

Bill of Rights in Action



SUMMER 2012

Volume 27 № 4

FDR AND THE BANKS

THE U.S. BANKING SYSTEM HAD COLLAPSED WHEN FRANKLIN D. ROOSEVELT (FDR) WAS INAUGURATED PRESIDENT IN 1933. FDR AND CONGRESS MOVED QUICKLY TO RESTORE PUBLIC CONFIDENCE IN THE BANKS. THEN THEY ENACTED MAJOR BANKING REFORMS.

After the stock market crash in 1929, economic conditions in the U.S. worsened into a deep depression. Industrial production slowed steadily, stock prices continued to fall, and unemployment went from 4 percent in 1929 to 25 percent by 1933.

Economists have explained a number of causes for what became known as the Great Depression. One is how the banking system operated.

Banking System

The banking system consisted of privately owned banks chartered by



Wikimedia Commons

ANXIOUS DEPOSITORS MILLED outside a bank early in the Great Depression.

states or the federal government. Most banking regulation was done by the states, but the federal government also operated the Federal Reserve System, commonly called “the Fed.” All federally chartered banks had to be members of the Fed.

The Fed was governed by 12 Federal Reserve Banks in different regions of the country and a Federal Reserve Board in Washington. Cre-

ated by Congress in 1913, the Fed’s role was to stabilize the banking system, which had been plagued by numerous bank panics in the 19th and early 20th century.

Bank panics could occur when depositors believed a bank was in financial trouble. They might hear that the bank had made bad investments, or a rumor might circulate that bank employees had embezzled funds. In a panic, depositors rushed to the bank to demand money from their accounts. Banks had some money on hand, but most of their money was invested or lent to others. Thus even a sound bank might have trouble paying its depositors in a panic. A bank might try to borrow from another bank, but other banks might turn it down. Once a panic began in one bank, it could easily spread to others, as people grew unsure about the banking system. If a bank closed, this would be a disaster ▶

FACING CRISES

This edition of *Bill of Rights in Action* examines crises – past and present. The first article explores the banking crisis, not the recent one, but the one in the 1930s. The second article examines the Munich agreement, made in the face of the threat of Nazi Germany. The last article looks at our current unemployment crisis and the prospect for future jobs in the U.S.

U.S. History: FDR and the Banks

World History: Munich and “Appeasement”

Current Issue: Unemployment and the Future of Jobs in America

Guest writer Lucy Eisenberg, Esq., contributed the article on Munich. Our longtime contributor Carlton Martz wrote the other two articles.

for its depositors since no national system of deposit insurance existed as it does today. Depositors would lose all the money in their accounts.

One purpose of the Fed was to serve as the “lender of last resort.” It was a kind of bankers’ bank, lending money to federally chartered banks in an emergency, such as a bank panic.

Another purpose of the Federal Reserve System was to make sure that private banks chartered by the federal government had enough currency (gold coins and paper money) to meet the needs of commerce. The Fed did this by regulating interest rates on borrowing to keep the money supply stable.

Fed's Actions in the Crisis

In 1931 in the midst of the Great Depression, the Fed acted to increase interest rates on savings accounts. The Fed wanted to encourage bank depositors to keep their money in banks and earn interest. Many depositors had been demanding their money back in gold.

The United States was on the gold standard. By law, paper money was backed by gold. The Treasury Department could only print money if the banking system could back it with gold. If depositors took gold out of the banks and hoarded it, the paper money supply would eventually shrink, depressing economic activity.

By raising interest rates, the Fed affected consumer borrowing. Higher rates meant tighter credit and fewer people could qualify for loans, which further reduced the amount of money in circulation.

Although designed as the “lender of last resort” for banks, the Fed was designed mainly to keep the big Wall Street banks stable. Almost all the bank panics in the past had occurred in New York City. Thus when banks began failing outside New York, the Fed failed to loan money to help the troubled banks. The Fed concluded it could stop the banking crisis by just making loans to the Wall Street banks. This policy worked on Wall Street, but banks continued to fail all over the country. Since many of these banks were not members of the Federal Reserve System, the Fed leaders

believed they had no responsibility to help them.

More than 5,000 banks closed their doors between 1930 and 1932. As a result, public confidence in the banking system vanished.

The Banking Crisis of 1933

In 1932, President Herbert Hoover, a Republican, established the Reconstruction Finance Corporation (RFC). This was a government agency set up to make loans to all banks in trouble whether they were members of the Federal Reserve or not.

During the first months of 1933, however, increasing numbers of bank depositors withdrew and hoarded paper currency and gold. More banks failed at a faster rate than the RFC could save.

Roosevelt realized what Hoover and many others failed to see: The banking crisis was mainly about people's lack of confidence in the banks.

In early February, officials from the Hoover administration appealed to Henry Ford to lend \$7.5 million to a large Detroit bank where he was a major shareholder. Ford refused. Hoover's officials, the RFC, and the Fed argued over who should step up to save the bank. None of them did, and the bank failed.

The governor of Michigan then ordered a state “bank holiday,” closing all the banks in his state. This prevented depositors from withdrawing their money. It was a drastic way to prevent banks from collapsing.

Several states had already closed their banks, and the Michigan bank holiday stampeded many other states to do the same. The states acted in

their own interests, ignoring how their bank closures would affect the rest of the country. By the time Democrat Franklin D. Roosevelt was inaugurated president in March 1933, every state in the nation had declared some form of bank holiday.

Between January and March 1933, more than 4,000 banks throughout the nation failed. Many were small banks, often in farm areas, that were not members of the Federal Reserve. But even the Wall Street banks, kept afloat by loans from the Federal Reserve, were in danger due to the banking panic that gripped the entire nation.

The Federal Bank Holiday

President Hoover had considered declaring a bank holiday to put the process of reopening the banks in federal hands. He doubted, however, that he had the legal authority to do this, so he did not act.

Two days after Roosevelt was inaugurated president on March 4, he issued a proclamation that declared a federal bank holiday. The proclamation also put the federal government in charge of reopening the banks.

The state and federal bank holidays had harsh consequences for most people. They could not cash checks or get money from their bank accounts. Some had trouble buying food and other necessities. Others resorted to writing IOUs or bartering goods.

FDR justified his action as necessary to stop future massive bank withdrawals and hoarding of currency and gold. If this were allowed to continue, the circulation of money would stall, further crippling the economy.

Three days after his proclamation, FDR sent to Congress the Emergency Banking Act. This act had been mainly drafted by Hoover administration officials, who had prepared a blueprint for closing and reopening the banks that the former president never used.

The act laid out a schedule for reopening the nation's banks after Treasury Department examiners evaluated their soundness. Strong banks would open quickly. Weakened banks would

receive loans and shipments of Federal Reserve Notes (paper currency). Insolvent banks would be permanently closed. The act also barred the export of gold to foreign countries.

In one day, the solidly Democratic Congress passed the Emergency Banking Act, and FDR signed it. This first New Deal law legalized Roosevelt's proclamation and gave him unheard of authority over the nation's privately owned banking system.

The First 'Fireside Chat'

Roosevelt realized what Hoover and many others failed to see: The banking crisis was mainly about people's lack of confidence in the banks.

To restore their confidence, FDR decided to speak to the people directly over the radio.

On March 12 at 10 p.m., Roosevelt spoke live from the White House to an estimated 40 million Americans across the country. A radio announcer introduced him: "The president wants to come into your home and sit at your fireside for a little fireside chat."

"My friends," the president began, "I want to talk for a few minutes with the people of the United States about banking. . . ." He adopted a conversational tone and spoke in plain language aimed at average Americans. He told them that he wanted to explain what had been done, why it was done, and what the next steps would be to end the banking crisis.

Roosevelt explained the banking system in five sentences. He pointed out that "when you deposit money in a bank, the bank does not put the money into a safe deposit vault." Instead, he said, ". . . the bank puts your money to work to keep the wheels of industry and of agriculture turning around."

He described how rushes on banks to withdraw cash or gold were caused by the "undermined confidence" of the public. He then gave his reasons for declaring a bank holiday and how the reopening of the banks would work.

He promised that banks with "good assets" would reopen immediately, and most of the others as soon



FDR AND PRESIDENT HOOVER rode together to Roosevelt's first inauguration on March 4, 1933.

Library of Congress

as they had been strengthened. He said, "I can assure you, my friends, that it is safer to keep your money in a reopened bank than it is to keep it under the mattress."

He agreed that some bankers were incompetent or dishonest and had used depositors' money for risky speculation and unwise loans. But, he continued, this was not true about the large majority of banks.

"And so," he said, "it became the government's job to straighten out this situation and do it quickly." He cautioned that a few banks may never reopen, and some individuals may lose their money.

Roosevelt concluded by appealing to the American people to have confidence again in the banking system:

We have provided the machinery to restore our financial system, it is up to you to support and make it work. It is your problem no less than it is mine. Together we cannot fail.

In response to Roosevelt's first Fireside Chat, tens of thousands of letters arrived at the White House. Most expressed appreciation for Roosevelt's frank and confidence-building speech.

When the first banks reopened, long lines of people formed outside them. These people were not withdrawing their money; they were depositing their hoarded cash and gold. The Treasury Department had planned a massive printing of Federal Reserve Notes to meet the banks' need for cash, but the printing was not needed since so many voluntary

deposits flowed back into the banks.

On March 14, the *Wall Street Journal* headline proclaimed, "Confidence Back as Banks Reopen." By the end of the year, most banks were operating again and proved to be solvent or nearly so. Only 5 percent of the banks were closed permanently due to insolvency.

Separating Commercial and Investment Banks

Public hostility toward all bankers was high in 1933. Many called bankers "banksters," after Al Capone and other well-known gangsters of the time.

Congress held hearings on "bad banking" practices. The hearings turned up evidence that some banks had used depositors' money to speculate in stocks and other risky deals to increase bank profits.

Senator Carter Glass (D-Va.) became the chief critic of these practices. Glass believed that banks should not be collecting deposits from people and speculating in the stock market with their money. He sponsored a bill, backed by FDR, that required banks to choose their form of banking. Banks could be commercial (checking, savings, and loans) or investment (stocks, bonds, and financing).

Glass argued that bankers should not put their customers' money in danger through risky investment schemes. In fact, Glass blamed the Great Depression on the intermingling of commercial and investment banking.

While bankers had applauded FDR's federal bank holiday, they ▶

strongly opposed his support of the bill to separate commercial and investment banking. They complained that this would hinder raising capital needed to get the economy moving again.

Wall Street banker Jack Morgan, son of the founder of J.P. Morgan & Co., bitterly opposed FDR. Morgan called him the “crazy man in charge.” But public opinion opposed the bankers.

The Glass bill prohibited commercial banks from buying and selling stocks and bonds or engaging in most other investment activities. Only investment banks could fully do these things. Investment banks, however, could not receive deposits for checking and savings accounts.

Insuring Bank Deposits

Between 1930 and 1933, depositors lost more than \$6 billion when almost 10,000 banks failed. In 1933, Rep. Henry Steagall (D-Ala.) championed a federal insurance program to protect the money people deposited in their banks. Deposit insurance, Steagall argued, would also stop the panic withdrawals of currency and gold that had plagued the banking system for over a century.

At first, FDR strongly opposed federal deposit insurance. He feared that the premiums banks would have to pay into an insurance fund would cripple them. He also worried that if the banks’ insurance fund had been used up, the government would be stuck with compensating insured depositors.

Another argument against federal deposit insurance was that it would encourage bankers to act *more* recklessly. This would happen, the argument went, because the government guaranteed a bank’s depositors their money even if the banker made risky loans that caused the bank to fail.

Economists call this situation an example of a “moral hazard.” This occurs when people or organizations are protected from the bad consequences of their risky or unwise actions. In effect, they are saved or bailed out. Thus, they may be encouraged to take a chance on repeating the same actions in the future.

Despite Roosevelt’s opposition,



MANY TIMES DURING HIS presidency, FDR addressed the nation on radio in what came to be known as “fireside chats.”

popular support for federal deposit insurance was overwhelming. Rep. Steagall introduced a bill that created the Federal Deposit Insurance Corporation (FDIC).

The Steagall bill insured deposits up to \$2,500. Any solvent bank (including state chartered banks) could join the FDIC. Member banks paid a small percent of their insurable deposits into a common fund from which payouts would be made to reimburse depositors for their losses in failed banks.

The bill by Sen. Glass separating commercial and investment banks and the one by Rep. Steagall insuring bank deposits were combined into the Banking Act of 1933. This is frequently called the Glass-Steagall Act, which FDR signed on June 16.

Banking Reforms Continued

The Banking Act of 1933 gave the Fed more tools to control the money supply and set interest rates on borrowing by banks, which affect consumer loan rates. These measures were designed to keep the money supply and prices stable.

Bankers continued to argue that separating their commercial and investment functions limited their ability to finance economic growth. Some scholars produced studies showing that banking abuses in the 1930s were overblown by Congress. Over the years, the Glass-Steagall Act was modified to

allow certain kinds of investment banking by commercial banks.

In 1999, a Republican Congress and Democratic president, Bill Clinton, repealed two key sections of the Glass-Steagall Act. This repeal eliminated most of the remaining barriers that stopped commercial banks from engaging in investment activities.

After the financial crash in 2008, however, some economists and politicians claimed the repeal of the Glass-Steagall provisions had led to a return to high-risk speculation by large commercial banks. As a result, the banks faced failure and had to be bailed out by the U.S. government.

Others rejected this view. They argued that the mortgage investment products that brought on the financial crisis were never regulated by the Glass-Steagall Act or were allowed before the 1999 repeal took place.

Instead of restoring the Glass-Steagall regulations, Congress enacted a new rule that limited commercial banks’ trading in stocks and other investments for their own short-term profit.

The Federal Deposit Insurance Corporation has been the least controversial of FDR’s big banking reforms. His fears about federal deposit insurance were never fulfilled. Today, the FDIC insures deposits up to \$250,000 (one account per bank). During the Great Recession from 2008 to 2011, the FDIC managed the closing of about 400 banks and made sure that depositors did not lose a penny from their insured accounts.

For Discussion and Writing

1. What did FDR believe was the main cause of the banking crisis in 1933? How did he try to solve this problem? Do you think he succeeded? Explain.
2. Why did Congress and FDR separate commercial and investment banks?
3. What is a “moral hazard”? What is the possible moral hazard of federal deposit insurance? Even with a moral hazard, do you agree the Federal Deposit Insurance Corporation is still a good idea? Why or why not?

For Further Reading

Alter, Jonathan. *The Defining Moment: FDR's Hundred Days and the Triumph of Hope*. New York: Simon & Schuster, 2006.

Kiewe, Amos. *FDR's First Fireside Chat: Public Confidence and the Banking Crisis*. College Station, Texas: Texas A & M University Press, 2007.

ACTIVITY

Moral Hazards

The existence of a possible moral hazard does not mean an action should never be undertaken. It does mean that one should balance the good of the action against the possible dangers or unintended consequences.

Meet in small groups to evaluate the following government actions. First, identify one or more possible moral hazards in the action. Second, decide if you agree with the government action despite the moral hazard(s) involved. Finally, explain your decisions to the rest of the class.

Government Actions

1. To prevent the collapse of the U.S. banking system, the government makes loans to big banks that invested heavily in packages of carelessly approved home mortgages.
2. Congress passes a law that reduces the principal on mortgages of homeowners when the current market value of the home is much less than they owe (so-called “underwater mortgages”).
3. The government makes loans to poorly managed auto companies to keep the industry alive in the U.S. and to save jobs.
4. Congress extends unemployment insurance payments to those who have been out of work for more than six months.

Standards Addressed

FDR and the Banks

National U. S. History High School Standard 24: Understands how the New Deal addressed the Great Depression, transformed American federalism, and initiated the welfare state. (1) Understands the first and second New Deals (5) Understands the significance and ideology of FDR and the New Deal (e.g., . . . how the New Deal changed the relationship between state and federal government)

National Economics High School Standard 8: Understands basic concepts of United States fiscal policy and monetary policy. (5) Knows that monetary policy refers to actions by the Federal Reserve System that lead to changes in the amount of money in circulation and the availability of credit in the financial system. (8) Understands that when banks make loans, the money supply increases, and when loans are paid back, the country's money supply shrinks

California History Social Science Standard 11.6: Students analyze the different explanations for the Great Depression and how the New Deal fundamentally changed the role of the federal government. (2) Understand the explanations of the principal causes of the Great Depression and the steps taken by the Federal Reserve, Congress, and Presidents Herbert Hoover and Franklin Delano Roosevelt to combat the economic crisis. (4) Analyze the effects of and the controversies arising from New Deal economic policies and the expanded role of the federal government in society and the economy since the 1930s

California History Social Science Standard 12e.3: Students analyze the influence of the federal government on the American economy. (4) Understand the aims and tools of monetary policy and their influence on economic activity (e.g., the Federal Reserve).

Munich

National World History High School Standard 39: Understands the causes and global consequences of World War I. (8) Understands the human cost and social impact of World War I

National World History High School Standard 40: Understands the search for peace and stability throughout the world in the 1920s and 1930s. (1) Understands treaties and other efforts to achieve peace and recovery from World War I

National World History High School Standard 41: Understands the causes and global consequences of World War II. (1) Understands motives and consequences of the Soviet nonaggression pacts with Germany and Japan (e.g., the Munich Agreement in 1938) (6) Understands the argument that the severity of the Treaty of Versailles caused unavoidable revolt against the nations that imposed it.

California History Social Science Standard 10.6: Students analyze the effects of the First World War. (1) Analyze the aims and negotiating roles of world leaders, the terms and influence of the Treaty of Versailles (2) Describe the effects of the war and resulting peace treaties on population movement, the international economy, and shifts in the geographic and political borders of Europe and the Middle East. (3) Understand the widespread disillusionment with prewar institutions, authorities, and values that resulted in a void that was later filled by totalitarians.

California History Social Science Standard 10.8: Students analyze the causes and consequences of World War II. (2) Understand the role of appeasement, nonintervention (isolationism), and the domestic distractions in Europe and the United States prior to the outbreak of World War II.

Jobs

National High School Economics Standard 5: Understands unemployment, income, and income distribution in a market economy. (1) Understands that personal income is influenced by changes in the structure of the economy, the level of gross domestic product, technology, government policies, production costs and demand for specific goods and services, and discrimination. (6) Understands that the standard measure of the unemployment rate is flawed (e.g., it does not include discouraged workers, it does not weigh part-time and full-time employment differently, it does not account for differences in the intensity with which people look for jobs). (7) Understands that many factors contribute to differing unemployment rates or various regions and groups (9) Understands frictional, seasonal, structural, and cyclical unemployment and that different policies may be required to reduce each.

California History Social Science Standard 12.4e: Students analyze the elements of the U.S. labor market in a global setting. (1) Understand the operations of the labor market (2) Describe the current economy and labor market, including the types of goods and services produced, the types of skills workers need, the effects of rapid technological change, and the impact of international competition. (3) Discuss wage differences among jobs and professions, using the laws of demand and supply and the concept of productivity. (4) Explain the effects of international mobility of capital and labor on the U.S. economy.

Standards reprinted with permission: National Standards © 2000 McREL, Mid-continent Research for Education and Learning, 2550 S. Parker Road, Ste. 500, Aurora, CO 80014, (303)337.0990.

California Standards copyrighted by the California Dept. of Education, P.O. Box 271, Sacramento, CA 95812.