Fed Credit Policy during the Great Depression

By Tim Sablik

Responding to the financial crisis of 2007–09, the Federal Reserve made loans to nonbank firms and purchased (and continues to purchase) mortgage-backed securities. These actions are examples of credit policy, which is distinct from monetary policy. But this is not the first time the central bank has engaged in credit policy. During the Great Depression, Reserve Banks exercised broad authority to lend to nonbank businesses.

For much of its history, the Federal Reserve has conducted monetary policy through the discount window—initially by rediscounting short-term commercial paper and later by purchasing Treasury securities on the open market. This policy of holding only high-quality, liquid assets protected the Fed's balance sheet from risk and avoided allocating credit to any particular sector of the economy. During the 2007–09 financial crisis, however, the Fed departed from this practice by purchasing mortgage-backed securities (MBS) and accepting MBS as collateral on loans to non-depository financial institutions.

Although definitions for credit policy vary, economist Marvin Goodfriend, a former director of research at the Richmond Fed who has written extensively on the subject, defines credit policy as "lending to particular borrowers or acquiring non-Treasury securities with proceeds from the sale of Treasuries." This *Economic Brief* employs Goodfriend's definition.

By allocating credit to specific firms or sectors, Goodfriend argues, the Federal Reserve distributes public funds (seigniorage reserves) to specific entities without the democratic review process that accompanies congressional appropriations. Additionally, when the Fed accepts non-Treasury assets onto its balance sheet, it exposes the public to the risk of securities not backed by the full faith and credit of the United States government. For these reasons and others, some economists and policymakers have contended that the Fed should not engage in credit policy.[1]

The Fed's proper role in providing liquidity has been debated many times during its history.[2] In fact, as early as the congressional debates over the Federal Reserve Act of 1913, some members of Congress argued that the Federal Reserve should have the authority to extend credit to individuals, as well as member banks, to allow the central bank to expand liquidity more effectively during financial crises. Ultimately, Congress decided that the Fed should not compete with commercial banks to make loans to the general public and should act as a lender of last resort for banks only.

The Fed's First Crisis

The United States was in the grips of the Great Depression in January 1932, when President Herbert Hoover signed legislation creating the Reconstruction Finance Corporation (RFC). This government entity was charged with making loans primarily to banks, credit unions, and other financial institutions. At the time, Reserve

Banks were only allowed to make very short-term loans to member banks and accept only real bills (short-term debt from businesses) as collateral. The Hoover administration felt that immediate action was needed to inject capital into banks. The RFC represented the largest U.S. government intervention in private markets during peacetime to date.[3] Nevertheless, Hoover balked at granting the RFC authority to lend to individuals, vetoing a bill in July 1932 that would have given the RFC such power. Congress promptly passed a new bill that amended the Federal Reserve Act by adding section 13, paragraph 3, which read in part:

> "In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank … to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount for member banks under other provisions of this Act when such notes, drafts, and bills of exchange are indorsed and otherwise secured to the satisfaction of the Federal Reserve bank."

Although section 13(3) seemed to signal a major expansion of the Federal Reserve's ability to allocate credit to individuals and businesses, a number of limitations kept it from having much of an immediate impact. The act stipulated that Reserve Banks could lend to individuals through the discount window only in exchange for commercial paper eligible for discount to member banks, which was not typically held by nonbank entities. Additionally, the Federal Reserve Board of Governors issued guidance stating that section 13(3) loans should not be made to banks, preventing nonmember banks, which would have been most likely to hold the appropriate commercial paper, from accessing the discount window. For these reasons and others, section 13(3) had minimal impact—the Reserve Banks loaned a total of about $1.5 million to 123 businesses over four years starting in 1932, according to Howard Hackley, who wrote a history of the Fed's lending practices while serving as the Board's general counsel from 1957–71.[4] Another reason for the minimal impact of section 13(3) was that it soon would be superseded by even broader authority to conduct credit policy.

Lending to Industry

On March 9, 1933, in the wake of a resurgent banking crisis, President Franklin D. Roosevelt signed the Emergency Banking Act. Although the legislation further amended section 13 of the Federal Reserve Act, Roosevelt and Congress decided that these changes were not enough. The banking crisis of 1933 had left banks reluctant to make long-term loans, and regulators required them to maintain certain liquidity levels. By early 1934, Roosevelt was concerned that banks were not extending the long-term credit small businesses needed to maintain their working capital.

At the time, the Federal Reserve was limited to making loans with maturities of no greater than 90 days, and the RFC could only lend to financial institutions. The Board of Governors agreed that something had to be done to meet the need for long-term loans to small businesses. According to a letter to the Senate Banking and Currency Committee in April 1934, quoted by Hackley, the Board said that "there exists an undoubted need for credit facilities for industry and commerce beyond those that are now being supplied through the commercial banks or that can be supplied through the ordinary operations of the Federal Reserve System."[5]

Congress began debating two proposals to remedy the perceived lack of credit for working capital. The first bill would have created a system of 12 federal credit banks modeled after and overseen by the 12 Reserve Banks. But Congress ultimately decided that the Reserve Banks should handle the loans directly. The second proposal was to expand the authority of the RFC to make loans to businesses. Though both plans seemed to address the same perceived problem, the RFC was envisioned as a temporary organization to serve as a backup to the Fed during the crisis.[6]

Congress passed both laws in the summer of 1934, adding section 13(b) to the Federal Reserve Act, granting Reserve Banks the authority, under exceptional circumstances, to directly extend loans with durations of up to five years to established businesses within their districts. Additionally, section 13(b) gave nonmember banks and other financing institutions access to the discount window. They also could purchase loan commitments from their respective Reserve Banks. The commitments gave the private lenders the option of transferring covered loans to the Reserve Banks (retaining only 20 percent of the risk) if the lenders faced sudden needs for liquidity. These loans and commitments were subject to the approval of the Board of Governors, but soon after the law's passage, the Board granted authority to each Reserve Bank to review and approve their own loans and commitments. The Board also expressed its support for the goals of the Fed's new authority in a press statement issued on June 28, 1934:[7]

> "Recognizing the need of these industrial and commercial businesses for additional working capital to enable them to continue or resume normal operations and to maintain employment or provide additional employment, Congress has granted the Federal Reserve banks broad powers to enable them to provide such working capital, either through the medium of other banks, trust companies, and other financing institutions or, in exceptional circumstances, directly to such commercial and industrial businesses. It is believed that the facilities thus afforded will aid in the recovery of business, the increase of employment, and the general betterment of conditions throughout the country."

The Board noted that the Federal Reserve's intent was not to "compete with local banks, but rather assist and cooperate with them in meeting local requirements for working capital." There was some concern in Congress and the Roosevelt administration that the Federal Reserve would be too reluctant to engage in direct lending, so the law established an Industrial Advisory Committee (IAC) at each Reserve Bank to oversee loan requests. Each Reserve Bank appointed five IAC members to one-year terms subject to approval by the Board of Governors.

The total amount in the Federal Reserve System available for lending was not to exceed the combined surplus of the Reserve Banks as of June 1, 1934, which was $138.4 million. Additionally, the secretary of the Treasury was authorized to pay $139.3 million to the Reserve Banks for lending purposes, bringing the limit on outstanding credit to $277.7 million, which was to be divided proportionally among the 12 Reserve Banks. The Fed quickly began to advertise its new authority, as described by Board member M.S. Szymczak in a speech to the Illinois Bankers Association: "Every effort has been made through pamphlets, letters, addresses, personal calls and even by radio to make the new functions of the Federal Reserve Banks widely known."[8]

By the end of 1934, the Federal Reserve System had approved 1,020 of 5,108 applications for commitments and direct loans. From the law's passage on June 19, 1934, to May 1, 1935, systemwide direct loans included $32.6 million to manufacturers, $5.8 million to wholesalers and retailers, and $5.5 million to miscellaneous industries such as construction, mining, lodging, and transportation. The grand total for approved direct loan applications was $43.9 million, or $738.4 million in 2013 dollars. (See Table 1 on the following page for a breakdown of loans and commitments by business category.)

The amount of loans and commitments outstanding would peak by the end of 1935 at about $60 million. (The Richmond Fed had about $2.9 million in loans and $2.3 million in commitments.) In 1935, and again in 1938, the lending authority of the RFC was expanded, and it took the lead in making government loans to industry. By 1937, the Federal Reserve System approved just 126 new loan and commitment requests, and the Richmond Fed approved just $220,000 in new loans.

Exiting Direct Lending

The RFC's broader authority to make industrial loans made Federal Reserve credit through section 13(b) less attractive to businesses. As the Great Depression persisted, some members of the Board of Governors argued that restrictions on the Fed's lending authority should be removed or additional authority should be

Table 1: Loans and Commitments Approved by Reserve Banks from June 19, 1934, to May 1, 1935

	Commitments		Direct Loans	
Business Categories	**No.**	**Amount**	**No.**	**Amount**
Manufacturers:				
Aircraft	0	$0	2	$1,150,000
Autos, trucks, and accessories	17	7,732,500	16	4,072,000
Chemicals and allied products	15	363,500	28	882,517
Electrical goods	9	1,027,000	4	32,000
Food products	27	1,029,300	68	1,959,000
Furniture, office and household equipment	31	1,964,500	46	2,448,000
Hides and leather	4	111,400	6	352,600
Jewelry and silverware	2	27,300	6	67,500
Liquors, wines, and beer	21	2,455,500	15	987,000
Lumber and builders' supplies	31	2,286,600	46	3,332,000
Machinery and machine tools	33	3,285,000	51	3,924,400
Metals	27	2,798,000	49	4,112,500
Paper products	10	398,700	14	1,636,400
Railway equipment	1	250,000	0	0
Rubber goods	1	200,000	1	30,000
Stone, clay, and glass products	6	1,265,000	13	235,250
Textiles	19	2,493,500	35	3,735,750
Wearing apparel, shoes, etc.	34	1,256,500	48	1,466,450
Wood products	6	451,000	13	474,000
Other	20	460,640	50	1,728,500
Total	**314**	**$29,855,940**	**511**	**$32,625,867**
Wholesale and retail trades:				
Autos and accessories	11	$116,200	22	$224,150
Chain and department stores	15	689,000	48	650,800
Clothing, dry goods, jewelry	16	435,500	25	230,850
Drugs, tobacco, and liquor	6	126,000	13	96,000
Florists, nurseries, etc.	4	49,000	5	97,000
Food products	30	1,985,900	50	1,359,450
Furniture	5	53,000	13	180,500
Grain, feed, seeds, etc.	12	753,000	28	799,000
Hardware and machinery	0	0	4	78,000
Lumber and builders' supplies	42	1,630,700	40	927,550
Oil	4	360,000	18	814,000
Other	10	235,500	26	355,000
Total	**155**	**$6,433,800**	**292**	**$5,812,300**
Miscellaneous:				
Contractors and construction	19	$1,572,000	37	$1,553,500
Hotels, apartments, restaurants, etc.	8	188,500	4	334,500
Laundries, cleaners, and dyers	1	6,000	13	277,200
Mines and quarries	1	60,000	15	966,500
Oil and gas production	0	0	3	210,000
Printing, publishing, and allied trades	22	953,000	51	811,600
Shipbuilding and repairing	0	0	1	75,000
Transportation	6	120,000	4	515,000
Other	5	227,500	30	750,900
Total	**62**	**$3,127,000**	**158**	**$5,494,200**
Grand Totals	**531**	**$39,416,740**	**961**	**$43,932,367**
Grand Totals in 2013 Dollars		**$662,546,488**		**$738,448,575**

Source: *Federal Reserve Bulletin*, June 1935, p. 340
Note: Direct loans were called "advances" in 1935. "Commitments" were essentially loan guarantees extended to lenders by Reserve Banks covering up to 80 percent of each loan's risk.

vested in a new entity to continue to provide credit to the struggling economy. In a statement to the Senate Committee on Banking and Currency in 1939, during hearings on a bill to modify section 13(b), Fed Chairman Marriner Eccles said, "I believe that the authority which has been given to the Federal Reserve banks in this respect has not been sufficiently comprehensive. Many loans which might otherwise have been made have had to be declined because of restrictions in the law."[9]

Eccles outlined a plan to create an Industrial Loan Corporation as part of the Federal Reserve System to oversee greater industrial loans and the purchase of companies' preferred stock. Such a plan would have repealed section 13(b), separating the lending function from the Federal Reserve's monetary policy role, similar to Roosevelt's original proposal. This bill did not pass, but as the United States geared up for war in the 1940s, the Federal Reserve would be called upon to assist in making industrial loans for militarization due to its experience lending under section 13(b).[10]

In 1947, Chairman Eccles again appeared before Congress during a hearing on a bill to repeal section 13(b) and grant broader, more permanent lending authority to the Federal Reserve. Eccles still perceived a need for the Federal Reserve to play some role in credit policy, but by then he viewed it largely as a supporting role:

> "The history of the Federal Reserve Act and its sole purpose was not to help banks as such but its purpose was to help commerce, agriculture, and industry, that was its basic purpose. The purpose was to see that the credit was provided. What this [bill] is undertaking to do is intended to help the banks to provide that credit."[11]

By the 1950s, sentiment at the Board had shifted against Federal Reserve lending to nonbank businesses.[12] In 1957, Fed Chairman William McChesney Martin testified before the Senate Banking and Currency Committee during consideration of a new bill to address small business credit concerns. Although Martin expressed support for government institutions to address gaps in private sector lending, he said that "it is undesirable for the Federal Reserve to provide the capital and participate in management functions in the proposed institutions."

On Aug. 21, 1958, the Small Business Investment Company Act repealed section 13(b) of the Federal Reserve Act, officially putting the Federal Reserve out of the commercial lending business. However, the emergency lending powers granted under section 13(3) remain part of the Federal Reserve Act and were employed during the most recent crisis to extend aid to financial institutions. Following the financial crisis, there has been some movement toward limiting the Fed's involvement in credit policy. In March 2009, the Federal Reserve and the Treasury Department released a joint statement noting that "actions taken by the Federal Reserve should … aim to improve financial or credit conditions broadly, not to allocate credit to narrowly-defined sectors or classes of borrowers."[13] More recently, the Dodd-Frank Act modified section 13(3) by striking the language allowing Reserve Banks to discount to "any individual, partnership, or corporation" and replacing those words with "participant in any program or facility with broad-based eligibility." Additionally, the Board of Governors now must obtain approval from the secretary of the Treasury before allocating credit under section 13(3). ■

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Endnotes

1 Richmond Fed researchers have written extensively on the topic of Federal Reserve credit policy. See, for example, Federal Reserve Bank of Richmond *Economic Quarterly*, Winter 2001, vol. 87, no. 1, special issue commemorating the Treasury-Federal Reserve Accord; and Hetzel, Robert L., "The Case for a Monetary Rule in a Constitutional Democracy," Federal Reserve Bank of Richmond *Economic Quarterly*, Spring 1997, vol. 83, no. 2, pp. 45–65. Additionally, Richmond Fed President Jeffrey Lacker has supported the idea of a

"credit accord," whereby the Fed would make an agreement with fiscal authorities not to engage in credit policy. See, for example, "Perspectives on Monetary and Credit Policy," Speech at the Shadow Open Market Committee Symposium, New York, Nov. 20, 2012, and "The Dangers of the Fed Conducting Credit Policy," Federal Reserve Bank of Richmond *Region Focus*, Fourth Quarter 2012, vol. 16, no. 4, p. 1.

[2] This *Economic Brief* looks at the early history of the Federal Reserve's involvement in credit policy. For a broader overview of the Fed's historical involvement in credit policy, see Price, David A., "When the Fed Conducts Credit Policy," Federal Reserve Bank of Richmond *Region Focus*, First Quarter 2012, vol. 16, no. 1, pp. 6–8.

[3] For more information on the RFC, see Todd, Walker F., "History of and Rationales for the Reconstruction Finance Corporation," Federal Reserve Bank of Cleveland *Economic Review*, Fourth Quarter 1992, vol. 28, no. 4, pp. 22–35.

[4] Hackley, Howard H., *Lending Functions of the Federal Reserve Banks: A History*, Board of Governors of the Federal Reserve System, May 1973.

[5] Hackley, p. 134.

[6] According to Hackley, the RFC was viewed at the time as a temporary emergency agency. This was reflected in the bill to expand its lending authority, which was set to expire on Jan. 31, 1935. Additionally, the original language of the RFC bill stipulated that the RFC would only make loans when credit "is not otherwise available at banks *or at the Federal Reserve bank of the district in which the applicant is located*" (emphasis added). The italicized words were removed from the final bill, making it less clear that the RFC should be secondary to Reserve Banks in making industrial loans.

[7] Reprinted in the *Federal Reserve Bulletin*, July 1934, vol. 20, no. 7, p. 429.

[8] Szymczak, M.S., "Recent Relations of the Federal Reserve System with Business and Industry," Speech before the Illinois Bankers Association, Decatur, Ill., May 20, 1935.

[9] Board of Governors of the Federal Reserve System, "Statement of Chairman Eccles before the Senate Committee on Banking and Currency with Reference to S. 2343," June 5, 1939.

[10] The Federal Reserve System would play a major role in guaranteeing government loans to the defense industry made under the V-loan program during World War II. According to Hackley, the Fed would approve $128 million in loans in 1942, "the peak volume for any year in the history of their industrial loan operations."

[11] "Federal Reserve Assistance in Financing Small Business," Hearing before the Senate Committee on Banking and Currency on S. 408, April 17, 1947.

[12] Congress also had begun to question the wisdom of the government being involved in credit allocation during this time. The RFC ceased operations in 1953 amid allegations of political corruption and patronage.

[13] Board of Governors of the Federal Reserve System and the Department of the Treasury, "The Role of the Federal Reserve in Preserving Financial and Monetary Stability," March 23, 2009.