries. It has placed a premium on liquidity incommensurate with its actual value, and to that extent made it more difficult to lay a foundation upon which the whole price and cost fabric may be readjusted.

If hoarding can be eliminated and funds thereby derived for the use of this Corporation from bona-fide long term investors, we will be in a position to relieve many commercial banks of assets which, though sound, are not suitable for their portfolios, in the present state of mental hysterial, because of their non-liquid character. Since the obligations of this Corporation are directly guaranteed by the Treasury, but are not eligible as collateral for loans to member banks and may not be purchased by the Reserve banks in the open market, they must bear a much higher rate of interest than governments do to be attractive to the banks. But since they are as secure as governments, and at the same time have no unique standing at the banks, they would seem to possess unusual appeal as a media of investment to the hoarder and the man with inactive bank balances. To the extent that the administrators succeed in drawing out these funds and finance the organization from the capital savings of the country, just so far do we feel that the legislation will prove sound and meritorious.

The dangers in the undertaking are quite apparent. The Secretary of Agriculture may prove to be a very poor banker, and this is especially true inasmuch as he will be subjected to political pressure in making loans. Likewise, this will be true of the Directors of the Corporation. Then the major portion of the funds of the Corporation will, in one way or another, be used to relieve banks of slow and doubtful assets. And, as it is quite possible that the funds of the organization cannot or will not be obtained from the capital savings of the country, they must then ultimately be obtained from the Federal Reserve banks. This will immediately begin to freeze the central banks, and where they are enabling member banks to absorb government issues to provide capital for the Corporation, it would, by increasing the reserves of the member banks disproportionately, inflate the lending power of the commercial banks. If this added lending power is later used unwisely, the results can be little short of chaotic.

However, we feel that the law under which the Corporation will function places those in charge of its control in a position to formulate a sound policy and avoid these pitfalls. It is a piece of outstanding emergency legislation. We think that if it follows Mr. Mills' statement that its purpose is "to free credit and not create it" much can be accomplished. It is up to the administration.

Wm. McC. Martin, Jr.
Jan. 27, 1932.