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Let Sleeping Failures Lie: The Reconstruction Finance Corporation

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(Note: The Great Recession continues to generate calls for at least New Deal-style response, if not much more. As has been noted lately, the New Deal actually began, in substance if not in name, under Franklin Roosevelt's predecessor, Herbert Hoover. His first program after the stock market crash of 1929 was the Reconstruction Finance Corporation. Below is a reprint of my article on the RFC, which was published in the November 1980 by the Cato Institute. See the original Policy Report [pdf] article for endnotes. Reprinted by permission.)

As the signs of the faltering economy become ever more manifest, some prominent businessmen and others are seeking solutions in the recent past. Believing that the present crisis is comparable to that of the Great Depression, they are showing interest in discarded economic strategies.

The bygone getting the most attention is the Reconstruction Finance Corporation (RFC). Created in January 1932, the RFC extended loans and guarantees to industries, banks, railroads, mortgage companies, farmers, and state and local governments in the name of economic recovery.

Prominent Businessmen

Two bill introduced in Congress this year [1980] would resurrect the RFC. Three prominent businessmen have recently advocated the creation of a similar agency. Henry Kaufman, an economist with the Wall Street brokerage firm of Salomon Brothers, has proposed a National Commission for the Revitalization of America. Frank A. Weil, a former Wall Street investment banker (now a Washington, D.C., attorney) proposes a government agency to anticipate problems rather than apply ad hoc remedies, as was done in the Chrysler case. And since 1974 Felix Rohatyn has openly called for recreation of the RFC. Rohatyn, perhaps the most prominent of these men, is a partner in the investment-banking firm of Lazard Freres and chairman of the Municipal Assistance Corporation, which overseas and floats bonds for the New York City bailout.

Rohatyn, an adviser to independent presidential candidate John B.Anderson before endorsing President Carter has bemoaned the American people's loss of confidence in their government:

No matter how much technical jargon we hear from economists and monetarists, we have to begin with the notion that people must believe their leaders know what they are doing and where they are going. In the United States today, this is clearly not the case. Alone among the leaders of the West, the United States seems unable to govern itself, and a visit to Paris or Bonn or Tokyo brings home the most startling difference; there, governments do seem to govern. There are direct links between the identification of a problem, a recommendation for action, and public debate, which are followed by a decision and implementation.

His recommendations for restoring the lost confidence, in addition to a temporary wage-price freeze, a 50-cent-a-gallon gasoline-tax hike, and limits on free trade, include a new RFC "to provide a safety net for certain industries, financial institutions, and municipalities in serious difficulties." Like all such nets, Rohatyn writes, "it should be initiated before, not after, further disasters."

Other corporate leaders and financiers have joined the chorus for a new RFC, including Henry Ford; William McChesney Martin, former chairman of the Federal Reserve Board; and Gustave Levy, senior partner of Goldman Sachs.

In September President Carter showed signs of adopting Rohatyn's suggestion. In his fifth (some say seventh) economic renewal program, Carter announced that he intended to create an agency that sounded similar to the RFC: the Economic Revitalization Board, which would set up an "industrial development authority" to channel tax revenues and private capital into economically troubled areas. Before that, when Carter announced an aid program for the auto industry, White House domestic affairs adviser Stuart E. Eizenstat said, "We consider this the first step of a national industrial policy."

Despite this enthusiasm for a new RFC, however, few have looked back at the original to assess its intentions, activities, and record. Such a retrospective survey may provide a clue to what to expect from a new RFC.

Hoover's Creation

The RFC was signed into law by President Herbert Hoover on 22 January 1932. The standard (and erroneous) view of the depression era is that government activism began after Hoover's term. Popular myth has it that Hoover, the last defender of laissez-faire capitalism, refused to act when the stock market crashed and plunged the nation into poverty. It took Franklin Roosevelt's election in 1932, this version has it, to get the government to end the economic debacle caused by free market.

As are so many "facts" about American history taught in government schools, this one too is apocryphal. Major corporate leaders had been prointervention since before the Progressive Era, and they found Herbert Hoover sympathetic. The New Deal, far from being revolutionary, was instead a continuation and expansion of Hoover's interventionist programs.

Both contemporary liberal and conservative analyses are too feeble to grasp what happened during the Great Depression. Liberals tend to believe that the business class was displaced by "the people" under FDR's leadership, conservatives that Roosevelt's "anti-business" regime brought socialism to America. Neither view is correct, which Rohatyn seems to understand. He writes, "The economic road that I would travel is more interventionist than the conservative dogma but also more business-oriented than liberals would like." He is a true descendant of the businessmen who helped erect the corporate state.

The RFC fits neatly into a chain of events that stretches back to the government industrial-planning agencies of World War I. The first RFC chairman, and the person who suggested to Hoover the idea of the RFC, was Eugene Meyer Jr., former managing director of the War Finance Corporation. Hoover's first choice for chairman was Bernard Baruch, the financier who headed the War Industries Board, and the influence of such businessmen and financial moguls dominated the RFC, as we shall see.

In late 1931 when Hoover called on Congress to create the RFC, he recommended that it should operate for only two years, but, like so many other government programs, it led a prolonged life. The RFC operated until 1953, when its authority was transferred to the new Small Business Administration. On signing the bill Hoover promised, "It is not created for the aid of big businesses or big banks. Such institutions can take care of themselves. It is created for the support of the smaller banks and financial institutions. . . ." We'll shortly see whether or not this pledge was fulfilled.

In the words of the RFC's second chairman, Jesse H. Jones, a Texas Democrat, banker, and businessman, the agency "loaned and spent, invested and gave away a total of more then $35 billion and authorized many billions more that were not finally used." The RFC thereby became America's largest corporation and the world's biggest and most varied banking organization, with almost unlimited authority to spend money. Jones boasted that the RFC used about $10.5 billion "without loss to the taxpayers" Indeed, he writes, a $500 million profit was returned to the Treasury.

During World War II the RFC became an agent of the military effort, disbursing some $22.4 billion. Jones writes that $9.3 billion of this was "unrecoverable" because after the war Congress authorized the Treasury to cancel some RFC notes.

Jones proudly recounts that although 5,000 banks failed during the depression, 7,000 were saved by the $4 billion RFC investment. With the market for mortgages frozen, the RFC jumped in and created the RFC Mortgage Co. and the Federal National Mortgage Association [Fannie Mae], which disbursed some $500 million from the RFC.

A billion dollars' worth of RFC help couldn't save one-third of the nation's railway mileage from going into receivership or bankruptcy, Jones writes, but another one-third would have gone under without help. To push up plummeting agricultural prices, the RFC lent $1.5 billion to farmers, most of which was repaid. To fulfill its public-works mandate, in 1932 alone the RFC authorized $147 million in cash and loan guarantees.

In mid-1932, Congress enabled the RFC to expand its services to include business and industry. Four years later, it had made 9,000 loans totaling $500 million. At its peak in 1934, RFC personnel numbered 12,000. As late as June 1949 it had 4,600 employees.

Secrecy and Big Business

The first several months of the RFC's operations were shrouded in secrecy. Neither Congress nor the public was permitted to know who was borrowing the money. The rationalization was that its customers' confidence in a particular bank would collapse if they knew that the bank was getting help. In July 1932 Congress amended the law and required the RFC to make public reports. In its months of secret operation, the RFC had lent of $1 billion, 80 percent of which went to banks and railroads. By the end of the year, the percentage had declined only slightly.

In a January 1933 investigative article, journalist John T. Flynn demonstrated that much of the RFC's largess was going to big banks and railroads, despite Hoover's promise. According to Flynn, the RFC lent the Bank of America $65 million, and of the $264 million lent to railroads, $156 million went to lines controlled by the Morgans, Van Swerigens, and the Pennsylvania Railroad. Murray N. Rothbard notes that of $187 million in 1932 loans that had been traced, $150 million went to repay debts held by a few banking firms, notably J. P. Morgan and Co. and Kuhn, Loeb and Co. Interestingly, Meyer's brother-in-law, George Blumenthal, was a member of the House of Morgan, and Meyer himself had served as liaison between Morgan and French government.

Flynn was mindful of the ironic connection between big bankers and the agency supposedly devoted to recovery: "Is it not worth a passing thought that almost all of the banks which had to seek help were under the domination of these political financiers who clustered round the throne and who coyly admit that they are the architects of the prosperity?"

The connection was fully acknowledged by Jesse Jones. In his book about the RFC he notes that in 1934 humorist Will Rogers attended a U.S. Chamber of Commerce dinner along with many major corporate leaders. Rogers noted in his newspaper column that the chamber's ostensible purpose was to keep government out of business. Yet, "as each [big businessman] stood up, Jesse [Jones] would write on the back of the menu card just what he had loaned him from the RFC. . . ."

Secrecy and big-business connections were not the only controversies surrounding the RFC. Charges of favoritism were also leveled against the agency. In June 1932, three weeks after resignation of RFC president Charles G. Dawes (who had been vice-president to Calvin Coolidge), the Central Republic Bank in Chicago, of which he was "honorary chairman," got a $90 million loan. (Its total deposits were only $95 million.) Union Trust Co. of Cleveland, whose board chairman was treasurer of the Republican National Committee, got a $14 million loan. The Guardian Trust Co. of Cleveland, a director of which was Dawes's successor, Atlee Pomerene, got $12.3 million. The Baltimore

Trust Co., whose vice-chairman was a Republican senator, got $7.4 million. The Union Guardian Trust Co. of Detroit, a director of which was Commerce Secretary Roy D. Chapin, got $13 million. In July 1932 Congress amended the law to forbid loans to any bank that had a director or officer on the RFC board.

Immense Power

Jones boasted that as RFC chairman he had immense power, but not everyone was as pleased by his power as he was. In fact, there was concern that the RFC had achieved an immunity from popular sovereignty that was inappropriate in a republic. For example, in 1943 Congress learned that the Board of Economic Welfare, set up in 1941 to enable Vice President Henry A. Wallace to stockpile strategic materials, had spent $1.5 billion, although Congress had appropriated only $12 million for administrative expenses. Jones, who by then was commerce secretary and federal loan administrator, told Congress that the money had been appropriated by the RFC, which had borrowed it from the Treasury at 1 percent. As it turned out, the RFC had appropriated some $34 billion to various bureaus in the same way.

The RFC lasted about twenty years longer than Hoover envisioned, and some of its offspring live on to this day. Aside from the Federal National Mortgage Association, the RFC also created the Export-Import Bank, initially to induce trade with the Soviet Union (a failure) and later to assist the Allies in the war.

Did the RFC contribute to ending the depression? Jones asserts that by the fall of 1939 the county was out of the depression and that recovery would have been delayed "but for the billions pumped into the bloodstream of our economy by the RFC." Yet unemployment stood at 9 million in 1939 and returned to its 1932 level until the United States entered the war.

Jones conspicuously neglects the question of where the billions came from. He assumes that had the RFC not used the money, it would have gone to waste. Clearly, the money came from the taxpayers. In 1932 Hoover signed one of the largest peacetime tax increases ever. All kinds of taxes were raised, including both personal and corporate income taxes and the estate tax. When capital is unusually short, a tax hike is especially inopportune.

The argument that the depression would have been worse if the billions had not been diverted from other uses is reminiscent of the story about the dog owner whose veterinarian accidentally gave the dog a stimulant instead of a tranquilizer. After the dog's violent rampage, the owner called the vet to thank him. "Think how much worse it would have been had you not given my dog the tranquilizer," the owner said.

Restored Confidence

One of the arguments for the RFC is that it maintained or restored confidence in banks and other institutions. But this [raises] the question: Should confidence in a failed banking system have been restored? Realizing that the depression was a period of readjustment after a period of malinvestment, Flynn wrote of the failing railroads, "The quicker the correction comes, the quicker the regeneration . . . will come. . . . Any attempt . . . to save weaker debtors necessarily prolongs the depression."

This observation gets at the crux of economic case against any affirmative government action in a depression. Such action necessarily impedes the readjustment to economic reality required by the artificial boom caused by monetary expansion. The RFC epitomizes the backward policies of Hoover and Roosevelt's New Deal, policies that deliberately set up obstacles to the market process.

Thus the historical case for a new RFC is not persuasive. Favoritism, political jockeying, and all the unintended consequences of power are inescapable features of government solutions. There is no reason to believe that a new RFC would be any different. The behavior of a political agency is not accidental. It is a result of its nature. An agency with billions to lend (and no profit-loss test) must select its borrowers some way; it must rely one someone's judgment. It will tend to rely on prominent bankers and brokers whose professional expertise is in finance.

Political Standards

Such an agency cannot lend money to everyone. What will be its standard of selectivity? In all probability, it will be prohibited from using the standard that private investors use. They look for actual or potential profit, which is a sign that consumers are being (or will be) satisfied. But a new RFC won't be able to do that. Its purpose will be to lend to those who cannot find private funds. A pending House bill that would create an RFC-type agency mandates that it lend only to borrowers who "have presented evidence that they are unable to obtain funds on reasonable terms from any other source. . . ."

There are only two reasons why a borrower can't get funds in the market: Either he is deemed unworthy of credit or his project is deemed unprofitable. Thus, a new RFC will be required by law to divert capital from those who can serve consumers well to those who can't. Rohatyn's belief that such an agency can be put on a sound banking basis has no validity because, by definition, the agency will exist to make unsound investments.

Since government agencies cannot use market criteria, they will use political criteria instead. Note that in the last twelve months, only Chrysler was bailed out, although as many people as Chrysler employs have their jobs threatened each year by business failures. What, but politics, explains that selectivity?

The whole of economic theory condemns the RFC's rationale, revealing it as a package of myths. First, there is the "no cost" myth, according to which if government loans or loan guarantees are repaid, the taxpayers have suffered no loss. This is the classic fallacy of accounting for only the visible effects of a policy. If $1 billion is lent to a firm from the Treasury or if $1 billion is lent privately because government guaranteed the loan, that is $1 billion less that is available for consumer-oriented investment. The lost goods, jobs, etc., are real, yet unmeasurable, costs. That the loan is repaid later, even with interest, does not make up the loss. The government must get the money from somewhere; that is the starting point of a loss that ripples throughout the economy.

The goods produced by the politically connected borrower don't represent gains to consumers. They had other preferences; otherwise the borrower would have been able to get capital without government intervention.

This illuminates the next objection to government "reindustrialization." It will necessarily transform the economic system from demand economy to a command economy. A business fails because consumers reject it. When the government props up failures, it overrules consumers. What they refused to do voluntarily, they will be forced to do as captive taxpayers. The result is a skewing of the economy away from consumers' purposes toward the objectives of bureaucrats and spokesmen for business and labor.

Capital Shortage

The most fallacious argument for an RFC is that it can provide capital when there is a shortage of capital. Obviously, the government has no capital of its own. The most it can do is redirect private capital and in the process take a handsome cut. So although the government is no solution, it can be the problem: Government policies absorb capital and bring on the very shortage it complains about. These policies include monetary expansion, taxes on income and capital gains, and cost-raising regulations. Relieving the capital shortage requires the removal of obstacles to capital accumulation, not the rearrangement of existing capital.

The most compelling argument against reindustrialization, however, is ethical. Its purpose is to be forcibly interfere with people's peaceful pursuit of their well-being, and its purpose is what indicts it. Private goals will be subordinated to "national objectives" chosen by distant rulers. Entrepreneurs whose plans don't conform to the policies would be prohibited from "wasting" scarce resources. In the national interest, all will be ordered to get in line and march.

America doesn't need an RFC or industrial policy. It needs more of what was responsible for its initial economic progress; individual liberty, respect for private property, and recognition of the rights of all.