A New Deal for Money and Banking, 1933 to 1935

Preliminary Draft

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Section 1. Introduction

During the 1930s, commentators and scholars used the term *The New Deal* to refer to policies that the Roosevelt administration implemented to ameliorate the catastrophic contraction whose nadir coincided with the administration's ascension. The New Deal impacted broad swaths of America's economy. Legislation expanded federal regulation of many industries; altered relationships between federal, state, and municipal governments; influenced relationships between labourers and employers, farmers and factories, and sellers and buyers of most products on the market. The New Deal's initial legislation focussed on the monetary and banking systems. Waves of reforms followed during the next three years. Much of that legislation focussed on money, banking, and finance.

This essay examines that legislation passed from 1933 through 1935. Key bills included the Emergency Banking Act passed during the banking holiday in March 1933, the Banking Act of 1933 passed in June of that year, and the Banking Act of 1935 passed in the summer of that year. Related legislation included the Securities Act of 1933, the Securities Exchange Act of 1934, and the acts that established the savings and loan industry.

This legislation aimed at four principal goals. The first was stopping financial panics. The second was halting deflation of the dollar and reflating prices to levels that prevailed before the contraction. The third was expanding the supply of credit. The fourth was establishing federal government influence (and perhaps control) over the supply of money, provision of credit, and level of prices.

Why did the New Deal emphasize these issues? Thousands of banks failed during the contraction beginning in 1929 and continuing until March 1933 (Richardson 2007). Policy makers believed the collapse of the financial system contributed to the length and depth of the

recession. While the Federal Government made a few attempts to address the financial calamity during the years of 1930-1932, their efforts proved to be too little and too late. In early 1933, the public lost faith in banks in general. Depositors fled from the financial system, forcing twenty-eight states to suspend operations of financial institutions operating within their borders and eventually forcing the president to declare a national banking holiday, which shut down all financial institutions in the nation for seven business days, reopened a small number of selected institutions during the next week, and then gradually resuscitating the financial system. In response to this disaster, the federal government changed the structure of financial regulation

Section 2: Precursors to the New Deal

The Roosevelt administrations' legislation pertaining to money and banking arose from a plethora of proposals whose existence preceded Roosevelt's election. Congress (and the Hoover administration) considered many of these proposals during the contraction that began in 1929 and deepened during the 1930s. A few of these proposals passed Congress and became laws. Others were debated by Congress but not adopted. Some sat on the shelf as fully-formed ready-to-implement plans, that had been written and reviewed by staffs of Congressional committees, executive agencies, and Federal Reserve banks, but which politicians on the Hill or in the White House decided not to implement (in some cases not to advertise to the public). Many proposals had been advocated by experts, analyzed by experts, and discussed during congressional hearings, but had not been written into legislation prior to Roosevelt's inauguration. This section reviews these intellectual and legislative precursors to the New Deal.

Congress considered an array of legislation during the initial years of the contraction. It passed the first substantial reform on 22 January 1932. This Act (c. 8, 47 Stat. 5) chartered the

Reconstruction Finance Corporation (RFC) and authorized the RFC to extend loans to all financial institutions in the United States, including state-chartered banks lacking links to the Federal Reserve, and to accept as collateral an array of assets, as long as the RFC's leaders deemed the loans to be "amply" secured. The RFC's mandate emphasized loaning funds to solvent but illiquid institutions, whose assets appeared to have sufficient long-term value to pay all obligations, but which in the short run could not be sold at a price high enough to repay current creditors. The RFC also loaned funds to the receivers of banks in liquidation, which enabled receivers to repay depositors as soon as possible, and repay the RFC in the future, when assets could be sold at higher prices. The RFC also loaned funds to Federal Land Banks, which financed farm mortgages, and Federal Intermediate Credit Banks, which financed seasonal agricultural lending. The RFC also advanced funds to railroads, which indirectly aided banks, since numerous banks possessed portfolios of railroad bonds, which declined in value as rail traffic declined during the depression, and to insurance companies, which also aided banks, since banks often purchased insurance on the values of their bond portfolios.

The Reconstruction Finance Corporation was a quasi-public corporation, staffed by professionals recruited outside of the civil service system, but owned by the federal government, which appointed the corporation's executive officers and board of directors. The RFC's initial capital came from $500 million in stock sold to the U.S. Treasury. The RFC raised an additional $1.5 billion by selling bonds to the Treasury, which the Treasury in turn sold to the public. In the years that followed, the RFC borrowed $51.3 billion from the Treasury and $3.1 billion directly from the public. All of the RFC's obligations were guaranteed by the federal government (Jones 1951).

On 21 July 1932, an amendment authorized the RFC to loan funds to states and localities for self-liquidating public relief projects, such as the construction of utilities and bridges, whose construction costs would be repaid by user charges and tolls. The amendment also authorized the RFC to loan funds to states and localities to provide relief for the unemployed, when those loans could be repaid by future tax receipts.[1]

On 27 February 1932, Congress passed the Banking Act of 1932. Senator Carter Glass and Representative Henry Steagall coauthored the legislation, which was initially called the Glass-Steagall Act, until that label became the universal appellation for the act that Senator Glass and Representative Steagall cosponsored in the summer of 1933. The Banking Act of 1932 expanded the Federal Reserve's lending powers, allowing Federal Reserve district banks to loan funds to member banks on the security of a broad range of assets equivalent to the assets accepted by the RFC. Loans secured by collateral previously ineligible for rediscount had to be approved by a minimum of five members of the Federal Reserve Board and had to pay a rate at least one percent above the prevailing discount rate. Federal Reserve districts could also loan funds to individuals, firms, and corporations, under restrictions mentioned above, and with the added stipulation that the borrowers prove that they had applied for but could not obtain credit from commercial banks in their own communities.

As the economic contraction continued, Congress commissioned a broad range of studies concerning banking and monetary matters and frequently held hearings on these issues. Experts from government and academia testified at length. Bureaucracies such as the Federal Reserve

[1] To accomplish its goals, the RFC established several subsidiary and allied corporations. These include the Metals Reserve Company, the Defense Plant Corporation (DPC), Defense Homes Corporation (DHC), War Damage Corporation (WDC), Rubber Reserve Company (RRC), Electric Home and Farm Authority (EHFA), Lafayette Building Corporation (LBC), Federal Facilities Corporation (FFC). Many of these agencies played important roles in financing economic expansion during World War Two. In 1953, Congress passed an act that disbanded the RFC, transferring most of its functions to the Treasury Department effective June 1954, to wind down its affairs. Treasury completed that task in 1954. Vestiges of the RFC survive in the federal bureaucracy today. Successor agencies include the National Science Foundation, General Services Administration, and the Office of Defense Lending.

Board, Office of Comptroller of the Currency, Department of the Treasury, and Department of Commerce submitted extensive written reports. These hearings revealed a consensus concerning the severity of the illness facing the financial system, but demonstrated divergent views on the causes of the disease, prognosis for the patient, and remedies that could encourage recovery. This spectrum of views spanned included almost all of the views that came to the fore during the Roosevelt administration.

Congressional staffers and executive-branch experts synthesized these views to create drafts of potential legislation. Congress discussed much of this potential legislation during hearings in 1931 and 1932. Some of it sat on desks on Capital Hill; some sat on desks in the White House. Key examples include materials that Roosevelt's administration used during its first week to declare a banking holiday and draft the Emergency Banking Act. All of this material had been prepared during Hoover's administration, vetted by legal and economic experts in the relevant committees and departments, and discussed at the highest levels, including in the Oval Office on several occasions with Herbert Hoover himself. The initial legislation of the New Deal, in other words, had been prepared by technocrats working for the preceding Republican administration and kept on the shelf. Roosevelt's economic and political advisers did not devise these ideas, or even draft the documents that they submitted to Congress and presented to the public. The Roosevelt administration simply provided the impetus for implementation.

Section 3: Legislation During 1933

Congress passed the Emergency Banking Relief Act on 9 March 1933, in the midst of the banking holiday, to facilitate reopening the nations' banks. The Emergency Banking Relief Act

clarified the Federal Government's authority to act during a national financial emergency. Herbert Hoover's subordinates in the Department of Treasury and the Reconstruction Finance Corporation wrote the Act, which sat on Herbert Hoover's desk for many months, as a last resort, to be used in dire circumstances. Franklin Roosevelt implemented the disaster plan immediately after his inauguration. He shut down the financial system using legal powers granted the president by the Trading with the Enemy Act which Congress passed during World War I. The Emergency Banking Relief Act ensured that the president possessed those wartime powers during times of peace and created the legal structure and financial authority needed to close, reopen, or liquidate all financial institutions in the United States.

The act contained five titles. Title I provided extraordinary powers to the President, authorizing him to declare an emergency, during which he could control the national finances and foreign exchange of the United States; prohibit the hoarding and export of gold; and dictate which banks would reopen, merge, or remain closed. Title II authorized the Comptroller of the Currency to seize and operate any bank in the United States. The Comptroller used this authority to appoint conservators for banks deemed unfit to resume operations but with the potential to recover. Conservators 'froze' existing deposits, allowing depositors access to funds according to a schedule determined by recoveries on assets, and segregated new deposits into separate accounts. Conservators strove to reopen, reorganize, or merge banks under their supervision. Title III authorized national banks to issue preferred stock. Preferred stock paid dividends not exceeding six percent per year and did not subject holders to double liability. The Reconstruction Finance Corporation could purchase preferred stock, and during the years that followed, did so in large quantities. Title IV expanded powers of the Federal Reserve. Federal Reserve banks were authorized to use as collateral for Federal Reserve notes all direct obligations of the United

States government (in the past they could only use gold and government bonds issued prior to World War One). Fed banks could also use as collateral all notes, drafts, bills of exchange, and bankers' acceptances acquired during the banking emergency. Fed banks could issue notes summing to 100 percent of the value of their United States government obligations and 90 percent of the estimated value of all other collateral. Fed banks also received expanded lending powers. Fed banks could make loans to member banks under "exceptional and exigent circumstances" whenever the loan was secured to the satisfaction of the Federal Reserve Bank. This provision expanded powers granted to Federal Reserve banks by the Glass-Steagall Act of 1932. Title V of the Act contained three sections. Section 1 allowed Federal Reserve banks to convert debt instruments of the United States federal government into currency at par value and to convert any circulating liability of a commercial bank (e.g. check, draft, or banker's acceptance) into cash at 90% of its apparent value. Section 2 authorized Federal Reserve banks to make unsecured loans to member banks at a rate at least one percent above the discount rate. Section 3 authorized Federal Reserve banks to loan funds to any individual or corporation for 90 days if the loan was secured by United States government securities. On 24 March 1933, an amendment expanded these powers, enabling Federal Reserve banks to loan funds directly to non-member banks and trust company for the duration of the existing emergency.

On 16 June 1933, the Banking Act of 1933 (Pub.L. 73-66, 48 Stat. 162) became law. Congress had considered progenitors of the legislation during preceding years. Senator Carter Glass, a democrat from Virginia and former Secretary of Treasury, had introduced banking reform bills in 1931 and 1932. Glass's bills advocated unifying banks into a single national system by permitting branch banking, confining commercial bankers to the banking business (i.e. taking demand deposits and extending short-term commercial loans), increasing their liability for

misconduct, and subjecting them to stricter governmental regulation. Representative Henry Steagall, a democrat from Alabama then chairman of the House Committee on Banking and Currency, sought to protect depositors by guaranteeing deposits, opposed unification of the state and national banking systems, and opposed branch banking. Glass's bill became a leading piece of legislation, generating discussion among businessmen and economists around the nation. Glass's bill passed the Senate in February 1932, and was reintroduced on the first day of the special session called during the banking holiday, and passed the Senate in May 1932. Representative Henry Steagall introduced his deposit-insurance bill in 1932. His bill passed the House of Representatives in May 1932 and again in May 1933. In June 1933, the two bills went to conference, where they were merged into a single act, which Congress approved on June 13 and the President signed on June 16. The final bill contains most of the provisions proposed by Senator Glass, with the exception of branch banking, which Steagall opposed, and the addition of deposit insurance, which Steagall advocated.

The Glass-Steagall Act contained several provisions which shaped the financial landscape in the United States during the next decades. First, the act established nationwide deposit insurance. This provision replaced the temporary insurance fund established by the Emergency Banking Act. It created the Federal Deposit Insurance Corporation (FDIC), under the management of a board of directors appointed by the President of the United States. The corporation's capital came from the United States Treasury, Federal Reserve District Banks, and banks that joined the insurance system. All banks that belonged to the Federal Reserve had to join the deposit insurance system. Non-member banks could join the system by subscribing to stock in the association. Those that joined had to meet the requirements for Federal Reserve membership by 1 July 1936. All insured banks could be charged assessments, if the stock of the

corporation proved insufficient to cover required insurance payouts. The FDIC insured the all deposits up to $10,000 and of larger deposits, 100% of the first $10,000; 75% of the next $40,000; and 50% of any deposit over $50,000.

Second, the act separated commercial from investment banking. The act required commercial banks to sell their securities affiliates within one year and restricted their bond departments to the purchase and sale of securities on the order of and for the account of customers. Underwriting investment securities was prohibited. Interlocking directorates between commercial banks and securities companies was also forbidden. Firms engaged in selling securities were prohibited from taking deposits one year after the enactment of the law (i.e. after 16 June 1934). The use of bank credit for the purchase of securities and speculation in securities markets was restricted. The Federal Reserve received powers to prevent member banks from extending loans for investment in securities markets.

Third, Banking Act of 1933 imposed stricter regulations on financial institutions. Some of these regulations sought to reduce conflicts of interest among officers and directors. For example, the act prohibited officers and directors of member banks from borrowing from their own institutions and required them to report all borrowing from all other organizations. The act also prohibited officers and directors of member banks from associating with corporations that loaned funds on the security of stocks and bonds. Officers and directors of federally insured banks also had to conform to these regulations.

Other regulations sought to alter conditions that engendered bank failures, particularly among small banks. One example is an increase in minimum capital requirements. Another example was the prohibition of payments on demand deposits (Regulation Q), which legislators expected would reduce the cost of funds for commercial banks and encouraged depositors to

place more of their funds in time deposits (i.e. savings accounts and certificates of deposit), providing commercial banks with a stable source of funds that was less subject to panics and runs. Additional examples were the restriction upon the use of bank credit for speculation, authorization of state-wide branch banking, federal supervision of group banking, modification of double liability, and increased authority of bank examiners.

Another restriction was the prohibition of private banking. Private bankers were individuals (or partnerships) that accepted demand deposits. The act required private bankers, after one year, to surrender either their deposit business or their dealing in investment securities. If they elected to conduct a deposit business, the law required them to submit to periodic examination by the Comptroller of the Currency.

Section 4: Legislation During 1935

In 1935, Congress passed the Banking Act of 1935. The act contained two key sections. Title I modified the deposit insurance system. Now, the FDIC insured the first $5,000 of all deposits and nothing over that amount. The FDIC collected an annual assessment of 1/12 of 1 percent of all deposits in insured banks with no provision for collecting 'special assessments' to cover periodic losses. Insured state chartered banks with deposits over $1,000,000 were still required to join the Federal Reserve System, but the deadline for doing so was pushed from 1936 back to 1942. Banks with deposits less than $1,000,000 were no longer required to join the Federal Reserve System. Those that had joined were given the option to depart, but only 50 of the roughly 7,500 banks that joined the system chose to leave it.

While Title I made minor modifications to the FDIC, Title II made major changes to the structure of the Federal Reserve System. These changes centralized control of supply of money and credit in the hands of the Federal Reserve Board of Governors. Title II changed the Federal

Reserve Board in the Board of Governors. The Board of Governors received the power to approve the governors and vice-governors of the twelve district banks. The Board of Governors also received the authority to set discount rates and establish lending policies. The act provided that "subject to such regulations as to maturity and other matters as the Federal Reserve Board may prescribe," a federal reserve district bank might discount any commercial, agricultural, or industrial paper for member banks, and might make advances to member banks secured by "any sound asset." The act also permitted the Federal Reserve to purchase securities issued or guaranteed by the United States government.

The new Board of Governors dominated a new Federal Reserve Open Market Committee, consisting of the seven members of the Board of Governors, the President of the Federal Reserve Bank of New York, and the presidents of four other Federal Reserve districts on a rotating basis. Title II provided this committee with the authority to establish policies pertaining to the purchase of securities in the open market. The committee's decisions became binding on Federal Reserve banks, which in the past, need to participate in programs of open-market purchases and sales recommended by the Federal Reserve Board.

The Depression-era Congress passed an array of additional acts which shaped the financial system for decades to come. Several of these acts dealt with deposit-taking institutions other than banks, such as savings and loans and credit unions. These organizations differed in the types of deposits that they accepted and the types of assets that they held. Commercial banks accepted deposits payable upon demand and provided customers with the opportunity to circulate those liabilities by writing checks. Commercial banks invested the preponderance of their short-term liabilities in short-term commercial loans, providing credit (often seasonal) to manufacturers, wholesalers, retailers, and farmers. Savings and Loans accepted only savings

deposits and invested the bulk of these long-term liabilities in long-term investments like home mortgages. Credit Unions did not accept deposits. Instead, members of credit unions (and related entities such as mutual savings banks and building and loan societies) held stock in a non-profit credit cooperative. The cooperative typically treated the shares of stock like savings accounts, allowing members to buy and sell shares just like individuals deposited and withdrew funds from commercial banks. In 1934, Congress passed the National Housing Act, which established the Federal Savings and Loan Insurance Corporation (FSLIC), which insured deposits in savings and loans and regulated the S&L industry. Congress also passed the Federal Credit Union Act, which established the Bureau of Federal Credit Unions to insure and regulate member-owned credit cooperatives.

Another series of acts regulated stock exchanges and securities markets. In 1933, Congress passed the Securities Act, which established federal regulation of securities issues. In 1934, Congress passed the Securities Exchange Act which established the Securities and Exchange Commission (SEC) to regulate the issuance, purchase, and sale of securities, particularly equities and debt instruments. The act required all public companies to submit periodic financial statements under penalty of perjury. In 1936, Congress passed the Commodities Exchange Act (ch. 545, 49 Stat. 1491, enacted June 15, 1936) which required all commodities futures and options to be traded on organized exchanges. To regulate those exchanges, the legislation established the Grain Futures Administration (GFA).

Discussion

This discussion section is under construction. Check back for periodic improvements.

During the 1930s and in decades thereafter, many observers argued that the New Deal had deeper and perhaps darker objectives than those discussed in this paper. One example is William McDonald. In *The Menace of Recovery*, he argues that the New Deal attacked capital and capitalism in a host of ways, including restricting competition, limited profits, campaigning against private ownership, fixing prices and wages, control supplies of commodities, and "government control of banking and credit." Through these means, the administration sought to make capitalism progressively unprofitable, limit "individual and corporate initiative," and relegate "presidents, treasurers, and managers (of corporations) to the status of hired men."[2] …..

We must admit that some of these fears had some foundation in fact. Several of the administration's chief proponents of monetary and banking reform, including both Laughlin Currie and Harry Dexter White, have been proven to be members of the Communist Party of the USA and spies reporting regularly to Soviet intelligence services. They may have had some ulterior motives. But, if so, their indirect approach did not destroy the banking and monetary systems, which appears to have operated smoothly and efficient, without panic or interruption, for the next fifty years, until their ideological opponents put in place a system which they claimed would be better suited to a modern capitalist democracy. It seems ironic that a system of money and banking set up, in part, by communists functioned well for such a long period of time, when its replacement, set up by advocates of laissez-faire theories, appears almost immediately to have spawned bubbles and panics which misallocated capital and spawned recessions worldwide. One resolution of this riddle is a recognition that most of the ideas

[2] Macdonld p. 371

implemented by the Roosevelt administration entered the public debate during the years (and in some cases decades) before the election. Almost all of the ideas that rose to the top had the support of large segments of the business and financial community, and while some of these ideas aroused ardent opposition, almost everyone

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