The Reconstruction Finance Corporation and the Great Depression: How Good Intentions Led to Calamity I

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1. Introduction

As the U.S. economy sank deeper into depression in 1931, novel remedies were proposed. This essay subjects one of the most important of these to a critical study, the Reconstruction Finance Corporation (RFC). While well-intentioned, the consequences led to collapse of the U.S. banking system in spring, 1933. Bernanke (1983) emphasizes this collapse as a key factor behind the severity and duration of the Great Depression. It converted an already severe depression into the Great Depression. The damage to the economy by the RFC continued during the New Deal. Instead of helping, the RFC hindered recovery throughout the 1930’s.

Rising bank failures engendered distrust of all banks. This distrust is shown by cash drains from banks that weakened them severely (Table 2). Distrust of banks means distrust of checks, the lion’s share of the means of payment. Scrutiny of contemporary bank balance sheets like those done by Calomiris and Mason (2003a, b) to conclude many were sound is beside the point. Nobody then, not even the banks themselves, could be sure of their own prospects for survival based on their own estimates. The Great Contraction of the money supply from 1929 to 1933 is a symptom of depression like the high unemployment. These are symptoms not causes. A Great Expansion of the money supply from 1933 to 1939 followed the Great Contraction but no Great Recovery ensued. One must look beyond these symptoms to grasp what was at work. Markets in a modern economy need reliable means of payment. For this the banks are crucial. Without trust in them came the Great Depression.

The Reconstruction Finance Corporation was intended to supplement the Federal Reserve System primarily in order to help banks outside the System. In 1932 a large fraction of the banks were not members of the System and could not borrow directly from Federal Reserve Banks. Plainly, all banks are affected, directly or indirectly, by some Fed actions, notably their open market operations. Indeed, it was widely believed that the main duty of a central bank was as lender of last resort. Hence those banks unable to borrow from the Fed were at a disadvantage. This is not to say that open market operations were neglected or not understood by the monetary authorities. However, because gold was the only asset legally acceptable as reserve by the Federal Reserve Banks, the size of their gold stocks set an upper bound on the magnitude of their purchases of Federal securities thereby limiting use of this policy. This obstacle came to the fore in fall 1931, after Great Britain left the gold standard. This led to a run on Federal Reserve gold by foreigners fearful that the Fed would follow Britain’s action.
Central bank loans to banks in distress were traditionally kept secret. Doing otherwise could only aggravate the difficulties of the borrowers as centuries of experience had shown. The RFC fell victim to political forces during the summer 1932, when the presidential campaign began, pitting the incumbent, Herbert Hoover, against the Democratic challenger, Franklin Delano Roosevelt. The RFC was a creature of government with a large horde of funds it could lend to private banks. Inevitably, accusations arose that favoritism, not merit, were behind some RFC loans. The Dawes' loan was the trigger. In June 1932, Charles Dawes had resigned as the first head of the RFC and had returned to his Chicago bank. This bank got a $90 million loan from the RFC only three weeks after Dawes resumed his leadership of it. These accusations of favoritism got specially prominent attention partly because the Democratic candidate for Vice President, John Nance Garner, was also the Speaker of the House and was thereby in a bully position to attract publicity for his statements. Accusations of political favoritism guiding the RFC's loans entered the political arena notwithstanding the dangers posed by publicity attendant on announcing in public which banks got RFC loans. One could always claim that this information would bolster, not diminish, confidence in the ability of the borrower to survive. Full publicity, revealing not only who got loans and how much of what they asked for they got, but also who was denied loans, was obviously against public interest. The tale is a sobering illustration of partisan tactics conflicting with the public welfare. Partisanship won. Garner was a key player in this contest not only that summer 1932 but also in January 1933 when he broke his promise to President Hoover to keep secret information about RFC loans made prior to August 1932. The resulting publicity about RFC loans to a leading Detroit bank led directly to the collapse of the banking system and the Great Depression.

But the damage to the economy due to the RFC did not stop in March 1933. It had a starring role in the New Deal. The well-intentioned RFC's preferred stock program impeded recovery of the economy. This program allowed the RFC to inject funds directly into banks by means of purchases of preferred stock in the banks. This preferred stock gave the RFC voting rights like shareholders of ordinary common stock in these banks. The RFC preferred stock at one time came to 35 percent of total bank common stock and, for some banks, the RFC held a controlling position. The preferred stock program was in effect a partial nationalization of U.S. banks. The composition of bank loans and investments show that with the preferred stock program, banks invested more in Federal securities than they lent to private business. To dwell on the effects is a waste of space.
2. Summer 1932

On January 22, 1932, President Hoover signed the act passed by Congress creating the Reconstruction Finance Corporation (RFC). This Federally chartered corporation was designed to lend directly to banks, railroads, states and local governments. A reason for establishing the RFC was dissatisfaction with the size of Federal Reserve actions to support its member banks. Another reason was the absence of a lender of last resort for those banks who were not members of the Federal Reserve System. Nearly half the U.S. banks, not being members of the Federal Reserve System, could not borrow directly from the Federal Reserve. Although many of these were smaller banks, still they accounted for over 30 percent of total deposits in June 1929. After this date the proportion fell steadily. By June 1932, it was just under 25 percent (Cagan, Table F-9). By December 1940, it was down to 16 percent of total deposits.

The best explanation for the creation of the RFC was a combination of the effects of the constraints on the lending power of the Federal Reserve Banks and the frozen state of member bank assets. Member banks could borrow directly from the Fed in two ways, by rediscounting their commercial loans or by presenting their own promissory notes as Banker's Acceptances to the Fed. However, both types of loans had to be short term, usually less than 90 days. Banker's Acceptances also required high quality collateral, typically Federal securities. Since the assets of many member banks stood on the brink of default, short term credit could not solve their problems. The RFC seemed to offer a better solution.

The RFC began work early in February. Simultaneously, between February and August 1932, possibly succumbing to Congressional and Presidential pressure in the form of the Glass-Steagall Act of February 27, 1932 that allowed Federal Reserve Banks to count their holdings of Government securities as part of their required reserves, the Federal Reserve bought more than $1.1 billion U.S. Treasury obligations. These purchases immediately increased the monetary base. While the Federal Reserve was buying in the open market as shown by the rise of their holdings of government securities in Figure 1 the RFC lent $1 billion.

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1 Section 10 of this Act allowed a Federal Reserve Bank to make loans to a member bank in its district who lacked adequate collateral. Aggressively used, this section could have been of great help to member banks with impaired collateral. For the details of the Federal Reserve open market purchases during 1932, see Friedman and Schwartz (1963, pp 384-389).
The sum of the seasonally unadjusted monthly Federal deficits from February to December 1932, namely, the increase in the Federal debt, came to nearly $2.5 billion (Firestone, 1960, Table A-4). Of this total increment of the Federal debt, the Federal Reserve bought $1.1 billion and holders outside the Federal government bought the rest, more than $1.382 billion, which is $160 million more than the RFC loans. Next consider the effects of the RFC’s actions on the banks and on the economy.

Four characters are in this tale; the Treasury, the RFC, the banks and the nonbanking public. Before the passage of the RFC Act, the Treasury had promised the RFC to buy its stock and its notes. By the end of 1932, the Treasury had bought $500 million in stock and over $810 million in notes from the RFC. The Treasury paid for its purchases by depositing funds into its account at the Federal Reserve Banks for use by the RFC. Since the Treasury was running a deficit and since the Federal Reserve bought no Government securities after August 1932, the Treasury had to borrow from commercial banks or the nonbanking public. As just noted, the total amount the Treasury had to borrow in order to cover the Federal deficit was nearly $1.4 billion. These borrowed funds obtained by the Treasury and deposited in the RFC account returned to the economy in the form of RFC loans, mostly to banks in difficulty. These RFC infusions replaced the funds withdrawn by bank depositors. Nor is this all. Those who bought the Federal debt acquired an asset, Treasury obligations, that they must have preferred to what they had sold or otherwise they would not have bought them. People who had their deposits in those banks that borrowed from the RFC ought to have become more confident in the safety of their deposits because now the Federal government was a fellow depositor. These activities should have alleviated public anxiety about the banks.

See RFC Quarterly Report December 31, 1932, Table 8.
The RFC - Treasury operations had another important effect. Federal debt is not defined as part of the money supply. Even so, it is how people behave that counts, not definitions by economists. The shorter the term to maturity of a Treasury obligation, the nearer it is to money. A 90 day Treasury Bill is as safe as cash as a store of value if interest rates are constant. Even if they vary, the Treasury Bill is redeemable at face in at most 90 days. A Bill is even used as “money” for some purposes, for example, as margin in trading accounts. If banks' holdings of Federal government securities count as part of their reserve requirements, then borrowing by the Treasury can raise the money supply. This was true during the Civil War under the National Bank Act of June 3, 1864 that allowed National Banks to include Federal debt as legal reserves. However, until the Glass-Steagall Act of February 27, 1932, the Federal Reserve Banks could not count their holdings of U.S. Treasury obligations as part of their reserves. This meant that the gold reserves of the Federal Reserve Banks imposed an upper bound on the amount of U.S. Treasury obligations they could buy, Federal Reserve Banks had to hold a 35 percent reserve in gold against their deposits. Consequently, each dollar of Treasury bonds they bought from member banks would raise the member bank deposits by one dollar and the required gold reserve by 35 cents. The rapid loss of gold by Federal Reserve Banks following Britain's departure from the gold standard diminished the Fed's ability to make open market purchases. While it is true that the Fed's excess gold reserves in October 1931 were over $1.2 billion, given the rate at which the Fed was losing gold at that time, a reluctance to buy Treasury paper seems prudent. Critics of the Fed are wiser only after not before the fact. Excess reserves as a percentage of total gold reserves fell to little more than 56 percent by July 1932. It was well over 80 percent in the previous year. (Banking & Monetary Statistics, Table 93).

The increments in Federal debt held by the public should have produced some effects on the economy similar to an increase in the stock of money, broadly defined to include near money, especially with a reduced average maturity of the Federal debt. Indeed the average maturity did decrease as is shown by Table 1 containing the figures on the composition of the Federal debt by term to maturity.
Table 1: Relative Composition of Federal Debt by Term to Maturity in Selected Years*  

<table>
<thead>
<tr>
<th>Date</th>
<th>Bonds</th>
<th>Treasury Bills</th>
<th>Treasury Notes</th>
<th>Special Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>6/30/31</td>
<td>0.819</td>
<td>0.136</td>
<td>0.027</td>
<td>0.018</td>
</tr>
<tr>
<td>6/30/32</td>
<td>0.744</td>
<td>0.174</td>
<td>0.066</td>
<td>0.016</td>
</tr>
<tr>
<td>6/30/33</td>
<td>0.642</td>
<td>0.138</td>
<td>0.205</td>
<td>0.015</td>
</tr>
<tr>
<td>6/30/34</td>
<td>0.623</td>
<td>0.110</td>
<td>0.251</td>
<td>0.015</td>
</tr>
</tbody>
</table>

*Derived from Historical Statistics 1957, Tables Y376-Y397.

The shift in the composition of the debt from longer term maturities, Bonds, to shorter term maturities, Notes, is striking. The share of Notes rose steadily, Bonds fell steadily, and Bills first rose, then fell. Hence the Federal debt did become more like money by virtue of its shorter average term to maturity.

These RFC and Federal Reserve operations were very large. In 1932, the Gross National Product was just over $58 billion in 1932 dollars, (HS F-1), the Federal Reserve infusion of high powered money alone was 1.9 percent of GNP. It was 5.46 percent of currency and demand deposits at the end of December 1932. The replacement of private debt by Treasury debt in the form of the RFC loans, which were $1.225 billion, is over 2 percent of 1932 GNP and is more than 6 percent of currency and demand deposits at the end of December 1932.

The economy did respond with a short lag to these infusions as measured by the rise in industrial production and stock prices. From July 1932 to December 1932, production rose by 13.8 percent (from 58 to 66) and stock prices rose by 32 percent (from 37.9 to 50.1).

One might suppose that two Federal agencies lending to the banks would be twice as good as one, but this was not to be. First, divided responsibility created an excuse for less action by each, especially the Federal Reserve. Second, the RFC had less resources and was more constrained than the Federal Reserve though it could lend to all banks, not only the member banks. Third, the RFC was under even more political pressure than the Federal Reserve System. The greatest difficulty arose from trying to keep secret the identity of the banks who had requested or had obtained loans from the RFC. Secrecy was the standard for the Federal Reserve Banks who obeyed ancient central bank tradition but such was not the case for the RFC. Partly to stop political favoritism from becoming a criterion to get an RFC loan and partly to silence accusations that this was indeed happening, the identity of the banks who borrowed from the RFC was made public each month beginning in August 22, 1932. A contributing factor may have been the $90 million loan made on June 27 to the Central Republic Bank in Chicago, headed by Charles Dawes, 3 weeks after he had resigned as the first president of the RFC. The Dawes' Loan was 18 percent of the initial capital of the RFC. The total deposits of Central Republic were $95 million so the RFC loan covered almost all of them. (Dawes had been Vice President in Coolidge's second term and was the author of the famous Dawes' Plan to
settle German reparations that were required by the terms of the Versailles Treaty. Owing to this work Dawes won the Nobel Peace Prize in 1925.) One may even claim that the Dawes’ loan averted a national banking panic in July and August 1932 given what happened later in Detroit in February 1933. It strains credulity to affirm that the loan to Central Republic had nothing to do with Dawes’ position as head of the RFC even if the loan did serve the public interest.

The story of the Dawes bank loan told by Jesse Jones (1951, chap. 4) who was to become chairman of the RFC in May 1933 and to remain in this post until 1946 is fascinating and important for understanding the politics of the situation. Jones, a leading Democrat and a member of the RFC Board appointed by President Hoover, has extravagant praise for General Dawes. Writing almost two decades later, he vividly describes the atmosphere in Chicago on June 25, 1932 two days before the start of the Democratic Convention, as he “watched the tail end of the terrible runs on the big downtown banks. Thousands of frantic, rumor-spreading depositors were still milling about every bank entrance in La Salle, Clark and Dearborn streets. Bank lobbies swarmed with nervous customers. Many of these people had already lost heavily in the collapse of several outlying neighborhood banks which had dotted almost the entire city.” (p. 73)

Dawes’ attempt to rescue his Chicago bank, one of the 5 largest in the city, may have reckoned on the disastrous national consequences of its collapse. Jones himself had recommended to President Hoover that the RFC make the unusually large loan to Central Republic. The President, after consulting his leading advisors, agreed. Seemingly politics did not affect the RFC loan to Central Republic since it was recommended by a prominent Democrat to the Republican President but the public did not know this fact at the time of the loan. Whether the loan was in the public interest is debatable. It was surely in the private interest of the owners of the bank and its depositors. Dawes himself announced the loan publicly ostensibly to calm fears about the safety of the deposits in his bank. The Dawes’ loan led to a political uproar in Congress. A consequence was an amendment to the RFC Act passed by Congress on July 17, 1932. This Amendment required the RFC to make public the amounts of their loans in each previous month but not the identity of the borrowers. As Jones put it (1951, p. 82), the debate in Congress was bitter and the House evenly divided 169 to 169. The Speaker, John Nance Garner, cast the deciding vote in favor of the amendment. By then he was the Democratic candidate for Vice President. (At the Democratic Convention Garner had been nominated for President as the favorite son of Texas by his fellow Texan, Jesse Jones.) This legislation applied only to new borrowers starting in August 1932 and did not apply to earlier loans. Given Hoover’s opposition to the amendment and the close vote in the House, his perhaps surprising failure to veto the legislation, a veto that very likely would have been sustained, has been convincingly explained by Sullivan (1936, pp. 46-9). After the legislation had passed the House,

3 The Board of the RFC unanimously opposed this legislation and for good reasons (Congressional Record-Senate, 1932, pp. 15612-3).
President Hoover was able to get the Senate to modify it so that the identity of borrowers from the RFC would be given to the Clerk of the House and Secretary of the Senate only to be made public by order of these legislative bodies themselves. Hoover’s statement signing the legislation is as follow:

"...the possible destructive effect on credit institutions by the so-called publicity clause has been neutralized by the declaration of the Senate leaders of all parties that this provision is not to be retroactive, and that the required monthly reports are all of a confidential nature and must be so held by the clerks of the Senate and the House of Representatives, unless otherwise ordered by the Congress when in session." (Sullivan, 1936, p. 48)

President Hoover did not expect Speaker Garner would not keep his word.

The identity of no borrower during the first six months of RFC operations was revealed in August 1932. Moreover, even the revelations starting in August had no effect on the number of bank failures from August to December 1932. Perhaps aware that their loans from the RFC would become public, banks were reluctant to tap this resource, fearing that doing so would worsen, not improve, their financial position by inciting runs (Olson, 1977, pp. 98-100). The record shows that the number of bank applications for loans from the RFC fell uninterruptedly from the peak in April 1932. The drop was especially big in August 1932. From August to March 1933, the number held steady. The number of approved loans closely matches the number of loan applications.

In view of this, it is surely amazing that in February 1933, at the height of the final banking crisis, Garner said, "There is no place now under the flag where a man can deposit $100,000 to check against and be sure he can get it. The banks are afraid to make loans, even on adequate security. I have contended consistently that there has been too much secrecy about what has been going on in the past twelve months. If the truth scares people, let it come. Let the people know all about everything the government does." (Jones, 1951, p. 83)

Given these facts we are led to ask what prompts runs on banks. A bank’s promise to pay depositors on demand can induce runs because it must redeem deposits as long as it can. A depositor worried about the solvency of a bank will withdraw his deposit as soon as possible. A fearful depositor wants to be first in line so that he can get his funds before the bank runs out of cash. A more pernicious rule can hardly be devised. A different rule giving all depositors the same fraction of their deposits depending on the size of the remaining bank assets might reduce the chance of runs. Such a rule now applies to some financial institutions. Open-ended mutual funds promise their customers payment on demand an amount equal to the current net asset value of their shares usually as determined by the closing prices of the stocks in the fund. A drop in stock prices underlying net asset value affects all customers in proportion to the size of their holdings. This makes runs on open-ended mutual funds less likely. Even so, such funds may be forced to raise cash by selling assets unpropitiously. To lower the chance of this, an open-ended mutual fund usually holds cash reserves. Notwithstanding the prudence of these arrangements, an open-ended fund remains vulnerable,
perhaps in lessened degree, to the same danger as a bank with demand deposits. Closed-end funds are less vulnerable to this pressure because their holders can get cash only by selling their shares in these funds on the open market.

A bank must have cash when facing angry and fearful depositors. A member bank could get cash from a Federal Reserve Bank if it had eligible commercial paper to rediscount. Neither mortgages nor loans in default were eligible. Therefore, the Fed could not be the lender of last resort to those members most in need.

A bank’s promise to redeem deposits on demand can always be honored if their reserves are 100 percent of their demand liabilities or if some perfectly trustworthy entity makes good the bank’s promises to all its depositors, not just those with small deposits. Indeed deposit insurance confined to only small deposits cannot save a bank in distress.\(^4\)

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\(^4\) Currie (1938, pp. 344-6) describes empirical results of a study on the distribution of demand deposits in 1935. He shows that almost 85 percent of these deposits were large.