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Franklin Roosevelt's Credit Principle

Franklin Roosevelt's credit budgeting

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Part 2 of 2

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In Franklin Roosevelt's budget addresses of 1934- 40, he is presenting the true understanding of debt upon which the Bank of the United States operated. And it becomes clear that Roosevelt generated increased productivity through that correct understanding.

So what does he do? As Hamilton did, when he became the veritable financier of the government, in the middle of the Revolutionary War or, as Alexander Dallas said when he came in as Treasury Secretary under James Madison, Roosevelt said the chief issue is restoring public credit. In his Jan. 3, 1934 budget address:

I have outlined the steps taken since last March for the resumption of normal activities and the restoration of the credit of the Government. Of necessity these many measures have caused spending by the Government far in excess of the income of the Government.

The results of expenditures already made show themselves in concrete form in better prices for farm commodities, in renewed business activity, in increased employment, in reopening of and restored confidence in banks, and in well-organized relief.

Tax receipts were way down in 1932 and 1933 because the government had taken a hands-off approach during Herbert Hoover's Administration (1929-33). Therefore, even normal functions of the government could not be carried out without creating a mounting deficit. We had to borrow a lot more than our revenues. But, we saw, now, by using the credit institutions, we had better prices for farm commodities, renewed business activity, increased employment, and so forth. FDR continues, characterizing it as follows:

This excess of expenditures over revenues amounting to over 9 billion dollars during 2 fiscal years has been rendered necessary to bring the country to a sound condition after the unexampled crisis which we encountered last spring. It is a large amount, but the immeasurable benefits justify the cost.

It is by laying a foundation of confidence in the present and faith in the future that the upturn which we have so far seen will become cumulative. The cornerstone of this foundation is the good credit of the Government.

We would restore the public credit by creating a real physical surplus, which is the idea of a productivity budget, rather than monetary budget. And he concludes that address as follows:

If we maintain the course I have outlined, we can confidently look forward to cumulative beneficial forces represented by increased volume of business, more general profit, greater employment, a diminution of relief expenditures, larger governmental receipts and repayments, and greater human happiness.

Under Hoover: Higher taxes; reduced revenues.

Later, in his Jan. 3, 1936 budget address, he comes back to this same theme, saying that in 1933, in spite of huge tax increases by Hoover, "federal tax receipts had fallen to such a low level that even normal expenses of Government could not be carried on without creating a mounting deficit." He continues:

Following the example of Hamilton, FDR reestablished the principle of public credit. "It is by laying a foundation of confidence in the present and faith in the future that the upturn which we have so far seen will become cumulative."

The national policy which we then adopted sought to stop the downward economic spiral by taking simultaneous action along a dozen fronts. The chief objectives were: To make bank deposits secure, to save farms and homes from foreclosure, to start public works on a large scale, to encourage home building, to increase farm crop values, to give useful work instead of a dole to the needy unemployed, to reduce all interest rates, to increase foreign trade in both exports and imports, to extend Government credit to railroads and other privately owned activities, to reduce unsound and generally disastrous speculation, to eliminate starvation wages, to seek a higher level of values, and then to maintain those values.

And, what he ends up saying in that 1936 budget address, is you start to see these increased tax receipts come in from all of the the economic activity that is going on, due to the increased spending. And he continues to make the point throughout. Let it be remembered, he said, I want to make a point that what we are seeing coming now is not from a few taxes: "I emphasize that the great bulk of increased Government income referred to above results from increased earning power and profits throughout the Nation and not from the new taxes imposed by the Revenue Act of 1935."

There were some new taxes imposed, but he is pointing out from the budget, that it was through the increasing earning power and profits that generated the increase in tax receipts. And, he also points out, that while a great increase of expenditures of the government was required by this crisis, a lot of it was in the form of loans, which would ultimately return to the Treasury—loans through the Reconstruction Finance Corporation and other lending institutions that were going to come back.

He concludes the 1936 address, saying:

The finances of the Government are in better condition than at any time in the past seven years. I say this because starting with the autumn of 1929, tax receipts began a steady and alarming decline while, at the same time, Government expenditures began a steady rise; today, tax receipts are continuing a steady climb which commenced in the summer of 1933, whereas Budget estimates for the next fiscal year will show a decreased need for appropriations.

"Our policy is succeeding. The figures prove it. Secure in the knowledge that steadily decreasing deficits will turn in time into steadily increasing surpluses, and that it is the deficit of today which is making possible the surplus of tomorrow, let us pursue the course that we have mapped.

It is pretty elementary. He is borrowing from the public; he is borrowing from those banks which he has reorganized with Glass-Steagall, but the borrowed funds are going toward things that are definitely going to increase the productivity of the country. That should be an elementary idea. But today, people have become stupid: *They are thinking about a debt as an object,* unconnected, completely in a vacuum. They are not looking at the fact that the government has to appropriate things as in order to generate increased wealth. And, people rail against taxation, while at the same time they are all for Wall Street's control of the economy, which acts itself as a tax on the people in every single transaction that occurs, through their their rigging, their speculation, and even the outright buying and hoarding of raw materials, of which JP Morgan was found guilty.

Budget cuts and the 1937 recession

In his Jan. 3, 1940 budget address, FDR reviews what happened to the progress that he spoke of in his 1936 address. He points out in 1940, looking back, that some people were eager to keep cutting the budget, which was the chief cause of the 1937 recession, in the course of making some other very important points.

He writes: "In the early thirties—prior to 1933— fiscal policy was exceedingly simple in theory and extraordinarily disastrous in practice. It consisted in trying to keep expenditures as low as possible in the face of shrinking national income." Sound familiar? "Persistence in this attempt came near to bankrupting both our people and our Government." And that was the "simple machine" policy of Andrew Jackson. Roosevelt continues:

Following 1933, the fiscal policy of the Government was more realistically adapted to the needs of the people. All about were idle men, idle factories, and idle funds, and yet the people were in desperate need of more goods than they had the purchasing power to acquire.

People were out holding money, banks were doing nothing, because they had not been reorganized yet. They were sitting with real wealth, but they also had ballooned speculative wealth, and the actual wealth that banks had through the savings of people and larger productive entities could have been put into use, but had to first be reorganized.

He continues:

The Government deliberately set itself to correct these conditions by borrowing idle funds to put idle men and idle factories to work. The deliberate use of Government funds and of Government credit to energize private enterprise . . . had a profound effect both on Government and on private incomes.

. . .The national income in four years rose 69 percent from 42 billion dollars in 1933 to 72 billion dollars in 1937, the largest absolute rise for any four-year period in our history, not even excepting the rise during the World War.

And then he says, as mentioned above, that unfortunately, some people wanted to balance the budget, so they started pulling back the whole system that was being created.

Rapid progress was made toward a balanced budget. By the calendar year 1937 excess of Government cash outgo over Government cash income had dropped to 331 million dollars. Unfortunately, just at the time when it seemed that the Federal Government would be able safely to balance its budget on the basis of a national income of approximately 75 billion dollars, maladjustments in the economic system began to appear and caused a recession in economic activity. The recession was due to a variety of causes stemming in the main from over-optimism which led the Government to curtail its net expenditures too abruptly, and business to expand production and raise prices too sharply for consumers' purchasing power to keep pace. A large volume of unsold goods piled up.

He concludes with a brilliant statement, attacking the false view of debt which was holding back progress and was behind the assumptions, while providing the clear concept that was coincident to the actual increases of productivity that were generated. He writes:

Debt, whether individual, corporate, or governmental, cannot be judged in a vacuum; it must be considered in light of earnings, assets, and credit standing. When the increase in the national debt is viewed against the background of what was accomplished by the growth of useful physical assets, and of effective national earning power, and by the strengthening of the Nation's credit and morale, there is no economic ground for anxiety, so far as the national debt is concerned, as to the Nation's future. And if our citizens understand the capacity of the Nation to produce increased national income and act thereon with all possible faith and practical energy, they will be in a position to anticipate balanced budgets without curtailing essential social programs.

FDR's Credit Banks

Having now thoroughly 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 Roosevelt's chief credit institution came to obtain the powers of direct lending, and why this is the most essential function to understand.

Now, without the government's direct hand, there is no way the bank system would ever come back in 2013. 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 department 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 bank system in such a shape that it could now function as part of a productive economy.

Now, as I mentioned earlier, there were assets in the bank 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

Roosevelt signs the Glass-Steagall Act in 1933.

themselves would ever cause a recovery just by the laissez fare 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. Now where were they going to get them, if the economy is collapsed, and no activity is going on.

Well, the Federal Reserve 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, if you read through it, 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

So Roosevelt had a problem. He was going to have to go around that Federal Reserve System. That system 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 Federal Reserve could not assist corporations. In 1932 it could not lend to any bank. They could discount a security, but they could not lend directly to a bank. The Fed could not even lend to its own member banks. Therefore, to even assist in the crisis situation of 1933, Congress had to give it special powers. But that was all to deal with the immediate financial crisis in 1932 and so forth.

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

By the end of 1933 there was a clear problem. Jesse Jones, at the head of the Reconstruction Finance Corporation (RFC), wrote on February 5, 1934, that "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. There was a study done by the business advisory council for the department of commerce, that showed that 45% of borrowers were having credit difficulties. In a study that they did, they found that only 374 of 1788 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, which is all that really means).

So here are the banks, reorganized, right? Through the Bank Conservation Act they went in and wrote off the bad assets, 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 size 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 Senator Henry P. Fletcher of the Senate Banking Committee of this fact, stating that there is a need for working capital for small businesses. He cites a study the Administration had done of banks and chambers of commerce (which we could be done again today), to determine how much credit was needed. And they found out that for 4958 banks and 1000 chambers of commerce, they found that small industries employing a certain amount of employees, and new employees, needed $700 million, and could employ 350,000 existing employees 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 will briefly review here.

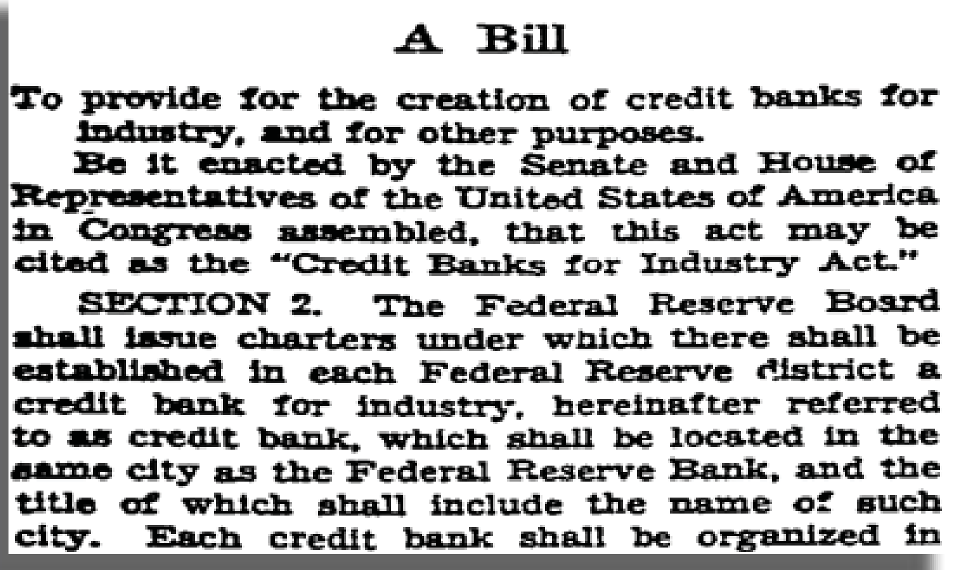
There were to be one in each Federal Reserve District, and they would be guided by industrialists, as the majority of the directors of each credit bank were to be "actively engaged in its district in some kind of industrial pursuit." They would advise for what to lend, to guide the economy forward with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

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


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 Creation of Credit Banks for Industry" was introduced to Congress, but did not pass.

The Industrial Advances Act

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

It was the beginning of 1934 when they proposed the credit banks. They likely wanted to get rid of Hoovers RFC and replace it with this 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 June Industrial Advances Act, which I just referenced. 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 more extensively 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, lending, purchase obligations from, and so forth.

There were two other parts of the Industrial Advances Act that read as a type of a bankruptcy reorganization for the industrial part of the economy. That it is not a question of writing off the bad assets, but, as in 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 the company can not make good on it. Instead, what the act did was to make sure the debt of the company would be tied to the ability of the company to finally produce above a level of break even, 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. They 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 gave the RFC the ability to make loans, directly, or in cooperation with banks or other lending institutions, as stated, but also 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 the relation of incomes, expenditures, and the borrowings that were going on, you can see that 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 zoom out, and 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 why there was an increasing surplus, was not because there was "deficit spending" in the abstract, but because the borrowing being done by the government was put 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, that 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.