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PUBLIC AFFAIRS PAMPHLETS

DEBTS— GOOD OR BAD?

BY MAXWELL S. STEWART

Did debts cause the depression?
How did our debt structure weather the crisis?
Are bonds sounder investments than stocks?
How can we ease the debt burden without injury to business?

PUBLIC AFFAIRS PAMPHLETS
No. 36 1939

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DEBTS— GOOD OR BAD?

By MAXWELL S. STEWART



IN a war boom, talk of debt tends to be overshadowed by discussion of speculative profits in the "war babies." But during the depression there were times when debt became one of the primary issues of the day. It was a headache for both debtors and creditors. In some places, the farmers organized to resist the sheriff when he sought to take over farms for non-payment of mortgages. In others, they bid a nickel or a dime for a horse at an auction following a foreclosure, buying up all the victim's property for a few dollars and returning it to him. In the cities, groups of neighbors formed to aid families evicted from their homes by carrying back the household goods which the police had dumped in the street.

For these people debt was more than a personal misfortune. It symbolized a social injustice. They struck out blindly against this injustice by taking the law into their own hands. But they did not solve the problem. Foreclosures and evictions

This pamphlet is based on *Debts and Recovery, A Study of Changes in the Internal Debt Structure from 1929 to 1937*, by Albert Gailord Hart and the Committee on Debt Adjustment, The Twentieth Century Fund, 1938.

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continued throughout the depression and for many years afterwards. Protests meant very little because the problem had two sides—the side of the one who owed the money and the side of the person to whom the money was owed. Thousands of elderly people had put their life-time savings into mortgages, and lost everything in the crisis. Both sides suffered from circumstances that were beyond their control. The problem of debt, particularly in times of economic change and violent price readjustment, is one of the most complex and difficult of our times. It is no wonder that we hate to think about it.

WHY WE HAVE DEBTS

YET it is a mistake to think of debts as something wholly bad. They are really quite useful—so useful that we couldn't very well get along without them. For a debt is nothing more than a promise to pay a certain amount of money at a given time. Or, the arrangement may involve a promise to pay in instalments. It is safe to say that if we didn't have debts, we should soon invent them. They serve three important purposes: (1) They provide a way of paying for the things we want when we can't pay in cash; (2) they enable an investor to put capital into a business without taking the risks of ownership; and (3) they are useful to the lender as a means of investing money saved for a "rainy day."

Debt as a Means of Payment

As a matter of fact, we seldom pay spot cash for the things we want. Employers do not pay their workers every day, or as soon as each job is completed. They owe the wages until the regular payday, which may come only once a month. Millions of Americans have charge accounts at department stores. They often ask their grocer to keep their account "on the cuff" until payday. Business houses rarely pay cash. They enter the accounts on their books, settling after a few days or weeks. Even then payments are not made in hard money. Sometimes debts are cancelled against debts—as for example

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between stockbrokers or banks. Usually they are settled by check—which is another form of debt. For a check is only a claim against a bank. It is worth something because the bank really owes the depositor money.

Debt as a Means of Investment

You would find it hard to invest your savings if debts hadn't been invented. Of course, it is always possible to go in business for yourself, to buy a house, or to buy stock. But in such cases you have no idea how much you can get back if you want your money in a hurry. And you may not want to share the responsibility of ownership. From the point of view of a business concern, borrowing is also convenient. It provides a way of obtaining more capital than could otherwise be found. And it does so without the necessity for yielding control to those who furnish the additional money.

Debt as a "Liquid" Asset

To the holder, a sound debt may be as good as cash and even more convenient. A checking account in a bank, for example, is ordinarily as good as currency. Government bonds are as good but not quite so convenient. Most bonds can be readily sold and turned into cash, provided the company behind them is financially sound. Such investments are not only reasonably "liquid," but they pay interest. They play an important part in our financial system.

WHEN DEBTS GO WRONG

ALTHOUGH debts are necessary, they can raise hob within our economic structure. This is particularly true in a depression. When a man borrows money, his ability to carry the debt depends on his income. If his income is cut, he may find that he can't pay regardless of good intentions. In a severe depression nearly everyone's income is cut, while debts remain unchanged.

Debts also create havoc in a boom, such as that which

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occurred in the last war. As prices rise, the debts created at a lower price level are easy to pay. And because they seem so easy to pay off, people go further into debt without much thought, creating a problem for the future.

It so happens that debts are one of the least flexible elements in our financial structure. Prices rise and fall; wages are increased or cut; but debts can be changed only with great difficulty. In a depression the mere paying of interest may take a very large share of our total national income. This frequently causes discontent and social unrest. It also creates a very real economic problem.

Debts and Property Values

Nearly all private debts are backed by a claim against the debtor's property. When we count up the total of all our debts we find that they come to the huge figure of two hundred and fifty billion dollars. Our total national wealth before the depression was only three hundred and sixty billion dollars. When we compare these figures, realizing that our national wealth fell sharply during the depression, it is easy to conclude the burden of debt is too great to be borne by the property on which it is based.

This, however, is being a little too hasty. Much of the "property" on which debts are secured is itself debt. The money owed by banks and life insurance companies, for example, is protected by the money owed to these institutions in the form of bonds owned by them. Business firms usually have about the same amount of money owed to them as they owe to others. A very large part of this debt structure weathered the depression. The chief difficulties were met with special types of debt, such as mortgages and loans secured by stocks, where the value of the property held as security declined very drastically so as to leave the debts without backing.

The Myth of Debt Maturities

Most debts, as we have seen, are contracts for payment on demand or at a scheduled time. But these contracts are not

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meant to be taken literally. Few persons intend to repay on the date set, and fewer yet are able to do so. In fact, the person who lends the money does not ordinarily want to be repaid right away. He looks on the debt as an investment, and as long as he feels sure that he will ultimately get his money he prefers not to be repaid immediately. He is like the bank depositor who asked if his money was really in the bank "because if it isn't I want to take it out, but if it is I don't want it."

Perhaps it is just as well that people do not try to pay off their debts too promptly. Our economic system is so put together that any sudden or general scramble to get out of debt would be a great calamity. If all the banks tried to pay off their debts, for instance, we should be short of what we now use as money. Prices would drop and the country would be thrown into a panic. Much the same thing would happen if any large group of debtors attempted to pay off their debts at one time. There would be a scramble for cash that would upset the whole economic system. Debts present no problem in normal times when the number of persons seeking to collect the money owed them is no greater than the number trying to lend money. But in a panic, when everyone is seeking to collect at once, the time schedule on the debts may present a very serious problem. Just what these problems are, in concrete terms, may be seen from a study of the effect of the depression on debts recently concluded by the Twentieth Century Fund. The following summarizes its findings.

DEBT IN THE DEPRESSION

WHEN the economic cyclone struck us in 1929, we had, as we said, more than two hundred and fifty billion dollars of debts in the United States. This includes all kinds of debts. Corporations owed some forty-seven billions on bonds; the federal, state, and local governments owed thirty-two billions; mortgages on farm and city real estate amounted to forty billions. Life insurance companies owed their policy holders some twelve billions; commercial banks were in debt to their de-

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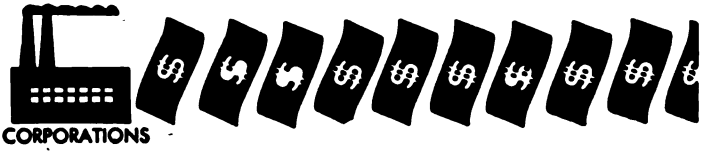
DEBTS OF CREDIT INSTITUTIONS IN THE U. S. IN 1929



CORPORATIONS



FEDERAL, STATE & LOCAL GOV'TS



MORTGAGES ON FARM & CITY REAL ESTATE



LIFE INSURANCE COMPANIES



COMMERCIAL BANKS



SAVINGS BANKS, BUILDING & LOAN ASS'NS.



SHORT TERM DEBT OWED BANKS & CORPORATIONS

Each symbol represents 5 billion dollars owed

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positors forty-seven billions, while savings banks and building and loan associations owed an additional fourteen billions. The total short-term debt owed to banks and corporations came to fifty-three billions.

We call all of these "debts," as indeed they are, but the depression affected these different kinds of debts in very dissimilar ways. If we are to understand exactly what happened, we shall have to deal with each separately in some detail. When we get through, we may realize what a difficult problem we are up against.

Banks and Similar Institutions

Let us look at the banks first. The bank is the kingpin in the debt structure. Roughly two-thirds of all America's debts are either owed to banks and other credit institutions, or are owed by them. More than half of these debts are held by ordinary, or commercial, banks. Next most important of the credit agencies are the life insurance companies. They owed over twenty billion dollars in 1937, eight billion more than in 1929. Third in importance are the mutual savings banks with debts of about ten billions. The building and loan associations owed their members about four and a half billions. The other private credit agencies were considerably smaller, but faced much the same problems in the depression years.

Recent years have seen the growth of a number of credit agencies clustered around the federal government. Among the more important of these are the Reconstruction Finance Corporation, the Federal Land Banks, the Federal Farm Mortgage Corporation, the Home Owners' Loan Corporation and the Federal Home Loan Banks. These agencies owed nearly six billion dollars in 1937, and were owed nearly eight billions.

The Bank "Holiday"

Few persons have forgotten the bank "holiday" of 1933 when every bank in the country was closed. This was the most dramatic episode of the depression as it affected banks and

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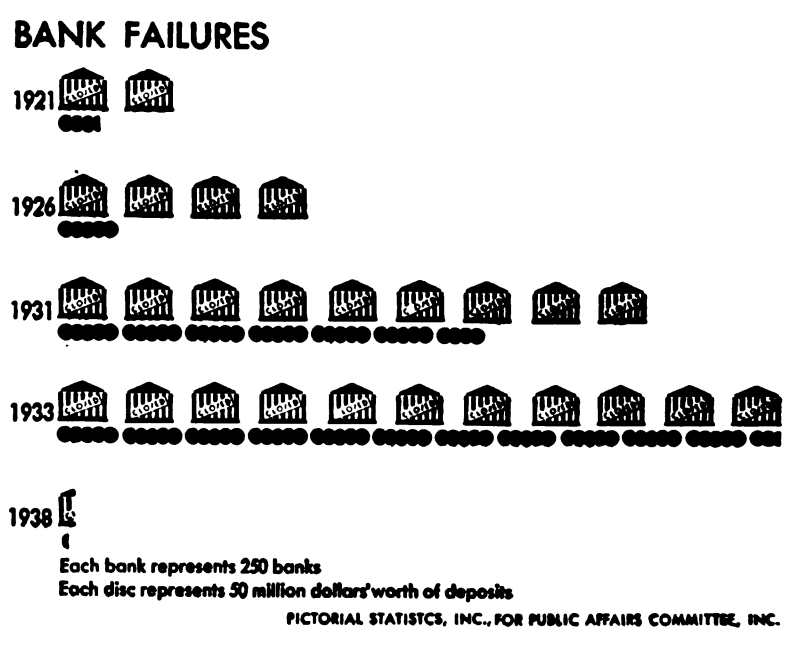

other credit institutions, but the banks' difficulties started long before 1933 and continued long after that immediate crisis was settled. In the years 1923-1929, banks were failing at the rate of seven hundred a year. Between June, 1929, and June, 1933, the total deposits in our commercial banks dropped more than one-third. This huge decline was partly the result of bank failures, but was mainly due to a drop in their loans and investments. During these years the banks collected about ten billion dollars more than they lent. Since the money they collected had been practically all deposited in someone's bank account, the total deposits of the banks dropped with each debt collected. Besides the ten-billion-dollar shrinkage in deposits resulting from the collection of loans, there was a net shrinkage of four to five billions from bank failures.

Between the middle of 1933 and the beginning of 1937, the tide reversed. Bank deposits jumped from $26,800,000,000 to $41,000,000,000. New loans and investments were from

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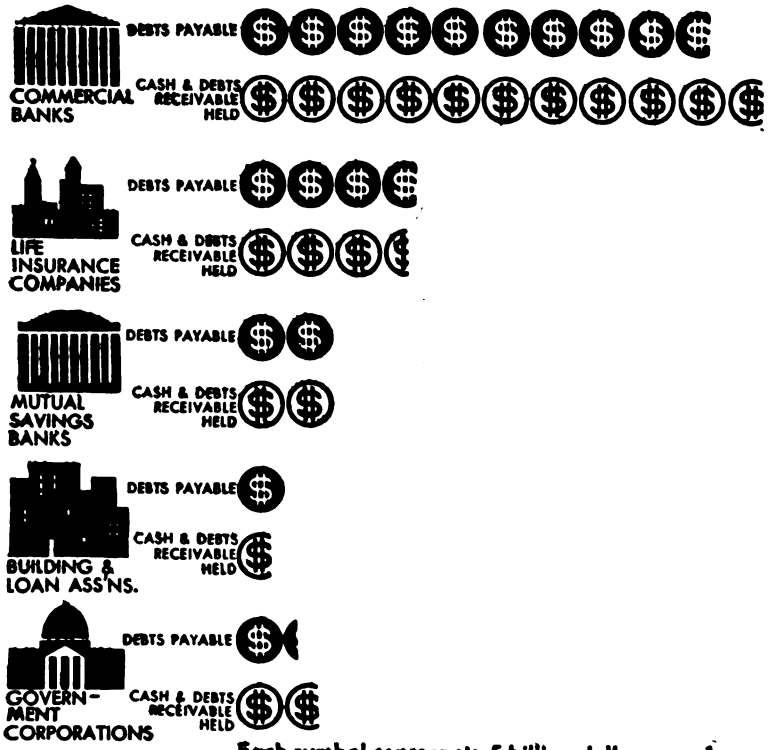
five to six billion dollars greater than repayments, while the settling up process of the closed banks released from three and a half to five billions more.

During the depression business became a creditor rather than a debtor in relation to the banks. In 1929 business owed the banks some twelve and a half billions more than it had on deposit; in 1933 its net debt was only four and a half billions. And by 1936 business had two billions more on deposit than it owed the banks. This situation continued through 1937. The banks owed money, on balance, to individuals in

IMPORTANT CREDIT INSTITUTIONS, 1936



Each symbol represents 5 billion dollars owed

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1929. Their debt was even larger in 1936, as a result of a sharp reduction in loans to individuals. The money which the banks owe business and individuals has been invested in recent years in government bonds. The government has taken the place of business as the banks' chief debtor. In 1929 only 14 per cent of the assets of the banks were invested in government securities. The proportion was 46 per cent in 1937.

Building and Loan Associations

Building and Loan Associations were perhaps the hardest hit of any credit agency during the depression. Over 90 per cent of their mortgages were on homes. During the prosperous 20's, they had enjoyed an exceptionally rapid growth. Between 1923 and 1929, membership in these associations doubled, while their total assets rose from $3,343,000,000 to $8,695,000,000—an increase of 160 per cent. Less than one-sixth of 1 per cent of the associations in existence failed during this period. This was a considerably better record than that made by the commercial banks during the same years. But beginning with 1929 trouble began. Members began withdrawing their money either out of fright or because they needed it. Real estate prices turned downward. Although an average of only 18 associations had failed a year in the period 1923-1928, there were 159 failures in 1929. The next year 190 associations went to the wall, followed by 126 in 1931 and 122 in 1932. The remainder were forced to pay off their members rapidly, and to foreclose on a considerable amount of property. From a high point of $8,800,000,000, the amount of assets fell rapidly each year, dropping to $6,400,000,000 in 1935 and $5,688,000,000 in 1936. And no longer was the money invested almost entirely in home mortgages. About one-quarter of their assets consisted of homes and real estate taken over from the owner by foreclosure. It was not until 1937 that the steady toboggan of the associations ended. In that year, for the first time since 1930, they were up slightly.

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Mutual Savings Banks

The mutual savings banks, which are found mainly in New England and the Middle Atlantic states, came through the depression in much better shape. This was largely due to good management. Their record before the crash was exceptionally good. In the ten years from 1919 to 1928 only four mutuals were suspended with a total loss of but $250,000. During the depression fifteen others closed their doors with a total loss of $19,000,000. These losses were trifling compared with their nine or ten billions in deposits.

It was not until the final stages of the banking crisis of 1932-1933 that the savings banks began to feel the pinch. During the final days of February and the first days of March, 1933, they suffered fairly heavy withdrawals. They were closed along with everything else during the bank "holiday." But they were quickly reopened and were operating normally by the end of 1933. Although interest rates have been greatly lowered and many banks have taken steps to limit the amount which can be deposited in any one month, they have continued to grow. In 1937, when the deposits of ordinary banks were shrinking, the savings banks continued to grow. Their deposits reached new high levels in 1938 and 1939.

Life Insurance Companies

Least hit by the depression were the great life insurance companies. They continued to grow during the first year of the crisis at almost exactly the same rate that they had grown throughout the '20's. In 1931 the growth was slower; in 1932 there was a shrinkage in their obligations, but an extremely small one. Business was up again in 1933 and has continued to grow steadily ever since. Like the savings banks, the insurance companies profited by the difficulties of the commercial banks and the building and loan associations.

They did not, however, completely escape difficulties. From the autumn of 1931 through March of 1933, many persons withdrew their money from the companies either by sur-

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rendering their policies or borrowing heavily against them. During 1932 these withdrawals were very nearly large enough to balance the usual excess of income over expenses and death payments. At the time of the bank holiday the demand for cash was so great that state insurance authorities temporarily stopped withdrawals. This was particularly necessary since the cash funds of the companies were tied up in the banks. The restrictions were quickly withdrawn, however, and by September, 1933, the situation was fully normal.

Life insurance companies have also been affected by mortgage difficulties, but their losses have been relatively small. Exact figures are lacking on the amount of real estate that has been taken over and sold, but it is known to have been considerable. The total amount of mortgages in their hands declined from a high of seven and a half billion dollars in 1931 to five billion in 1937. As in the case of the banks, this loss was more than made up by sharp increase in investment in government bonds. Although the earnings of the companies have dropped as a result of relatively low rates of interest paid by government securities and other present-day investments, the decline has not been so great as that suffered by the savings banks. Between 1929 and 1936 the average rate of interest of all bonds, mortgages, and policy loans held by the companies dropped only from 5.1 per cent to 4.5 per cent.

Guaranteed Mortgages

Mortgages on real estate have always been an unusually popular investment. They pay a relatively high rate of interest, and they offer a very real security. It is difficult, however, for a person with money to invest to find a borrower who wants a loan of just the size and kind he is prepared to offer. Moreover, he runs a risk of having his particular mortgage go bad without being in a position to do anything about it. Having no personal contact with the borrower, he has no way of knowing the risk or protecting himself against it. In order to overcome these difficulties, certain companies began to guarantee mortgages and also to sell "mortgage certificates."

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The growth of this business, particularly in New York City, during the '20's was almost fantastic. In 1920 there were only eleven companies issuing guarantees with a total of $529,000,000 in outstanding mortgages. By 1925 there were twenty-six companies with a total business amounting to $1,214,000,000. This figure was more than doubled again by 1930 when there were fifty companies with a total of $2,867,000,000 in mortgages. More than $2,200,000,000 of this business was in the hands of four huge companies. These giant companies were built up still more during the first couple of years of the depression. But they were gradually being undermined by the shrinkage of real estate values and an increasing number of defaults. In 1933 the entire structure was suddenly swept over the precipice. The State Superintendent of Insurance took over the companies and found an appalling situation. Of $1,810,000,000 in mortgages securing the "guarantees," $1,089,000,000 was in default and only $721,000,000 was in good shape. In addition, some $67,000,000 was owed in unpaid interest, taxes, and insurance premiums. The guarantees turned out to be completely worthless. One of the largest of the companies had only $21,600,000 in capital to meet guarantees totaling $862,000,000—or a little better than two cents on each dollar. Widespread corruption and mismanagement was found to have existed in many of the companies. Money was loaned on vacant lots which had been "improved" by building sidewalks. Advertising was found to have been so misleading as to have been definitely fraudulent. These dishonest practices may have caused this type of business to be judged too harshly, but many of the difficulties would have been encountered even if it had been carried on honestly.

Instalment Houses and Brokers

Another big item in the debt picture is the money owed to instalment finance houses. These agencies lend money to enable persons to buy automobiles, refrigerators, and other articles on the instalment plan. In 1929 the three main automobile finance companies alone had outstanding loans of

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$750,000,000. The amount dropped to $290,000,000 at the end of 1932, but rose again to $1,280,000,000 in 1937.

Brokers' loans were an enormous item in the 1929 boom, reaching a total of more than eight and a half billions in the autumn of that year.

Corporate Debt and the Depression

Corporations of all types owe money. In 1930 the total debt of American corporations—not counting the banks and agencies just discussed—was in the neighborhood of 75 billion dollars. Of this about 48 billions were long-term debt and 27 billions short-term. Railways alone owed some 14 billions.

It is frequently said that the debts of corporations played an important rôle in bringing about the depression. It is argued that too large a burden of debt weakens certain companies, and that their collapse causes a business decline which forces other companies to sell goods at a sacrifice and to cut their purchases, thus making the situation worse. Once the depression is under way, it is claimed, certain debts, such as the railway debt, are so rigid that a smooth adjustment of costs and prices cannot take place. The facts, however, do not bear out these arguments. There is little evidence that debt had much to do with starting the depression. There were few important failures in 1929 or 1930. It was only when the crisis had already become severe that debts became an important problem. Where needed price reductions were refused during the depression, debts were at most an excuse—as with railway rates. There is no doubt, however, that the struggle of "illiquid" railways to keep out of receivership discouraged industrial buying and thus contributed to the hard times.

The Railways

The experience of the railways with debts has been particularly interesting. The operating revenues of all railways were $6,485,000,000 in 1929. Three years later they had fallen to $3,219,000,000—a drop of just over 50 per cent. Operating expenses also fell off by nearly half, but wage rates, taxes, rents,

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interest, and debt charges changed but little. Passenger and freight rates were held rigid by Interstate Commerce Commission regulation. Thus trapped, the railways' net income of $861,000,000 in 1929 was transformed into a deficit of $164,000,000 in 1932. There was some improvement between 1934 and 1937, but many roads are still in a bad way. In 1936 only about three-fourths of the interest due on Class I railway bonds was actually paid. In all, more than $400,000,000 in unpaid interest accumulated between 1929 and 1937. The price for railway bonds declined sharply, making it difficult if not impossible for them to obtain new money through loans. The recession of 1937-1939 increased the difficulties of the roads, and it is doubtful whether even the stronger railways will be able to support their debts in the long run. Loans from the Reconstruction Finance Corporation have helped temporarily, but it is believed that more drastic action will eventually have to be taken to rescue the roads. It has been suggested that the railroads are entering a period of economic old age, and that their failure to pay their debts when they had the money may make it necessary to write off many of the debts in the not-too-distant future.

Debts of Individuals

A large part of our debts are owed by individuals. At the end of 1934, individuals owed a total of some thirty-four billion dollars on long-term mortgages. Short-term debts amounted to an additional nine billions. But individuals, as a group, are owed more money than they owe. Commercial banks alone owed them twenty-four billions for deposits in 1934. Savings bank deposits added another ten billions, while life insurance companies would have to pay out sixteen billions if their clients all demanded immediate repayment of the cash surrender value of their policies. In addition, individuals held some fifty billions in bonds, and ten billions in mortgages. At the very least, then, individuals and unincorporated firms had a hundred billion dollars owed to them, while their debts were not more than a third as much.

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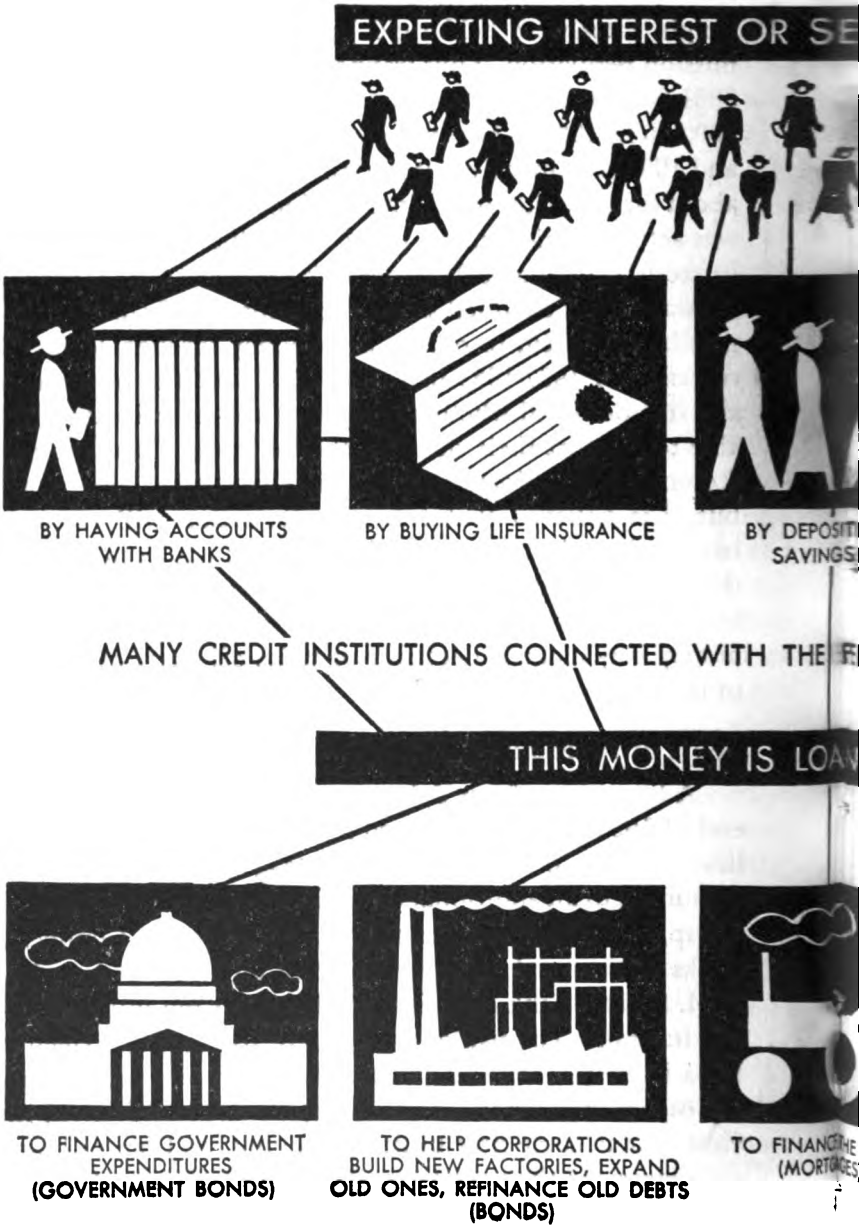
THE FUNCTION OF DEBTS



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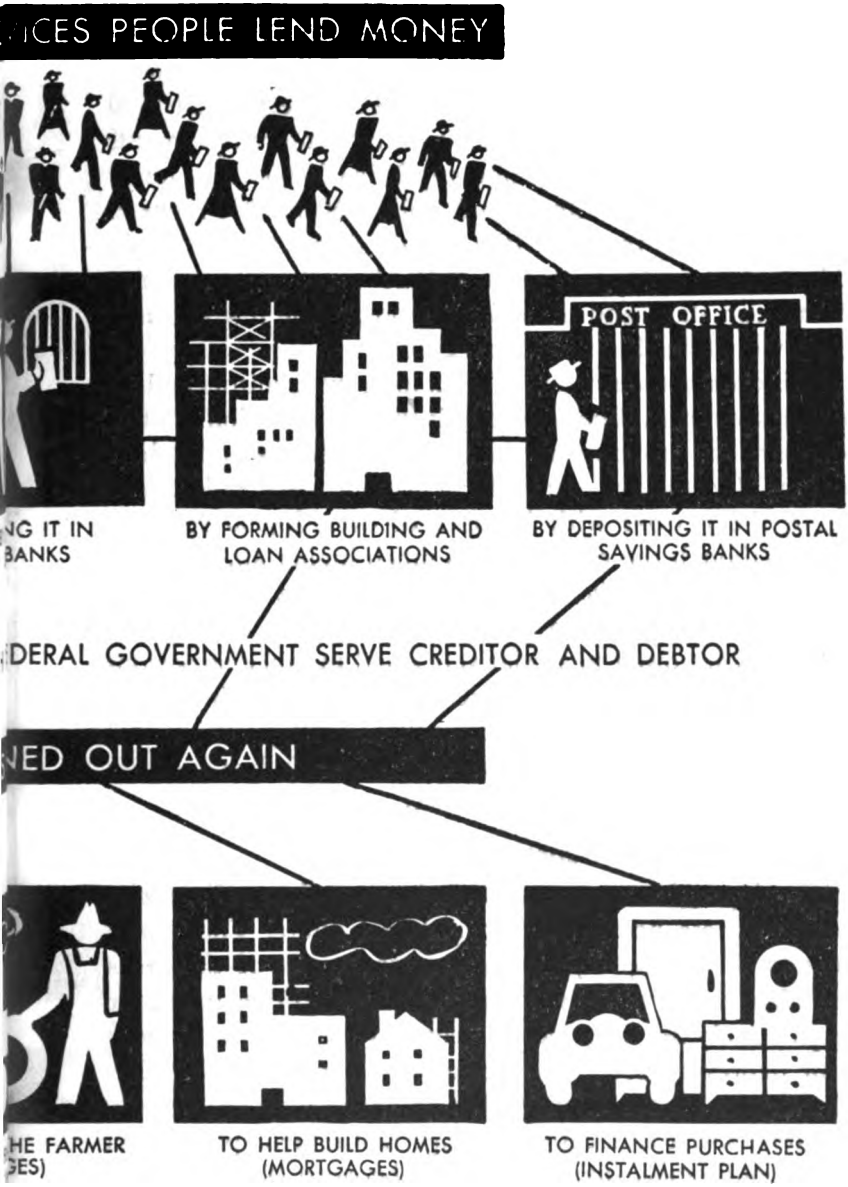

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Who Are the Creditors?

Study of the income tax statistics suggests that most of the debts owed to individuals are owed to a relatively small number of well-to-do persons. We find, for example, that in 1930 persons with incomes of over $5,000 received interest payments of $1,350,000,000. They paid out only $615,000,000. The lower income groups, on the other hand, paid $350,000,000 more in interest than they received. It is estimated that the well-to-do hold some ten or fifteen billion dollars' worth of tax-exempt government, state, and municipal bonds, while few are held by individuals in the low-income groups.

This does not mean that all rich men are creditors and all poor men debtors. The tendency is in that direction. But at every level of income some persons are debtors and others creditors. Income tax figures for 1934 show that only about half of the persons with incomes of over $5,000 received interest—though the proportion is much higher among those with incomes over $100,000. By and large there are probably more persons in debt than with a credit balance. The bulk of these debts are owed to a relatively small number of persons with high incomes. But there are many with large incomes—particularly business men—whose debts are larger than their assets. And there are still many persons with low incomes whose heads are entirely above water.

Fall of Debts in the Depression

The depression was particularly hard on the small debtor, especially those holding mortgaged real estate. Those who clung to their property throughout the worst of the crisis were often left in a precarious plight. On the other hand, the comparatively few who were reasonably secure at the outset of the depression seem to have improved their position. Detailed figures on this point, however, are lacking.

There was a tremendous change in the debt position of private individuals, taken as a group, between 1929 and 1936. Their short-term debts fell from twenty-nine to less than nine billion dollars. This contrasts with an increase of two billions

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in cash and bank balances, and a similar rise in the money owed individuals by other financial institutions. Altogether, including both short- and long-term items, they were thirty-five billion dollars more in the black in 1936 than in 1929.

This may seem odd in view of the fact that we usually think of the depression as bringing only suffering and privation. But a large part of the shift did not help anyone. It merely represented the cancellation of debts through bankruptcy and foreclosure. Perhaps one-third of the total was the result of such action. Another large part was accounted for by the practical disappearance of brokers' loans. These loans, used almost entirely to finance Wall Street speculation, dropped from eight and a half billions in 1929 to about half a billion in 1938. Bank loans using stocks as security suffered a similar drop, when the persons who borrowed the money were sold out after suffering heavy losses. This accounted for another six billions. As for the rest, we must remember that a mere reduction of debt does not necessarily lead to prosperity. The failure of mortgage debt to rise, for instance, does not mean that people were building houses and financing them by sounder methods than going in debt. Rather, it means that people were not building houses. A fall of debt along with active business—indicating that financing was taking other forms—would be a matter for public rejoicing. But a drop when construction is stagnant, and when what building there is is largely debt financed, is merely another symptom of depression.

HOW THE DEBTS WERE ADJUSTED

WE have learned something of the size of our debts and seen something of the impact of the depression on the debt structure. You may well ask how we stood the shock as well as we did. Our indebtedness was heavy in 1929 even at the level of income and business prevailing in that year. The national income dropped by more than half between 1929 and 1932. The dollar increased in value as a result of falling prices. But debts remained pretty much the same except for foreclosures

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and loans called in. How was the adjustment made to the lower income and the more valuable dollar? It is safe to say it could not have been done without government help. This took different forms in dealing with each kind of debt. Let us look at them one at a time.

Banks and Credit Institutions

The banks, as we have seen, bore the brunt of the shock. Early in 1932, when it first became apparent that the banking situation was becoming serious, Congress established the Reconstruction Finance Corporation. Its primary purpose was to make loans to banks and railways which were in danger of collapse. In all, this agency lent some six hundred million dollars by June, 1933. Some relief was also given to the banks by more lenient valuation of assets by the bank examiners. But neither of these steps touched the roots of the difficulty. The bank "holiday" of March, 1933, forced more drastic action. Banks which could not meet their obligations in full were denied permission to reopen. Their assets were sold or collected and their depositors paid as much as possible. In all, the depositors failed to collect some seven hundred millions of the four billions they had in these closed banks. The banks themselves had to write off about a billion dollars in bad debts.

The government did not actually give money to the banks to help them keep open. But it aided them in many ways. Government loans to the railways kept many of them from bankruptcy, and thus indirectly helped the banks. Many mortgages on which payments had been stopped were rewritten with government assistance. Some $471,000,000 in farm loans—all in distress—were taken off the banks' hands. And more than $500,000,000 in city mortgages were similarly taken care of. Part of these mortgages were held by the closed banks. But the bulk of the money released went to strengthen the banks that had been reopened.

Some months following the reopening of the banks, the government set up the Federal Deposit Insurance Corporation to provide insurance to individual depositors against loss

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in case of future bank closings. As some of the banks needed still further strengthening, Congress authorized the R.F.C. to purchase preferred stock in the commercial banks. Sound banks as well as weak ones were urged to accept this assistance, so as to prevent the public from becoming frightened when a bank made such a sale. By June, 1934, the R.F.C. had invested over a billion dollars in this manner.

The Building and Loan Crisis

No organizations went through more severe readjustments than the Building and Loan Associations. The situation would have undoubtedly been much worse except for the establishment, late in 1932, of twelve regional Federal Home Loan Banks. These institutions are very powerful financially, having been provided with $125,000,000 in capital by the Treasury. They, together with the R.F.C., lent heavily to the local associations to help them tide over the crisis. Of even greater assistance was the Home Owners' Loan Corporation. It took over hundreds of millions of dollars' worth of bad and doubtful mortgages from the associations—paying them off in bonds. This enabled the associations to repay their members. Further efforts were also made to stimulate the building and loan business by (1) organizing a group of Federal Savings and Loan Associations with federal charters; (2) direct investment by the H.O.L.C. in both federal and state building and loan associations; and (3) the insurance of shares by a Federal Savings and Loan Insurance Corporation.

Other Agencies

Neither the mutual savings banks nor the life insurance companies needed much special assistance during the crisis. The savings banks were closed during the bank "holiday," but were mostly reopened quickly. They received no special aid although they benefited from the activities of the H.O.L.C. and similar government agencies. The main problem of the life insurance companies has been to find places to invest the huge amount of money entrusted with them during the

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depression. Outside of government bonds—paying very low rates of interest—there have been comparatively few opportunities. The fact that the companies have earned considerably less on their investments than before the depression has not caused any serious difficulty. It has merely meant that dividends to the policyholders have been reduced.

The Mortgage Companies

The guaranteed mortgage companies were not saved. They were liquidated. Many of the mortgages were handed over to the creditors; the rest are being cared for by successors to the old companies, without, of course, the guarantee. The mortgage certificates presented a more difficult problem. Although the number of mortgages was not large, there were 200,000 investors whose claims had to be considered. And practically three-fourths of the mortgages were in default. The mortgage certificates were finally handed over to a specially created Mortgage Commission of the State of New York. Some, but not many, of the mortgages were foreclosed. Others were scaled down. And the rest were placed in the hands of trustees for the certificate holders. The extraordinarily heavy losses that were incurred in this field were chiefly the result of bad, or corrupt, management on the part of the mortgage companies.

ADJUSTING THE FARM DEBT

BACK in 1932 farm mortgages were first-page news. "Strikes" were organized against foreclosures in many parts of the country. Nearly half of all of the farm debtors were back on their payments. With farm prices down to a third of the 1929 level, hundreds of thousands of honest farmers were simply unable to pay their debts.

Altogether the farm mortgage debt was about $9,500,000,000 in 1928. It was cut to $7,700,000,000 in 1935. The greater part of this reduction was accomplished the hard way—through foreclosure. The life insurance companies alone took over $600,000,000 worth of farm land between 1929 and the end of

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1934. Most of this land was not immediately resold because of the extremely low prices prevailing. When it is resold, the debt will rise again as the buyers take out new mortgages.

Special Measures

The number of foreclosures would undoubtedly have been higher had not twenty-two states, including most of those in the Middle West, passed moratorium laws. These held up foreclosures from one to three years in the hope that the situation would be improved by a rise in prices. Most of these measures were still in force at the end of 1938.

Special protection was also given to debt-ridden farmers in amendments to the federal Bankruptcy Act in 1933 and the Frazier-Lemke Acts of 1934 and 1935. Under the 1935 Act, the farmer was protected against foreclosure for three years. At the end of that time he could redeem his property by paying the appraised value.

The Farm Credit Administration

Beginning in the spring of 1933 the most elaborate measures were taken to extend direct aid to debtors. Federal Land Banks had been in existence since 1917, but they were wholly unable to cope with the situation created by the depression. With the establishment of the Farm Credit Administration in May, 1933, the Land Banks were given more money and encouraged to lend on easier terms. And a new type of loan was created—Land Bank Commissioner Loans—which were even more liberal. About 400,000 farmers received loans of one type or the other during a two-year period. Over two billion dollars was thus thrown in to check the flood of foreclosures.

The process was a relatively simple one. The new government agencies took over the mortgage from the former creditor, paying for it in Farm Mortgage Corporation bonds. If the mortgage was large in relation to the value of the land, as was usually the case, the Land Bank issued a first mortgage for all that it could carry. Then the remainder was covered by a second mortgage issued by the Land Bank Commissioner.

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Money was advanced, where necessary, to pay back taxes and other debts. Some land already foreclosed was redeemed.

Farmers' Short-term Debts

In addition to mortgages, many farmers were heavily in debt to local stores, mail-order houses, and farm equipment dealers. During normal times they could usually borrow from a bank to meet these debts. There was also a group of twelve Federal Intermediate Credit Banks which had some hundred millions in outstanding loans in 1929. These loans were to farmers' cooperatives rather than individual farmers, though the government made some "seed loans" to farmers who had suffered from drought. The widespread failure of country banks during the early years of the depression made additional assistance imperative. Several new agencies, such as the Regional Agricultural Credit Corporations—connected with the R.F.C.—and the Production Credit Corporations were formed specially to meet this need. Even with these new agencies, much less credit was available to the farmers than in the more prosperous '20's.

Scaling Down Farm Debts

The federal government also assisted in scaling down the debts of many farmers. About one-fifth of the loans made by the federal agencies between 1933 and 1935 were "adjusted," so that the farmer had to pay less than he had previously owed. On the average, approximately one-third of these debts was lopped off. Altogether some 100,000 farmers benefited to the extent of about $1,000 apiece, a total reduction of $100,000,000. But as some $350,000,000 in past-due taxes, short-term bank loans, and other short-term debts were transferred into mortgages, the total mortgage debt did not decline.

Many more farmers were helped by a reduction in interest rates. Before the depression most federal farm mortgages carried interest rates of from 5¼ to 6 per cent. A series of acts by Congress temporarily reduced this rate, and that charged on Land Bank Commissioner Loans was cut to a maximum of 4

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per cent. Farmers were also aided by placing all loans on an annual payment basis, so that there could be no danger of the whole amount falling due in a bad year.

HOME MORTGAGES

IN terms of dollars, the problem of home mortgages in the cities was even greater than that of farm mortgages. About half of the homes in the country were mortgaged in 1930. The total indebtedness was at least twenty-two billion dollars. About two-thirds of this was owed to building and loan associations, banks, and life insurance companies. The remaining third was owed to individuals. Most of these mortgages were short term. About half were scheduled to fall due within six years.

Even in 1929 many home owners were in difficulty. There were twice as many foreclosures in this year as there had been in 1926. By 1931 there were three times as many, and the real crisis was just beginning. In 1932 foreclosures rose to 382 per cent of the 1926 level, and in 1933 to a peak of 395 per cent. During the crisis, 38 per cent of the persons with mortgages on their homes fell behind in their payments. They fell behind, on the average, more than ten months. Their plight was due, in most cases, to unemployment. Those who retained their jobs during the depression had little trouble in making payments. But those without jobs or other sources of income soon found themselves in dire straits.

The H.O.L.C.

The measures taken to relieve the situation were very similar to those adopted to help the farmers. In 1932 the government made money available through the R.F.C. and the Federal Home Loan Banks for the lending agencies, particularly the building and loan associations. The moratorium laws of 1933 helped the city as well as the farm debtors. But the most substantial aid came in that year with the setting up of the Home Owners' Loan Corporation. The H.O.L.C. had a cash capital of $200,000,000 and authority to lend up to two

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billion dollars. This limit was later raised. The new agency was immediately deluged with requests for loans. By the end of 1934 some 1,750,000 applications had been filed asking for a total of $5,650,000,000. The granting of loans was a slow, tedious process, and many requests could not be granted. Still by June 12, 1936, when the making of loans was suspended, 1,018,000 had been granted amounting to $3,100,000,000. About 90 per cent of this money went to the holders of the mortgages in payment for back principal and interest. The remainder was used to pay back taxes and for necessary repairs and reconditioning. Quite a number of the mortgages were scaled down in the process of making new loans. Just how many is not known. But we do know that the loans actually granted totaled 7 per cent less than the applications for those particular loans. This is almost exactly the same amount by which the farm mortgages were cut.

Some help was also given to distressed owners by the insured loans of the Federal Housing Administration and by new lending by building and loan associations made possible by federal aid. Although these loans were intended primarily for new borrowers, a large part actually went to help old debtors. As a result of these measures the number of foreclosures gradually fell off until they were below the 1929 level in 1937 and 1938. But home owners are by no means out of the woods as yet. The combination of low rents, high taxes, and high repair costs leave them in a precarious situation at the present time. Despite the progress which has been made, removal of the moratorium laws might produce a new crisis.

FINDINGS AND RECOMMENDATIONS

WE hear a great deal about the crushing burden of debt. But it means very little when we say that the total of all our debts is two hundred and fifty billion dollars. Or that this is nearly equal to our national wealth. For every debt is not only owed by someone, but to someone. Most persons both owe and are owed money. The only single figure which tells much

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about the burden of debts is the proportion of our national income required to meet interest payments. This was about 6.3 per cent in 1929 and rose to a peak of 12.5 in 1932. Only interest on long-term debts is counted, and the interest received by the debtor is deducted from the total. It is clear, then, that these figures present the crux of the problem: How can debtors meet fixed and regular interest payments out of a changing and unpredictable income? Added to this is the problem of paying off the debt when it comes due. Most debts are payable in the near future. Ordinarily they are extended when they fall due. But in a crisis, such as that of 1932-1933, when the chances of paying them are the least, it is often impossible for the lender to grant such an extension.

Part of the difficulty arises from the fact that dollars are an unsatisfactory measure of purchasing power. A dollar is worth considerably more today than it was in 1929. No one knows what it will be worth a year from now. Yet we have to use the dollar as a standard of measure because we have no other.

Recommendations

After a careful study of the facts, the Committee on Debt Adjustment of the Twentieth Century Fund is convinced that debts were among the chief causes of the depression—though certainly not the only major factor. While many of the debt difficulties were results of the depression, other things besides the depression were wrong with the debt structure. Debts contributed to the lack of balance from which the depression came, and the weakness of the debt structure made the business decline much more severe than it otherwise would have been.

The Committee is convinced that our economic life would be much more healthy if debts were not incurred so frequently, or if the present debt structure were cut down. By this it does not mean to suggest that debts do not serve a useful purpose. Short-term debts help sell goods. The debts of banks serve us as money. It would be impossible for most persons to buy homes without mortgages. Rapidly growing cities could

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not pave their streets, erect public buildings, lay sewers, or build a water system if they could not sell bonds.

But debt, though highly useful as a tool, is also highly dangerous. Where money can be obtained by other methods without too great difficulty, they should be used. And, where the debts are necessary, an effort should be made to reduce their dangers. The specific recommendations which follow are designed to carry out these principles.

Limitations on "Legal" Investments

The Committee recommends, first of all, that the existing laws and regulations which force insurance companies, savings banks, and trustees to invest almost entirely in debts, should be relaxed and perhaps eventually abolished. Many states now require that agencies such as are mentioned above—which deal in other people's money—invest this money only in mortgages, or certain kinds of bonds—all of which carry a fixed interest and provide for repayment in a specified number of dollars. These requirements shift a large part of the nation's savings away from direct investment in real estate, business, or common stocks. For it is easier for a company to get money by going into debt than by selling a share in its profits.

Mortgages and bonds are supposed to be a "conservative" investment, while common stocks are frowned on as a little risky. But the experiences of the depression have forced us to change many of our ideas. The fact that a bond is for a specified number of dollars is no safeguard against loss. Nor does it serve as a protection of purchasing power in a period of rapidly rising prices such as occurred during the World War. An investment in common stocks of a well-managed corporation without heavy debts, or in real estate, may be more truly conservative than an investment in the "legal" securities. Laws should be changed to take account of the changed situation.

For the time being, the stock investments by life insurance companies and similar agencies might be limited to a small part of the institution's assets. They might also be limited to

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companies with a reasonably stable earning record. And no one institution should be allowed to hold more than a very small proportion of the stock of a given corporation. But with such safeguards, the Committee felt that investment in common stocks—and real estate—should be encouraged rather than prohibited.

Elimination of Tax-exempt Securities

Further new issues of securities by federal, state, and local governments should not carry exemption from income taxes. The Committee points out that tax exemption for government securities has two undesirable effects: (1) Because interest rates are reduced, government bodies find it too easy to go into debt; (2) Tax exemption makes investment in governmental bonds too attractive to those persons who can best afford to take the risk of investing in new businesses.

Getting Away from Other Debt-favoring Policies

The federal and state governments should strive to discourage debt financing, rather than to encourage it, as they now do through income-tax policy, regulation of utility rates, and the control of local government debts. The federal income tax on corporations, for example, counts as "income" all money paid out to stockholders or added to surplus, but does not so count the interest paid to bondholders. This means that dividends are taxed twice (once as corporation income and once as income of the stockholder); while the interest received by the bondholder is taxed only once. This discrimination adds to the difficulty of raising money by sales of stock as compared with issuing bonds. It is a major flaw in our tax structure and one that should be remedied as soon as possible.

Similarly in fixing the rates charged by railways, power companies, and other public utilities, state and federal commissions usually take into account the rate of earnings. The rate considered "fair" is usually higher than the interest rate on good bonds. In making improvements, therefore, the com-

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panies are encouraged to borrow money rather than sell stock and increase the number of owners. Moreover, state governments have been too easygoing in their attitude toward the debts of the local governments under their authority. It is true that small districts and rapidly growing areas cannot very well pay for their improvements as they go along. But large cities can and should. Pressure should be brought on the local communities to avoid debt, and reduce existing indebtedness where possible.

Debt Maturity

Plans for the repayment of debts should be related to the probable economic life and earning power of the underlying assets. There is nothing to be gained by pretending that a mortgage or similar investment will be paid off in a few days or months. On the other hand, debts should not be treated as permanent. Few persons can afford to "pay for a dead horse." Even businesses cannot count on going on forever, as is shown by the experience of streetcar lines and railways. Most debts, therefore, should provide for a regular payment on the principal throughout the entire period of the debt. And in no case should the debt run as long as the life of the asset on which it is based. The regular payment plan adopted by the various federal mortgage lending agencies might well be taken as a model for other lenders.

Appraisal Methods

Appraisal of assets underlying debts should be made more systematic and objective. In the past there has been a tendency to be too generous in estimating the value of the property to be used as a security for debts. The Committee urges a careful study of experience in making appraisals as to what pitfalls should be avoided.

Mortgage Moratorium Laws

The present situation does not warrant immediate removal of existing mortgage moratorium laws. But plans should be

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laid for their gradual elimination by a tapering-off process, to begin just as soon as business conditions improve enough to justify it. Despite business recovery in recent years, many city mortgages are still in bad shape. Nor is the situation likely to improve as long as widespread unemployment continues. It is clear, therefore, that the moratorium laws cannot be lifted all at once. If possible they should be tapered off with some sort of an annual payment plan which protects the debtors against being asked for repayment of the principal all at one time.

Further Reforms in Debt Adjustment

The Committee praises the recent changes in the Bankruptcy Act and urges that further reform should aim to secure conversion of debts into direct ownership in the reorganization of corporations, and to increase the flexibility of debt contracts. Still more attention needs to be given to rights of the debtor when bankruptcy or foreclosure is caused by general business decline and is not primarily the debtor's fault. It is especially difficult to safeguard those who have defaulted on their mortgage debt. Some states have insisted on a "redemption period" during which the debtor may recover his property. This has not worked out very well in practice and has added fresh complications as to the ownership of real estate. In the case of corporations, however, the debtor's moral claims may be safeguarded by the issue of rights to buy stock in future years if the business improves. It is also a good thing to go as far as possible to turn the creditor's claims into preferred stock or "income bonds" so as to bring about greater flexibility.

Need of Fact Finding

The United States Department of Commerce has recently established a section in the Bureau of Foreign and Domestic Commerce for research in the field of debt. This is an important step in the direction of better public knowledge of the question and better founded government policies. But more

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can and should be done in obtaining and publishing facts on the debt situation. There is need for a broad study such as only the federal government could make. And there is already a considerable amount of information in the hands of the government which should be made public. All possible encouragement should also be given to private studies.

Coordination of Federal Emergency Agencies

Most of the credit agencies set up by the federal government during the depression were designed to be temporary. The Committee believes that they should ultimately be discontinued, but points out that some of them, such as the R.F.C., still serve a useful purpose. If new agencies are created or some of the old ones revived, more care should be given to coordination. At the very least, the Treasury or the Director of the Budget should be represented with substantial supervisory power on every agency which is backed by government credit. In addition, some government agency should be charged with the duty of watching the activities of all government bodies in relation to debts. Such an agency is needed particularly to formulate proposals for debt policy.

Debt Policy as a Remedy for the Depression

The Committee is emphatically of the opinion that while sounder debt policies can help to forestall depressions and ease crises, they cannot alone bring recovery. Government aid can provide a breathing spell—as it did in 1933—and thus prevent gross injustices. But sustained recovery from depressions depends on new financing, and most of the money must be obtained, as in the past, from stockholders and others who are involved as owners. To this end, the Committee on Debt Adjustment of the Twentieth Century Fund is convinced that means must be found to make this type of investment more attractive to those who have the money to invest.

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First Printing, October, 1939

Printed in the United States of America

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