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REPUBLICAN STAFF COMMENTARY

UNITED STATES MONETARY HISTORY IN BRIEF

PART 1: THE FIRST & SECOND BANKS OF THE UNITED STATES—RISE AND FALL

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Monetary policy and the Federal Reserve are often perceived to be shrouded in mystery or incomprehensible to all but central bankers. This three-part monetary history series attempts to remove that veil of mystery by offering an historical vantage point that sheds light upon and makes monetary policy more comprehensible.

CENTRAL BANKS: DEFINITION & CONSTITUTIONAL FOUNDATION

Central banks are chartered by national governments to have a legal monopoly over a nation's currency and bank reserves. To manage a nation's money supply, they use monetary policy tools, such as open market operations (e.g., buying/selling gold, silver, government debt securities, etc.); setting reserve requirements (i.e., deposits of currency, gold or silver that must be held at the central bank) for commercial banks and financial institutions; and acting as lender of last resort for solvent but illiquid commercial banks and financial institutions during a financial crisis. Central banks also supervise commercial banks and financial institutions.

The United States Constitution provides the legal foundation for a central bank in Article I, Section 8, Clauses 5 and 6, which give Congress the power "to coin money [and] regulate the value thereof," and Clause 18 to make laws "necessary and proper for carrying [out] the foregoing powers." America's first central bank was established in 1791 by the 1st Congress.

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FIRST BANK OF THE UNITED STATES

Secretary of the Treasury Alexander Hamilton issued his "Report on a National Bank" on December 14, 1790, and in 1791—based on his report—Congress chartered the **First Bank of the United States** (1791-1811).

Congressional debate over the First Bank foreshadowed the cataclysmic event to envelope the nation 70 years later with a general north-south divide and fierce exchanges over the role of federal and state governments. Echoes of the early opposition to the First Bank have run throughout our nation's history, even down to some of the populist arguments of the present day. Nevertheless, America's need for a central bank was acute, as the country had to manage the significant Revolutionary War debt incurred by the states; and the country needed a stable currency to facilitate commerce and trade within the fledgling United States and with countries abroad.

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Yet, as economist Richard Timberlake argues, the First Bank was not meant to be a modern central bank. Rather, the bank Hamilton envisioned would be a public bank to help the federal government secure loans, "aid in the sales of public lands … and eventually provide a uniform paper currency."[1]

(Continued on the next page …)

After supporters of the First Bank won the debate, the next major development in U.S. monetary policy was Congress's adoption of the **Coinage Act of 1792**, which placed the United States on a "**bimetallic standard**" of gold and silver (see Appendix for a discussion of the gold standard, the silver standard, and bimetallic standard and how they operated). Confusing as such a bimetallic standard may be in the 21st century, it made sense in the late 18th century when the United Kingdom—the world's dominant economic power—operated on a gold standard, while France—America's Revolutionary War ally—operated on a silver standard.

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The Coinage Act fixed the mint prices of gold and silver at a ratio of 15:1 (i.e., $19.39 per troy ounce for gold, $1.29 for silver) so that, relative to their prevailing market values, gold was slightly overvalued and silver was slightly undervalued. These mint prices encouraged the importation of gold for coinage and accumulation of gold reserves at the First Bank. Beyond the political considerations of Hamilton (favoring relations with Britain) and Thomas Jefferson (favoring relations with France), the accumulation of gold was important since foreign creditors required payment of interest and principal of U.S. government debt in gold.

Hamilton's economic policies had the effect of transforming the U.S. government debt from a liability into a highly valued asset in domestic and foreign financial markets. Thus, Hamilton created a powerful financial tool for the U.S. government to finance its national defense and meet other needs.

During its 20 years of operation, the First Bank was a hybrid central-commercial bank, modeled on the Bank of England. It was a public-private partnership, in which private investors owned 80% of its stock while the federal government owned the rest, with the Treasury conducting regular examinations of the Bank for safety and soundness. In addition to issuing a uniform currency in the form of First Bank notes (bank notes are paper currency), the First Bank served as the depository and fiscal agent of the federal government; supported the credit of the federal government; and regulated state-chartered banks through the First Bank's acceptance of state bank notes or demanding their redemption in specie (i.e., gold or silver coins and bullion). Consequently, as noted by Timberlake, the First Bank began to exercise modern central-banking functions:

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> *through its currency transactions with other banks. If it felt that credit restraint was called for, it presented the notes of other banks for redemption in specie. If it felt that credit ease was in order, it expanded its own credit availability to businesses and to other banks and generally treated the notes of other banks with 'forbearance.'*[2]

Although the First Bank was careful not to exert too heavy a hand and generally received favorable reviews for fulfilling its purpose, congressional critics in Jefferson's party continued to question the Bank's constitutionality. They would have their hour when the Bank came up for renewal at the end of its 20-year charter.

STORM CLOUDS GATHER OVER THE FIRST BANK

When the First Bank's charter came up for renewal in 1811, one of the Bank's harshest 1791 congressional critics and opponents, James Madison,

had become president. Yet, the dynamics had changed in the intervening 20 years as Madison's concerns had been allayed through witnessing the value and necessity of the Bank.

However, politics being what they were, Madison was afraid of being seen as ideologically inconsistent (i.e., "flip-flopping" on the Bank question), and he wanted to show deference to his mentor, President Jefferson, who opposed the First Bank. So, Madison did not publicly declare support for renewing the First Bank's charter, though he directed Secretary of the Treasury Albert Gallatin to seek renewal of the First Bank's charter from Congress.

The Senate failed to renew the First Bank's charter in 1811 due to a combination of constitutional questions and fears and allegations that British stockholders were dominating the Bank. Absent a central bank, President Madison had an especially difficult time financing the War of 1812.

The House of Representatives renewed the charter, but the Senate failed to pass it due to a combination of constitutional questions and fears and allegations that British stockholders were dominating the Bank. How the Bank was defeated in the Senate was especially ironic as Madison's Vice President, George Clinton—who had been elected after the 12th Amendment to the Constitution, which aimed to ensure the President and Vice President would not be ideological opponents—cast the tie-breaking vote against his own administration's bill to renew the Bank. So, with the bill's defeat, the United States was left without a central bank, while on the brink of war.

WAR OF 1812 & LIFE WITHOUT A CENTRAL BANK

The Madison administration's failure to renew the First Bank's charter proved consequential in the **interregnum period** (1811-1816) when the United States did not have a central bank. Notably, Madison had an especially difficult time financing the War of 1812; Secretary of the Treasury Gallatin could raise only $38 million out of an authorization for $61 million in bonds. Furthermore, in this period, the number of state banks grew from 86 to 246, and total bank notes grew from $28 million to $68 million, resulting in a cumulative 34% increase in prices. Had the First Bank continued to operate, many of these difficulties could have been avoided.

SECOND BANK OF THE UNITED STATES

Out of the interregnum experience arose the **Second Bank of the United States** (1816-1836). Speaker of the House Henry Clay worked with the Madison administration to charter the Second Bank on the same basis as the First Bank. However, Madison pressed the Board of Directors of the Second Bank to name as its president his Secretary of the Navy, William Jones. This decision proved disastrous. Through both corruption and incompetence, the Second Bank came close to failing as Jones augmented, rather than restrained, a speculative bubble in western lands. In 1819, Jones was forced to resign, and the board chose former House Speaker Langdon Cheves to replace him as the Second Bank's President.

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Meanwhile, the Treasury—now under the leadership of Secretary William Crawford—acted like a central bank, while the Second Bank "proved to be nothing more than a convenient buffer for the unpalatable but 'necessary' policies of the Treasury Department" to contract the money supply and bring inflation under control. Under Cheves, total bank notes were reduced to $45 million by 1819. This saved the Second Bank but at the price of much economic pain including: the financial **Panic of 1819** and resulting recession (the first presidential-induced recession); a 27% decline in prices

through 1824; and a growing populist sentiment against the Second Bank. Notably, the Second Bank—rather than President James Monroe's administration, which was really the guilty party in the fiasco—drew the ire of presidential aspirant, General Andrew Jackson.

In 1822, Nicholas Biddle succeeded Cheves as president of the Second Bank. Biddle, who proved especially competent, returned the Second Bank to the First Bank's central banking function of regulating the state banks through its acceptance of state bank notes or its demand for their redemption in species. Under Biddle's leadership, this central banking function was used to stabilize the U.S. economy and prevent financial panics.

America's economy has prospered with an independent central bank, managed by competent individuals; America's economy has not fared as well absent a central bank or when a central bank endures interference from politicians.

Again though, the storm clouds gathered over the Bank with the 1828 election of President Andrew Jackson. In 1832, Jackson vetoed Sen. Henry Clay's bill to renew the Second Bank's charter. Nonetheless, there was dissent even within Jackson's cabinet over the issue of the Second Bank. Jackson fired two Secretaries of the Treasury, who refused to remove government deposits from Second Bank (the Bank's charter, which ran to 1836, had not yet expired) and place them in Jackson-favored state banks. Finally, in 1833 Jackson's acting Secretary of the Treasury Roger B. Taney complied with the demand, and there is speculation that Taney's reward for this action was a subsequent appointment as Chief Justice of the United States.[3]

BAD MONETARY POLICY & ECONOMIC COLLAPSE

Through the **Coinage Act of 1834**, Jackson devalued the U.S. dollar by 6.6% to $20.67 per troy ounce in terms of gold, but not in terms of silver, thus increasing the gold-to-silver mint price ratio from 15:1 to 16:1, which by slightly overvaluing gold and undervaluing silver relative to prevailing market prices again caused an inflow of gold. This led to a 42% increase of bank deposits and a 36% increase in prices from 1834 to 1836.

Distribution of the Surplus and **Specie Circular** were disastrous policies. The populist reaction against the Second Bank and the ensuing policies caused a 36% drop in the money supply in 1836-37. One such policy came from Jackson signing an 1836 bill that distributed the federal surplus of $28 million to the states. To pay the states, the Treasury withdrew $28 million in federal deposits from Jackson-favored state banks in species. This triggered an immediate contraction in loans and bank notes from the banks that lost their deposits. Of these funds, states deposited $23 million into other state banks and retained $5 million in species. This conversion into species reduced the aggregate reserves available to support loans and bank notes nationwide. Moreover, banks that eventually received deposits from the states took time to expand their loans and bank notes. (In the 1800's, there were no wire transfers. Rather, specie and notes had to be transferred by wagons, often over uncertain roads.) Finally, Jackson's 1836 Specie Circular, which required payment in gold or silver for the purchase of federal lands, increased the demand for gold and silver coins, compounding the contractionary effects of the distribution of the surplus.

The capricious monetary policies of President Andrew Jackson were a major cause of the Panic of 1837.

Thus, Jackson left office as the U.S. began to suffer from the **Panic of 1837** and the ensuing depression. This policy-induced depression was the second longest and second deepest depression in U.S. history, only superseded by

the Great Depression of the 1930's, and as Milton Friedman noted, the great depression stemming from the Panic of 1837, "is the only depression on record comparable in severity and scope to the Great Depression of the 1930's."[4]

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Bad policies continued to prevail, including the "Independent Treasury," under which President Martin Van Buren consolidated federal deposits from state banks at the Treasury. Ultimately, the U.S. economy did not recover from the Jackson-induced depression until 1843—two years after the defeat of Jackson successor and one-term President Van Buren.

CENTRAL BANKING FROM THE TREASURY

Though the Whig party won the control of both Congress and the presidency in 1840 on a platform that included a pledge to create a Third Bank of the United States, President John Tyler, who succeeded William Henry Harrison after his brief tenure, vetoed a bill to charter a Third Bank in 1841. Consequently, the Treasury assumed a limited central-banking role in the years preceding the Civil War. Tariff revenues were highly elastic, while federal outlays were relatively constant. This allowed the Treasury to act as an 'automatic stabilizer'—issuing U.S. government debt securities (i.e., Treasuries) when tariff revenue was low and redeeming them when revenue was high.

Even when the U.S. has been absent a central bank, the Treasury has conducted central banking activities—with mixed results.

CURRENCY PROBLEMS & TECHNOLOGY PRECEDING THE CIVIL WAR

Generally, from 1836—when the Second Bank ceased its interstate operations—until the Civil War, the United States did not have a national currency. Historians have called this the **free banking era** (even though the United States never actually had free banking as defined by economists). With many states liberalizing their laws about chartering banks, the quality of supervision and regulation varied widely, creating many problems. Some states, especially in the south and west, suffered from numerous wildcat banks that opened with insufficient capital. The wildcat banks would make loans and issue bank notes, only to fail in a matter of months. As a result, bank notes did not trade at par (face) value with each other. Instead, the value of notes from different banks fluctuated daily (much as national currencies do today in foreign exchange markets).

In this environment, economic development suffered from the bad monetary policy of the period. The fluctuating value of state bank notes and losses on notes from failed wildcat banks were costly, taking a toll on the growth of interstate commerce. Yet, technological advances like the steamboat, railroad, and telegraph were forging a single national economy out of the previously separate local economies, highlighting the need for a single national currency—even absent a central bank.

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With this as background, one of the sub-issues of the 1860 campaign was the question of a national currency. The newly formed Republican Party, in the tradition of the Federalist and Whig Parties, favored the creation of a single national currency to replace state bank notes, while the Democrat Party supported the status quo. Regardless, changes would be afoot as the nation was driven into its most devastating war, again, absent a central bank.

APPENDIX: DISCUSSION OF STANDARDS

Gold Standard

Classical gold standard: There are two versions of a classical gold standard—**gold coin standard** and **gold bullion standard**. Under a gold coin standard, a country defines its unit of account in terms of a fixed weight of gold (i.e., mint price). The mint will freely coin gold at the mint price, gold coins are in circulation, and the central bank (or commercial banks in the absence of a central bank) will freely convert bank notes into gold coins at the mint price. Under a gold bullion standard, a country defines its unit of account in terms of a fixed weight of gold (i.e., par value). However, the mint will not freely coin gold and gold coins are not in wide circulation. Instead, the central bank will freely buy or sell gold in large quantities, known as bullion, at par value. Exchange rates among the currencies of all countries operating under a classical gold standard are effectively fixed. A classical gold standard is largely self-regulating through domestic and international gold flows.

A classical gold standard may not provide long-term price stability.

The profitability of the gold mining industry—which is affected by the size and frequency of new gold finds, mining and processing costs, and technological progress—effectively determines the monetary base and the price level in all countries operating under a classical gold standard. Therefore, a classical gold standard may not provide long-term price stability. Indeed, decade-long periods of both price inflation and price deflation occurred under the classical gold standard.

Gold exchange standard: Under a gold exchange standard, a country defines its unit of account in terms of another country's currency (i.e. anchor currency) that is freely convertible into gold at par value. The central bank will freely exchange its bank notes for the anchor currency at the fixed exchange rate.

Like a classical gold standard, the exchange rates among countries operating under a gold exchange standard are fixed to the anchor currency and to each other. Unlike a classical gold standard, however, a gold exchange standard is not self-regulating. It is dependent on the behavior of the central bank in the anchor country.

Silver Standard

A silver standard is similar to a gold standard except silver is the metal used.

Bimetallic Gold and Silver Standard

A bimetallic standard is actually an alternative metallic standard.

Under a bimetallic gold and silver coin standard, a country defines its unit of account in terms of a fixed weight of gold and a fixed weight of silver, known as mint prices. The mint will freely coin both gold and silver at their respective mint prices. In theory, both gold and silver coin should be in circulation, and the central bank (or commercial banks in the absence of a central bank) will freely convert bank notes into either gold or silver coins at their respective mint prices. In practice, however, a bimetallic standard is actually an **alternative metallic standard**. When one monetary metal becomes "dearer" (i.e., its market price rises relative to its mint price), coins in the "dearer" monetary metal will go out of circulation, and individuals and firms will drain the dearer monetary metal out of the central bank by exchanging bank notes for coins or bullion in the "dearer" monetary metal. The "cheaper" monetary metal, whose market price falls relative to its mint price, will effectively become the sole monetary metal. This process will reverse as market prices of gold and silver fluctuate relative to their respective mint prices.

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[1] Timberlake, Richard H., *Monetary Policy in the United States: An Intellectual and Institutional History*, The University of Chicago Press, Chicago, 1993, p.5.
[2] Ibid., p.10
[3] For background on Taney's appointments, *see* Abraham, Henry J., *Justices, Presidents, and Senators: A History of the U.S. Supreme Court Appointments from Washington to Clinton*, Rowman & Littlefield Publishers, Inc., New York, 1999, pp. 74-76.
[4] Friedman, Milton, *A Program for Monetary Stability*, Fordham University Press, New York, 1959, p.10.

For reference and further reading, see, Timberlake, Richard H., *Monetary Policy in the United States: An Intellectual and Institutional History*, The University of Chicago Press, Chicago, 1993.