Franklin Roosevelt's 'Credit Banks'

by Michael Kirsch

This is Part IV of a lecture given on July 29, 2013, titled "FDR's Approximation of the Bank of the United States Credit System." Parts I-III appeared in the last three issues of EIR.

Having now discussed the credit principle and its relation with the authority of government, and also the correct understanding of debt in the American credit system, I want to conclude with a review of how President Franklin Roosevelt's chief credit institution came to obtain the powers of direct lending, and why this is the most essential function to understand.

Today, without the government's direct hand, there is no way the banking system would ever come back this year. But in 1933, the issue was the same.

The government decided, first of all, to write off all of the worthless debt, which was first made possible with the Bank Conservation Act, and then made permanent with the Glass-Steagall Banking Act: separating bond departments of member banks, restricting them from buying and selling securities, underwriting investment securities, interlocking with security companies, receiving deposits by firms engaged in security dealing, etc. All of these separations of investment and commercial banking were done to get the banking system in such a shape that it could now function as part of a productive economy.

There were assets in the banking system that were idle, and the government could borrow those, and allow the banks to invest in the public debt of the government, because then the government would direct that idle capital toward the things that were going to drive the economy forward, and, by the way, increase the valid profit of those banks more than they themselves could ever do.

But, after writing off all the worthless debt, and passing the Glass-Steagall Act, there is *no way* that those banks by themselves would ever cause a recovery just by the laissez-faire structure of the Federal Reserve System. Because in the structure of the Federal Reserve System—not to mention everything else wrong in its creation and the intention behind it—there was no credit in the sense of intended credit. There was credit that could be infused if the member bank went to the Federal Reserve and said, "I have a security, a promissory note, a bill of exchange. Will you monetize it, will you discount this security?" Then they could get credit; but the banks had to have those securities. Where are they going to get them, if the economy is collapsed, and no activity is going on?

The Fed does not care; it is just laissez-faire; it is going to respond to the supply and demand of the member banks—not even to the real economy. The Federal Reserve Act does not have anything to do with the real economy. It simply has to do with these member banks and just passively monetizes notes. It does not *intend* anything.

FDR's Problem with the Fed

Roosevelt had a problem. He was going to have to go around that Federal Reserve System, which was not going to generate a recovery.

After reorganizing the banks, then he had to say, "How am I going to take this laissez-faire passive bank structure, which does not even have the ability to lend to member banks, and transform it?" In March 1933, the Emergency Bank Act gave the Federal Reserve, in Section 13, the power to make advances to any individual partnership or corporation on the promissory notes of such borrowers. It could not do even that simple action before this emergency act. The Fed could not assist corporations. In 1932, it could not lend to any bank. It could discount a security, but it could not lend directly to a bank. The Fed could not even lend to its own member banks. Therefore, in the crisis situation of 1933, Congress had to give it special powers, but that was to deal with the immediate financial crisis.

What Roosevelt was interested in was not the financial crisis of the banks per se, but how he could get this Federal Reserve structure to directly lend for other parts of the economy—corporations, individuals, and for other purposes. His idea was to set up 12 "Credit Banks for Industry." The way that this came to be was as follows.

By the end of 1933, there was a clear problem. Jesse

Bill to Create Credit Banks for Industry

A Bill

To provide for the creation of credit banks for industry, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, that this act may be cited as the "Credit Banks for Industry Act."

SECTION 2. The Federal Reserve Board shall issue charters under which there shall be established in each Federal Reserve district a credit bank for industry, hereinafter referred to as credit bank, which shall be located in the same city as the Federal Reserve Bank, and the title of which shall include the name of such city. Each credit bank shall be organized in

FDR's proposed "Bill to Provide for the Credit Banks for Industry" was introduced to Congress, but did not pass.

Jones, at the head of the Reconstruction Finance Corporation (RFC), wrote on Feb. 5, 1934, "Banks are not extending enough new credit." He continued:

"There is never a day that the RFC does not have applications for individual and industrial loans that are perfectly sound. They are not loans that would be liquidated in a few months, but many of them could be made by the local bank and could be liquidated if the borrower is given reasonable time and notice."

There was not enough lending by the banks. The Business Advisory Council did a study for the Department of Commerce, that showed that 45% of borrowers were having credit difficulties. They found that only 374 of 1,788 applications were actually approved, despite the sound position of the firm and the eventual liquidation of the loan (meaning it would be made good upon).

So here are the banks, reorganized, right? Through the Bank Conservation Act, the bad assets were written off, and then Glass-Steagall was passed in the Banking Act of 1933. The banks were sound, so why were they not lending?

It was because the entire structure of the Federal Reserve System was a problem. Roosevelt said, what we have to do for the sake of smaller, medium-sized business concerns, and the growth of the overall economy, is to figure out how to take this Federal Reserve structure and transform it permanently into a direct lending system. That was his intention.

Roosevelt wrote on March 19, 1934 to Sen. Henry P. Fletcher of the Senate Banking Committee, stating that there was a need for working capital for small businesses. He cited a study the Administration had done of banks and Chambers of Commerce (which could be done again today), to determine how much credit was needed. And they found out that for 4,958 banks and 1,000 Chambers of Commerce, small industries needed $700 million, and could employ 350,000 existing, and 350,000 new employees.

At the beginning of the letter, he writes, "May I suggest to your Committee legislation to create twelve Credit Banks for Industry." Henry Steagall introduced the bill into the House, and Henry Fletcher introduced a companion into the Senate, as "A Bill To Provide for the Credit Banks for Industry." I was able to obtain the original of this draft legislation, which I will briefly review here.

There was to be one in each Federal Reserve District, and they would be guided by industrialists, as the majority of the directors of each credit bank were to be "actively engaged in its district in some kind of industrial pursuit." They would advise what to lend, to guide the economy forward with direct lending. That was going to be a very efficient structure.

The two main powers were, 1) to directly lend in extraordinary circumstances to businesses and industries, but also, 2) to assist the other lending corporations and financing institutions, such as mortgage companies, trust corporations, banks, and credit corporations. The credit bank would guarantee a loan or engage in it 50%, or back it up. They would promote banks in the area to lend themselves, and set the context, and in extraordinary circumstances, to directly lend.

Here are excerpts from Section 3 and Section 4 of the bill:

"Each credit bank shall have power to discount for, or purchase from, any bank, trust company, mortgage company, credit corporation for industry, or other financing institution operating in its district, obligations having maturities not exceeding five years, entered into for the purpose of obtaining working capital for any established industrial or commercial business; to make loans or advances direct to any such institution on the security of such obligations....

"In exceptional circumstances, when ... an established industrial or commercial business located in its district is unable to obtain requisite financial assistance on a reasonable basis from the usual sources, the credit bank may make advances to, or purchase obligations of, such business, or may make commitments with respect thereto, for the purpose of providing it with working capital."

The Industrial Advances Act

The credit bank bill did not pass, but the end result of this proposal was the passage of the Industrial Advances Act in June 1934.

It was the beginning of 1934, when the credit banks were proposed, the intent was likely to get rid of Hoover's RFC and replace it with the credit bank transformation of the Federal Reserve System. But instead, since they could not get it passed, the RFC was given all of the exact, verbatim powers which *were* to be given to these credit banks for industry, in the Industrial Advances Act. Prior to that act, the RFC had no such general lending powers.

Along with the RFC, the Federal Reserve was given similar powers, which I have written about elsewhere. They were given the power to discount, purchase securities from financial institutions, and when an industrial or commercial business in the district would be unable to acquire other financial assistance from a bank, to make advances to it, lending, purchasing obligations from it, and so forth.

There were two other parts of the Industrial Advances Act that read like a type of bankruptcy reorganization for the industrial economy: that it is not a question of writing off the bad assets, but, as in Alexander Hamilton's maxim of public credit in 1790, to make sure that every debt and every loan (of the corporations, in this case) is not something which is a self-evident object that will bankrupt the company because it cannot make good on it. Instead, what the Act did was to make sure that the debt of the company would be tied to its ability to finally produce above a level of breakeven, whatever the time scale of the reorganization had to be (of course that does not mean for all cases, as there are some failed companies that should go down).

Accordingly, the RFC was given the power to extend the time of payment of a loan, through renewal, substitution of new obligations, with a maximum time for such renewal to be established by the board. It could also make such further loans and contracts for the completion of projects, and for additions and improvements and extensions necessary for proper functioning of the completed project, and which would increase assurance of the borrower to repay the entire loan or loans.

Thus, not only did the Industrial Advances Act give the RFC the ability to make loans, directly, or in cooperation with banks or other lending institutions, but also to transform the monetary debts of industries into credit debts, tied to the future completion of products and overall increased productivity of the economy. All of this was intended as a permanent structure of the Federal Reserve System in the original 12 Credit Banks for Industry bill.

Conclusion

In Roosevelt's budget addresses, in a sense, in the shadows of his discussion of what budgeting should be, in terms of incomes, expenditures, and borrowings, he was performing a fine-tuned balancing act toward an overall increase of the productivity of the country. You see his concept of how to organize the financial system.

But then you realize that that organization and fine-tuning were only possible because of the credit lending institutions in operation, as I have reviewed in the other parts of this lecture. The reason there was an increasing surplus was not because there was "deficit spending" in the abstract, but because the borrowing by the government was for physical improvements that would truly increase the overall national wealth.

Most significantly, it is important to look back to Roosevelt to see that success demanded a direct lending institution, in the form of the transformed RFC, which was very similar to the Bank of the United States principle—and to see that such a lending institution is inherent in the Constitution itself, and in the Constitution's ability to uphold the inalienable rights of man.

This is the lesson of Franklin Roosevelt, and his credit principle.