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Volume Title: Federal Lending: Its Growth and Impact

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Volume Publisher: NBER

Volume ISBN: 0-87014-372-7

Volume URL: http://www.nber.org/books/saul57-1

Publication Date: 1957

Chapter Title: Effects on Allocation of Resources

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Chapter URL: http://www.nber.org/chapters/c2721

Chapter pages in book: (p. 40 - 44)

tion of guarantees of defense loans, and by roughly the same amount that Reserve bank credit increased. There was a sharp contrast between the reduction in the net advances of central banking credit in 1945–46 and 1948–49, in an effort to curb price inflation, and the large annual increases in federal loans and loan insurance outstanding. Since 1949 the two series have followed quite similar courses.

Thus, on the whole, the movements of federal loan and loan insurance policy were even less well correlated with monetary than with fiscal policy. Such a divergence might be defensible under some circumstances, of course, but the record reveals defects in federal monetary policies as well as inadequacies in the management of the lending and loan insurance programs, from the standpoint of economic stability.

In short, comparisons (1) between federal credit activities and fiscal and central banking activities, and (2) between all of these federal financial operations and business cycle behavior give a checkered result. The principal generalization that appears warranted by the investigations is that diversity of movement and lack of counter-cyclical coordination have characterized federal financial operations in the past.

One characteristic of federal credit programs has been that, once set in motion, they tended, in the aggregate, to expand, regardless of general economic conditions. Aggregate federal loans and loan insurance continued to rise through the late thirties and early forties during economic recession and expansion alike. The most important unstabilizing effects were experienced during the post-World War II boom, when, largely as a result of federal insurance and guarantee of home mortgage loans, federal credit operations worked counter to federal fiscal and monetary policies. The authors give this explanation:

". . . Aggregate federal credit is a mosaic of many pieces: each particular program has been designed to accomplish some special purpose and has been managed with that end in view, often without regard to its effects on over-all economic stability. Yet in the aggregate the programs have at times exerted a profound influence on prices and production."

Effects on Allocation of Resources

Because of the many other, and more important influences at work, the effect exerted by federal credit programs on the allocation of resources is subtle and difficult to trace. Still, the investigators were able to identify certain changes in employment and output, prices, incomes and financial position of producers, and regional shifts in economic activity, which seem attributable to the operations of the federal credit programs.

In *agriculture,* by increasing the supply of credit and reducing its costs, federal credit programs probably maintained a larger allocation of resources to farms than would otherwise have occurred. The consequent increase in the supply of agricultural products may have reduced somewhat the percentage of national income received by farmers when, as in the 1930's, demand was not active. The chief effects of federal credit programs on increasing farm output probably occurred through the expansion in Land Bank lending in 1934–35, and through the later expansion in production credit and rural electrification, especially in the post-World War II period.

The Land Bank program introduced and encouraged long-term amortized mortgage lending at relatively low interest rates, and helped to protect farmer ownership by the large-scale refinancing program of 1934 and 1935. Most of the funds lent by the Farm Security Administration and the Farmers Home Administration were used for purchasing farms, and in later years for farm enlargement and improvement. The biggest part of these funds went to southern states. Among the borrowers under the Farmers Home Administration program, it was found that increases in output, income, and net worth were greater than the national averages for farmers.

Production and subsistence loans, or rehabilitation loans, represented the greatest part of the Farmers Home Administration program, and no doubt have had important effects on the income and bargaining position of the borrowing farmers. These loans were intended to help low-income farmers build up their productive assets and living necessities so that labor and management skills could be used more effectively. Evidence indicates considerable success in enabling such borrowers eventually to qualify for private credit.

Provision through the REA program of central-station electric power has facilitated the technological revolution in agriculture, extending the base for the profitable employment of borrowed funds, and thus indirectly affecting farm output. The southern and midwestern areas received the major part of the REA credit granted.

Farm credit aids have brought about a greater uniformity of credit costs, and thus may have shifted resources to regions where costs of private credit have been highest and bankruptcies most frequent – the Old South and the Great Plains.

In *business,* federal credit has played so small a role (compared to private financing) that it probably has not had much direct effect on aggregate employment and production. Through 1941 the ratio of federal business credit to total corporate debt never rose much above 1 per cent.

At its highest, in 1943 and 1949, it was only 3 per cent. A mild upward trend can, however, be observed.

It seems likely that federal credit aids to agriculture and housing have had more influence, indirectly, on business markets and employment than have the programs directly serving business.

For financial institutions, loans of government agencies were more important from 1932 to 1940 than their borrowing from private sources. However, by 1950 this public debt had been retired, except for some $800 million outstanding to savings and loan associations. Public holdings of stocks and shares of banks, trust companies, insurance companies, and other financial institutions were considerable in the late thirties and early forties, but by 1953 this investment had also largely been retired.

The authors conclude that, in the aggregate, "federal credit to business has not been large enough to exert important over-all effects on employment and production, on the formation of new enterprises, on the size of the business population, or on the average asset-and-liability structure of American enterprise; and effect of governmental influence on the stability of the supply of business credit has been through aid to lending institutions rather than to business directly."

But federal lending programs *have* had a selective effect on the allocation of economic resources through aid to particular types of business concerns.

First, federal agencies provided significant assistance to a few established industries considered essential to national security – i.e. railroad transportation, ocean shipping, foreign trade. Second, federal help has been used to stimulate investment in new firms and new industries. The RFC made many loans to firms in relatively unfamiliar lines that were unable to obtain private credit because the risks could not be gauged. Examples are loans to motels, fresh-frozen food canning and packing firms, petro-chemical firms, and food locker enterprises.

Newly established and very small firms have been assisted through VA guarantees of private loans, and through financing by the RFC, the Federal Reserve Banks, and the Smaller War Plants Corporation. Commercial banks usually consider such loans too risky, but federal credit aid to such enterprises has loosened up the private credit market by helping to familiarize commercial banks with this type of lending operation.

Third, federal agencies have carried on "marginal" financing of firms which were financially weak but appeared to have reasonable prospects of success, and of firms whose rapid growth had outstripped their financial resources. Marginal financing was provided by Federal Reserve Bank loans, by RFC, and in many cases by the guarantees of war production loans made by the War and Navy Departments and by the U.S. Maritime Commission.

The principal objective of federal *housing* credit programs since 1934 has been to increase the volume of construction. How successful has this effort been?

To get at the answer, three important ways in which federal loan insurance may stimulate construction were considered:

1. Loan insurance can increase the willingness of builders to invest by reducing the equity required and by raising their expectations as to the salability of the final product;
2. Loan insurance should increase the willingness of lenders to invest in mortgages, other things being equal.
3. Loan insurance can widen the financing market and help reduce down payments and carrying charges.

Two important periods were examined critically: the years immediately after the enactment of the National Housing Act in 1934, when a determined effort was made to revive the construction industry through credit programs, and the years following World War II, when a no less determined effort was made to increase construction by the provision of liberal mortgage credit.

The weight of evidence is that in the thirties neither the loan insurance program for home modernization and repair nor the home mortgage insurance program played an initiating role in the recovery in construction expenditures. Both, however, contributed to an increase in construction activity once recovery was under way – in the first case, modestly; in the second, to an unknown degree.

After World War II, liberal credit terms were made available to home buyers through FHA and VA home mortgage insurance, and Federal National Mortgage Association purchases of home mortgages from private lenders. The question whether these liberal terms produced a higher level of housing output than would otherwise have been achieved is complex. A comparison of the home building booms that followed World Wars I and II – after allowance for changes in population and rates of family formation – strongly suggests that residential construction was actually *less* after World War II than would have been expected on the basis of post-World War I experience.

The primary effect of the credit liberalization program in this period was apparently to be found in construction costs and housing prices. After the war, construction costs rose significantly more than costs of other types of output; and rose more for home construction than for commercial and factory construction. The main cause lay in more rapid increases in prices of building materials, particularly of lumber, than of semi-manufactured goods generally. The result was that the prices of houses increased more rapidly than the prices of consumer goods generally, and certainly of consumer durable goods. Thus, a considerable part of the impact of the federal housing credit programs after 1946 was raising the costs of residential construction and the prices of homes above what would otherwise have prevailed.

Some other effects of federal credit aids to housing from the thirties to the fifties were: promotion of a decrease in the average size of homes and in the number of rooms per home, a trend in keeping with urbanization and the decline in average family size up to World War II; second, stimulation of multi-unit projects developed on a cooperative ownership basis; and third, increases in the scale of operation of home building enterprises, which raised production efficiency.

Effects on Credit Markets and Lending Practices

Federal credit aids have modified the markets, practices, and economic functions of the private financial system in profound and enduring ways. Indeed, it seems probable that the institutional effects of federal credit programs have been more important than their effect either on aggregate economic activity or on allocation of resources.

In *agriculture,* federal credit aids lengthened maturities, liberalized terms of credit, and tended to increase the size of the average farm mortgage loan. They also worked toward greater uniformity in both mortgage and production credit costs throughout the nation, bringing the largest relative reductions in the costs of farm credit in the South and West. Federal Land Banks functioned as leaders in farm mortgage markets, setting terms and conditions that private lenders were compelled to meet if they were to retain their positions in the market. To a lesser degree, the production credit associations have likewise been aggressive market leaders in the field of production credit, encroaching upon the markets formerly served exclusively by nongovernmental lenders. In part, commercial banks and life insurance companies have yielded market position to the publicly sponsored agencies; in part, however, they have met the increasingly liberal terms with loans carrying lower interest charges and longer maturities. These effects of federal lending on farm credit markets occurred mainly during a long period of decline in the structure of interest