Reconstruction Finance Corporation and the Great Depression III

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4 The Reconstruction Finance Corporation during the New Deal Period

The RFC launched in the Hoover administration became a leading actor in the New Deal. It embarked on an unprecedented course early in 1934 when it was authorized to buy $823 million of preferred stock from 4,524 banks. This RFC preferred stock was unusual because it had voting rights equal to those of common stock. The first effect of this new program was a large infusion of capital into some banks without requiring them to have acceptable collateral. This laudable goal was to have unfortunate consequences that sadly confirm that he who pays the piper calls the tune. The most striking instance is shown in a series of news items in the New York Times starting January 3, 1934. A small story with a Washington January 2 date line reports that a subcommittee of directors of the Continental Illinois National Bank of Chicago in which the RFC owned [sic!] a controlling interest, was planning to come to Washington to discuss with Jesse Jones the question of who would become the new chairman of this bank. Jones had been elevated from RFC board member to its head by President Roosevelt. Another item in the same issue reports that the $75 million common stock of Continental Illinois had been reduced by $50 million and replaced by an equal amount of preferred stock owned by the RFC. This gave the RFC by virtue of a two to one majority voting control over Continental Illinois. It used its power to install Walter J. Cummings, the first head of the Federal Deposit Insurance Corporation (FDIC), as new chairman of Continental despite opposition from many of Continental’s directors. The January 12 New York Times quotes Jones as denying that the RFC would use the same tactic on the First National Bank of Chicago although it had bought $25 million of preferred stock in that bank. The RFC had also bought $50 million of preferred stock in the Chase National Bank of New York and also denied that it would exercise its power as it had in Continental Illinois. However, Mr. Aldrich, the chairman of Chase, is quoted in the New York Times as follows: "In spite of a definite published statement of the President of the United States to the contrary, there seems still to remain in the minds of many the feeling that the sale by a bank of preferred stock to the Reconstruction Finance Corporation will place in that corporation undue control over the affairs of that bank, and that such undue control may be exercised to the detriment of the interest of holders of common stock."

A front page New York Times story on December 5, 1933 brought to light another pertinent fact about RFC control over banks. This story concerns the $90 million RFC loan in July 1932 to Dawes' Central Republic Bank & Trust, the 5th largest in Chicago. The loan had become due on December 2, 1932, but as of November 5, 1933, $62 million had not been repaid. Moreover, the bank owed the RFC nearly $2 million in accrued, overdue and unpaid interest. Jesse Jones testifying before the Senate Banking Committee informed the Senators that it was the practice of the RFC to carry such loans on their books as payable on demand but that in fact the RFC had never demanded payment in any case thus far. Can one doubt that banks in these circumstances kept a close eye on their RFC overseer?

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10 Phillips (1995, pp. 86-9) discusses both economic and political issues surrounding the RFC during the New Deal period.
Fears about the control over business by the RFC were heightened by a later New York Times story, July 3, 1934, quoting Jesse Jones, "We are not bothered much about management," and then went on to say "when a corporation comes to the government for money it ought to be required that the salaries it pays are reasonable." Jones (1951, pp. 50-1) ingenuously describes a "rather ticklish reconstruction job" on the First National Bank of Amarillo Texas in which the largest shareholder and owner, W. H. Fuqua, was replaced by Tully Garner, the son of Vice President Garner after an evening meeting between Jones and T. Garner's parents. Jones says that while the father was silent, the mother approved the choice of her son to head the bank.

RFC preferred stock as a percentage of total common stock in all member banks reached nearly 38 percent by the third quarter of 1935. This gave the RFC considerable voting power over these banks. The RFC's share slowly fell to about 13 percent by the last quarter of 1941.

![RFC Preferred as Percent of Bank Common Stock, Qrtly](image)

**Figure 5**

The behavior of bank holdings of Federal securities is a revealing display of RFC power. Figure 6 shows bank holdings of Federal obligations relative to their private business loans quarterly from 1920 to 1940.
This ratio fell from 33.5 percent at the end of the first quarter of 1919 to below 25 percent in just one quarter. It stayed low throughout the 1920's, between 15 and 20 percent. The ratio began to rise in 1931. From the end of the first quarter of 1931 to the end of the last quarter of 1932, it rose from 22 to 43 percent. By the end of the second quarter of 1933, only three months after the New Deal began, it rose to 53 percent. The increased Federal deficit while a factor was surely not the whole story. By July 1, 1936, banks held 10 percent more U.S. Treasury obligations than they had lent to private business. Therefore, more than half of all member bank loans went to the Federal government. The ratio of bank holdings of Federal securities relative to their loans to private business fell during the last half of 1936 and continued falling throughout 1937, touching a low barely above 88 percent in the last quarter of 1937. For a detailed explanation for the drop in member bank holdings of U.S. government securities as their response to the higher reserve requirements imposed by the Federal Reserve see (Telser, 2002). From the last quarter of 1937 to the end of 1941, when the U.S. entered World War II, the ratio began to climb, reaching 108 percent by the end of the period we study.

U.S. obligations being default free are safer than loans to private business. While it is true that banks began to shift more of their loan portfolios to Federal government paper two years before the start of the RFC's preferred stock program, it seems likely that potential government control over bank affairs had an effect on their lending policy. What RFC official would criticize a bank for taking undue risk by purchasing U.S. government securities? The following statement by Jesse Jones is noteworthy. "Many banks had a ratio of deposits out of proportion to their capital. Because they couldn't lend profitably, they were inclined to retire their RFC capital without replacing it with private capital. To retard that movement we agreed, late in 1936, to accept interest-bearing United States Government bonds at par and accrued interest from banks in retirement of their RFC capital whenever the retirement should take place. Thus a bank could earmark long-term government bonds against its RFC capital, and, if the bonds bore 2 1/2 per cent interest the capital would cost the bank only 1/2 of 1 per cent a year, which is cheap capital." (Jones, 1951, p. 37). 

Figure 6

Ratio Bank Holdings US Securities to Loans Qrtly
The rate of return on preferred stock was initially set at 5 percent but it was soon reduced to 4 percent and then to 3.5 percent. On October 1, 1936 it was reduced to 3 percent (Jones, 1951, p. 36). Hence the cost to a bank of RFC preferred stock fell from 5 percent to 3 percent. This infusion of capital into a bank that sold preferred stock to the RFC boosted its reserves by the whole infusion like any sale of common stock but unlike a deposit that would raise its required reserves. Therefore a bank could increase its loans to its customers by a bigger multiple than from an ordinary deposit of equal size. It would even be profitable for a bank to buy U.S. Treasury bonds from the public or from another bank because this would not affect its reserve. Only Treasury bond sales by the Fed reduces the stock of high powered money. Therefore the preferred stock program of the RFC could increase the stock of high powered money dollar for dollar. The argument that a bank which sells preferred stock to the RFC thereby impairs its reputation makes little sense. Indeed, on the contrary, it would strengthen, not weaken, the credit standing of the bank to have acquired additional capital from the RFC by selling preferred stock to it.

However, the statement by Jesse Jones needs elucidation. It implies the RFC preferred stock program was not successful insofar as it did not stimulate enough bank lending to private business. In an attempt to prod the banks to lend more to private business, the RFC would accept “earmarked” U.S. Treasury bonds from the bank in return for canceling RFC’s holdings of preferred stock in the bank. It would be profitable for a bank to set aside its Treasury bonds in this program because the bank would lose 2 1/2 percent interest on Treasury bonds and would save 3 percent on its RFC preferred stock for a net gain of 1/2 percent. Moreover, the exchange of Treasury bonds for RFC preferred stock would not affect the bank’s required reserve.

Buying Treasury bonds to replace RFC holdings of preferred stock would not prod a bank to lend more to private business. Indeed the main thrust of the Jones program would have the opposite effect to the one Jones claims. It would induce banks to buy US Treasury bonds instead of lending to private business. The bank’s incentive to do so is limited by the amount of preferred stock it had sold to the RFC. Therefore Jones’ device discouraged, not encouraged, bank loans to private business.

The least intrusive tool in the hands of the monetary authority for changing the money supply is open market operations. When a Federal Reserve Bank lends to a member bank in return for banker’s acceptances or rediscounts the bank’s commercial paper, it can control the channels of bank credit. It thereby affects the direction of bank credit more than purchases or sales of Federal securities in open market operations. Bank lending to private business, even when backed by collateral, depends on information about the credit standing of the borrower so it must obtain more details about the borrower’s business. The Reconstruction Finance Corporation, an agency of the Federal government, by its purchases of preferred stock from commercial banks imposed conditions on them without peacetime precedent.

5. Conclusions

The sequence of events described here demonstrates that at each critical stage there were many alternatives. Some could have led to a happier ending than the collapse of the banking system. I show that at each critical stage the choice was often the worst.

Olson (1977, p. 9) asserts wrongly the initial rate on RFC preferred stock was set at 6 percent soon reduced to 4 percent. Given that Jones stated the correct figures in his book published 16 years before Olson’s, this carelessness is inexcusable.
The record supports two propositions. First, owing to the political repercussions engendered by the RFC, it caused the collapse of the banking system. This collapse transformed a severe depression into the Great Depression. Second, after the new administration took office the RFC began a program of injecting capital into banks by buying preferred stock from them. This placed effective control over many banks in RFC’s hands. The well-intentioned but unintended effect was to discourage bank lending to the private sector. The RFC thereby hindered recovery from the Great Depression.
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