Chapter 1

Free Banking and Private Money

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In his December 1776 pamphlet *The Crisis*, Thomas Paine famously said, "These are the times that try men's souls." He then proceeded to lay out a detailed assessment of America's military challenges in fighting the British. But after the fighting was over, America faced the task of creating a new, independent state separate from British trade and especially independent from the banks of the City of London. The story of money and debt in America is the chronicle of how a fragment of the British empire broke off in the late 1700s and supplanted and surpassed Great Britain in economic terms by the end of WWI. Though Britain for centuries was the dominant economic system in the world, America would come to lead the global economy by the early twentieth century.

The English pound was not the first great global currency, nor will the dollar likely be the last. Mankind has been through cycles of inflation and deflation more than once, going back to before Greek and Roman times. The story of money in each society is a description of the ebb and flow of these states in economic as well as social terms. The latest

version of this repeating narrative features a still very young country called America, which has used money and the promise of it to build a global economic empire, but one that may now be in question after almost a century of relative stability.

When the 13 colonies reluctantly declared independence from Great Britain in 1776, the young nation had no independent banking system and no common currency, even though most colonists knew the political and financial traditions of Europe. The Articles of Confederation the infant nation adopted in 1777 did not even give the central government the ability to levy taxes to retire the war debt. European banks and governments met the capital needs of the young nation via loans and even provided what limited physical means of exchange were available aside from pure barter. Pawnbrokers were the predominant source of credit for individuals, and businesses obtained commercial credit from banks, mostly foreign. Foreign coins and some colonial paper money were in circulation, but barter was the most common means of payment used by Americans from the start of the nation's existence through the Civil War.[1]

Sidney Homer and Richard Sylla wrote in the classic work *A History of Interest Rates*:

> The American colonies were outposts of an old civilization. Their physical environment was primitive, but their political and financial traditions were not. Therefore, the history of colonial credit and interest rates is not a history of innovation but rather a history of adaptation.[2]

The first American government had no credit and was dependent upon private, mostly foreign banks and wealthy individuals for financing. Upon winning independence, the colonies formed states and issued colonial currency. Bonds were issued when possible, with individuals and even the government of France subscribing in the earliest days of the young nation.

The Bank of North America was established in Philadelphia by the Continental Congress in 1782 and became the first chartered bank in the United States. Creating a new bank under the control of the American government was an effort to gain some independence from private banks and also from foreign states.

David McCullough's Pulitzer Prize-winning biography, *John Adams*, presents several scenes where the ambassador of the new American government went literally hat in hand to the capitals of Europe seeking hard currency loans to finance the most basic needs. The tireless Adams was able to secure from foreign banks huge sums that sustained the colonial war effort. But as Adams knew too well, his family and other Americans suffered horribly due to inflation and scarcity in those early years. "Rampant inflation, shortages of nearly every necessity made the day-to-day struggle at home increasingly difficult," McCullough relates. "'A dollar was not worth what a quarter had been,' Abigail [Adams] reported. 'Our money will soon be as useless as blank paper.'"[3] This need was acute since the U.S. government lacked the power to tax or the means to collect it. Nor would the American people tolerate higher taxes, because of the unhappy experience with Britain. The leaders of the American revolution had led a political revolt against unfair taxes, thus they were not in a position to then raise taxes to pay for the war.

Adams was neither an apologist for debt nor for inflation. He believed that having a national debt was a good thing because it created relationships with other nations that would help the infant nation survive and grow. In his prolific correspondence with Thomas Jefferson, Adams showed the sharp contrast between on the one hand wanting to create a constituency among financial powers for America's national debt while on the other hand expressing his opposition to having private bankers and banks. In fact, Adams advocated creating a single national bank to serve the needs of the country, with branches in the individual states. Adams wanted to prohibit the states from chartering banks themselves and to have one single, national institution, perhaps under public control. Ron Chernow wrote in his excellent 2004 biography, *Alexander Hamilton*, that Adams viewed banking "as a confidence trick by which the rich exploited the poor." He quoted Adams similarly saying that "every bank in America is an enormous tax upon the people for the profit of individuals," suggesting that one of the more conservative founders of the United States would have preferred banks to be run as a giant collective, not-for-profit utility. Adams differed significantly from Alexander Hamilton on these issues, even though like Hamilton he was interested in strengthening the country's financial position. Hamilton was a great advocate of private banks and debt, and

believed that that finance was the key both to state power and economic growth. Chernow confirms that Adams wanted one state bank with branches around the nation, but no private banks at all.[4]

The charter of the Bank of North America lapsed in 1790 and two years later, the State of New York chartered The Bank of New York, which is the corporate predecessor of the company now known as Bank of New York/Mellon. Supported by New York's powerful merchants, the bank was first organized in 1784 and was led by Hamilton, a New York lawyer, who became the first Treasury Secretary and a future leader of the United States. So important was the Bank of New York to the local economy that much of the region's commercial activity was financed by this single institution for decades as the number of banks and thus competition grew slowly. The formation of the bank was not just a financial event, but a very significant political milestone as well that greatly elevated the power of New York.[5] There was no real money nor any payment system in existence for the country. All trade had been financed by English and other foreign banks up until the Revolutionary War. Now the United States had to create a new financial system to replace these relationships, a process that would take more than a century.

The demise of the Bank of North America came as a political battle raged over whether the federal government should assume the debts incurred by the states and cities during the war against Britain. The final agreement from the southerners to support the assumption of state debts was tied to the compromise over moving the location of the capital city from New York to Philadelphia temporarily and eventually to an entirely new capital on the Potomac River to be called Washington. But this "compromise of 1790" engineered by Jefferson and Hamilton did not deal with the issue of a national bank.

The Bank of the United States

President George Washington chartered the First Bank of the United States in 1791. This was the government's attempt at creating a permanent central bank of issue for the infant nation. Madison and Jefferson opposed the bank, but Adams ironically led a sizable majority in the

Congress that favored the measure. McCullough described Adams's views on banks and economics in *John Adams*:

> Adams not only put his trust in land as the safest of investments, but agreed in theory with Jefferson and Madison that an agricultural society was inherently more stable than any other—not to say more virtuous. Like most farmers, he had strong misgivings about banks, and candidly admitted ignorance of "coin and commerce." Yet he was as pleased by the rise of enterprise and prosperity as anyone. . . .[6]

The First Bank of the United States had just a 20-year charter. While it was a bold and novel innovation, the bank only provided credit to established merchants. During the presidency of Thomas Jefferson, the agrarian and other interests not served by the Bank successfully pushed for the establishment of state-chartered institutions to serve the need for credit of a very rapidly growing nation. The state-chartered banks also created alternative sources of political power in the states. The First Bank's charter was not renewed due to the intense attacks by the advocates of Jeffersonian cheap money principles, who taking the lesson of King George III and his taxes, rightly feared that a "central bank" would be dominated by the central government. Even or, worse, it could be dominated by the bankers and merchants in New York and New England commercial centers such as Boston.[7]

In 1811, the First Bank of the United States was resurrected by the New York merchants who controlled it and chartered anew by the State of New York. Today the successor to that corporation is known as Citibank N.A., the lead bank unit of Citigroup Inc. Now two of the largest banks in the new nation were located in New York. This point was not lost on representatives of the other states in the union and especially the Jeffersonian faction in the Congress, who represented agrarian interests dependent upon New York banks for trade credit

The decision not to renew the First Bank of the United States left the United States to fight the war of 1812 against Britain with no means to finance the military struggle, much less the general operations of the federal government. Then Treasury Secretary Albert Gallatin, who was no advocate of public debt, made careful plans to borrow up to $20 million via the First Bank to finance the war, but instead was

forced to seek loans from abroad because the First Bank was disolved. Along with Hamilton, Gallatin was one of America's first great financial geniuses, and a talented bond salesman to boot. He is memorialized by a large marker in front of the Treasury building in Washington, having also served as Commissioner for the Treaty of Ghent, as well as minister to both France and Great Britain. Because America's position with the nations of Europe was that of debtor and former colonial possession, Gallatin's financial expertise was invaluable. His role recalled the invocation of Hamilton and also of Adams of the virtue of increasing the number of nations willing to hold the American government's debt.

As the nation reeled from the financial disaster of the War of 1812, a heated debate continued in the Congress regarding the need for a common currency and a new bank of issue for that currency. Notes issued by banks in New York, for example, could not be used at face value to settle debts in other states. The problem of the scarcity of adequate medium of exchange had existed since colonial times and often made it difficult for creditors to secure payment from customers, even if the customer wished to pay! By 1814, the federal government itself was unable to pay its bills and was on the brink of financial collapse. Treasury Secretary Alexander Dallas was forced to suspend payments on the national debt in New England due to a lack of hard currency, a necessary move since all Treasury debts had to be paid in gold or silver. Following the capture of Washington by the British in that year and the default on the national debt, the United States was on the verge of financial and political dissolution.[8]

The creation of the Second Bank of the United States was the American government's next attempt at establishing a central bank, an effort that came only after significant political debate and negotiation. Many Republicans fought the resurrection of the Bank of the United States, fearing that its size and ability to do business across state lines would give it monstrous political power that would prove uncontrollable. There was also a strong suspicion by representatives of southern colonies that the Second Bank would be controlled by New York business and financial interests. But after the destruction of the Federalist Party following the War of 1812, the Republican majority in the Congress eventually chartered the Second Bank of the United States, albeit with very limited powers.

The first time the measure to create the Second Bank came up before the Senate in February 1811, it was defeated by the tiebreaking vote of Vice President George Clinton of New York, who was empowered to cast the vote in his role as presiding officer of the Senate. He justified his action because the "tendency to consolidation" reflected by the proposal for a national bank seemed "a just and serious cause for alarm."[9] The subsequent proposal to charter the Second Bank was not passed by the Congress until 1815, but then was vetoed by President Madison. A year later the Congress reconsidered the matter. This time, the bill passed the Congress and President Madison signed it into a law.

The late Senator Robert Byrd, the West Virginia Democrat who was one of the longest serving members of the body, wrote in his 1991 history of the Senate that the early debates regarding a central bank "were far from over and would surface again within the coming decades to alter significantly American political history." Byrd also notes that coincident with the authorization for the Second Bank, the Congress for the first time dared to provide themselves with an annual salary. Previously, members of the Congress had been paid $6 per day or about $900 per year. Wartime inflation had greatly reduced the purchasing power of this per diem compensation, so the Congress voted itself a $1,500 per year annual salary. The decision was a political disaster and led to the defeat of two-thirds of the members of the House in the following election.[10]

Ironically, many Republicans who supported the Second Bank considered themselves heirs to the libertarian legacy of Thomas Jefferson. When they finally supported the proposal, however, they were following the plan of Alexander Hamilton of New York and other supporters of a strong central government and the virtue of private banks for supporting economic expansion. These same Republicans, who essentially held a one-party lock on the Congress during that time, opposed funding for interstate roads and canals, and even the railroads, to help the struggling economy. The Republicans of that era doubted that the central government had the power under the Constitution to fund internal improvements, yet they did support the central bank. The fact was that the United States was changing as fast as it was growing and with that change was losing many of its libertarian attributes. The nation's founders, whether federalist or anti-federalist, found the

process bewildering. Susan Dunn, professor of Humanities at Williams College, wrote:

> Jefferson and Madison's Republican Party championed the enterprising middling people who lived by manual labor. But the year before he died, Jefferson felt lost in a nation that seemed overrun by business, banking, religious revivalism, "monkish ignorance," and anti-intellectualism . . . The Founders' revolutionary words about equality, life, liberty, and the pursuit of happiness, along with their bold actions, had unleashed a democratic tide—one so strong that within a few decades many of them found themselves disillusioned strangers living in an egalitarian, commercial society, a society they had unwittingly inspired but not anticipated.[11]

Following the creation of the Second Bank of the United States, the American economy grew rapidly and more private banks were created, but the largely powerless federal government provided virtually no finance to support this growth by funding public improvements. The Congress preferred to leave this task instead to the cities and states which, naturally enough, turned to borrowing rather than taxation to finance economic growth. By 1840, the total debt of the states amounted to some $200 million, a vast sum by contemporary standards given that total U.S. gross domestic product or GDP was just $1.5 billion. Much of this debt was issued by banks chartered by the states and was held by foreigners.[12]

Though the Founders had made provision under the Commerce Clause of the Constitution for trade between the states free of tariff, there was no provision for a common currency or banking system tying the nation or even the individual states together. A similar problem is evident today in the European Union, which has a common currency, the euro, but no real economic integration. To provide some liquidity, state-chartered banks issued various forms of notes to the public in return for some future promise to pay in hard money—that is, gold. There was no common means of exchange nor any backstop for banks, which from time to time needed emergency infusions of funds. Panics occurred when public unease about particular financial institutions, companies, or the markets caused deposit runs on

individual institutions that could grow into a general financial crisis that affected regions or even the entire country. Crises of just this sort would become the hallmark of the U.S. economy for the next century.

In 1809, for instance, the Farmer's Exchange Bank in Gloucester, Rhode Island, failed—one of the first significant bank failures in the United States. There was no Federal Deposit Insurance Corporation or Federal Reserve System to provide support or even organize the orderly liquidation of the bank. This task fell to state and local authorities. The demise of the Farmers Exchange Bank illustrated the types of financial schemes and public panics that would trouble the United States for decades to come. Financial-pioneer-turned-confidence-man Andrew Dexter, Jr., writes James Kamensky, "challenged the notions of his Puritan ancestors by embarking on a wild career in real estate speculation, all financed by the string of banks he commandeered and the millions of dollars they freely printed. Upon this paper pyramid he built the tallest building in the United States, the Exchange Coffee House, a seven-story colossus in downtown Boston. But in early 1809, just as the exchange was ready for unveiling, the scheme collapsed. In Boston, the exchange stood as an opulent but largely vacant building, a symbol of monumental ambition and failure."[13]

A democratic society and a free market economy cannot exist without both great ambition and equally great failure. However, in the American experience, financial fraud and the tendency of politicians to use debt and paper money, rather than taxes raised with the active knowledge and consent of the voters, are common elements from colonial times right through to the present day. The collective failure of the Subprime Debt Crisis of 2008 is a larger reprise of the types of mini crises that occurred in the United States centuries before this period, crises that were limited by the relatively primitive state of communication and transportation.

State Debt Defaults

By the mid-1830s, the United States was in the midst of an economic boom characterized by inflation and speculation in public land sales, as well as road and canal projects. Many of these projects were badly

needed but were often poorly conceived or entirely money-losing investments. The several American states employed borrowing to finance needed improvements in order to avoid increasing taxes, and they even used sales of public land as a means to reduce debt. States along the Atlantic coast, where the economy was more developed and other sources of revenue such as tariffs were available, generally avoided costly property taxes, while less developed inland states could not sustain their governments with low property taxes and ran into financial trouble. The low or no property tax regimes in many western states are a legacy from the colonial period. This resulting unequal development became even more acute because the areas needing investment and often growing the most rapidly were precisely the western states and territories that were starved for cash, not so much for investment but simply as a means of exchange.[14] In some of these states, the need for money was met in a primitive way by discovering and extracting gold and silver from the ground.

During the 1830s speculation in land also flourished, with state-chartered banks providing the paper to fuel the rising land values. This investment bubble had the effect of making the states look fiscally sound because of rising land prices. Some inland states even suspended property taxes due to supposed "profits" on bank shares, which often comprised a large portion of state investments. But the illusion of wealth and public revenue would fade with the Crisis of 1837, when many of these state banks failed, the equivalent of a nation's central bank failing today. The Crisis of 1837 was the fourth and most stunning depression in the U.S. up to that time and the first financial crisis that was truly national in scope.[15] Between 1841 and 1842, Florida, Mississippi, Arkansas, Michigan, Indiana, Illinois, Maryland, Pennsylvania, and Louisiana ran into serious fiscal problems and defaulted on interest payments. The first four states ultimately repudiated $13 million in debts, while others delayed and rescheduled their debts, in some cases years later. Alabama, Ohio, New York, and Tennessee narrowly avoided default during this period.[16] Because many states used state-chartered banks as vehicles for borrowing, the public naturally became alarmed when the states ran into financial problems and public programs established during prosperous times could no longer be funded.

In the early 1800s, paper money issued by private, state-chartered banks generally traded at a steep discount to the face value when converted into precious metal, especially when it was issued by banks outside of the state or local market where is was presented for payment. The notes used at that time generally promised to pay the bearer of the note a certain amount of physical gold or silver upon demand. The experience of banks failing was all too common for Americans in that period.

There was deep suspicion in the marketplace when a note from a far-away, state chartered bank was presented for payment. This was one reason that payments by and to state and federal agencies were done only in metal coins, not paper, and most contracts of the day likewise specified metal as the consideration. In the 1840s there was no telephone, no internet or even telegraph, and no local clearinghouse for banks to use to validate the authenticity of paper money issued by private banks. No surprise, then, that people in America and around the world preferred the security and certainty of gold and silver coins to paper money, even when the banks issuing the paper were backed by sovereign states.

The suspicion of paper money was part of a broader suspicion of bankers and the economically powerful that flowed through most of American society. Fleeing the religious and economic oppression of European society, Americans came to the New World for a fresh start and also an opportunity to live free of the stratified economic system of Europe, where even in the eighteenth century opportunities for advancement where few. Two centuries later, Western Europe remains a far less dynamic market for new businesses and banks than the far younger U.S. market. Having money that was independent of political authority granted individuals a level of freedom from inflation that was a key part of the American ideal. Thus when the states began to falter financially, the cohesion of the entire nation was threatened. Most Americans still identified themselves with their home state or town rather than as citizens of the United States. The political fact of union among the states had still not quite been settled because of the issue of slavery, but the overall fragility of the state-run financial system contributed to the mounting political pressures on the nation.

As many states fell into default on their obligations during the 1840s, repudiation of debt by state-chartered banks was a hotly debated

subject. In Arkansas, for example, Governor Archibald Yell explicitly urged debt repudiation in his 1842 message to the state legislature, which had created various state-chartered banks as vehicles for funding state expenditures via borrowing. Such was the political uproar against banks and debt generally that the Arkansas state legislature passed a constitutional amendment in 1846 to liquidate all state-chartered banks and prohibit the creation of any new banks in that state.[17]

In Pennsylvania, starting in the mid-1830s the Commonwealth had chartered the United States Bank of Pennsylvania to cover fiscal shortfalls with debt. By 1839, the bank had defaulted on its obligations several times, but the response from the state legislature was to authorize more borrowing—a charming reminder that the present-day problems of federal deficits are not a new phenomenon. Despite rising deficits, the Commonwealth of Pennsylvania delayed making any meaningful fiscal reforms until the mid-1840s, by which time it was in default on its debt. In payment on the Commonweath's $40 million in debt, its citizens were forced to take scrip bearing 6 percent interest because the state was broke.[18] In essence, Pennsylvania began to issue its own currency when it could not borrow or would not tax in sufficient amounts, a phenomenon that has reappeared in the United States in the twenty-first century. As the states, most notably California, New York, and Illinois, struggle today under mountains of debt, unfunded pension obligations, and other expenses, issuing scrip has again become a popular alternative to tax increases.

By 1840 many American states had gained a well-deserved reputation in Europe for not repaying loans, although the U.S. government managed to service the federal debt in good order. From $75 million in debt in 1791 to a peak of $100 million after the War of 1812, the Treasury paid down the federal debt to a mere $63 million in 1849. The U.S. government only paid down its debt once in the 1830s and then only by the accident of having a fiscal hawk named Andrew Jackson as President. In general fiscal restraint at the federal level was the rule in the first century of the nation's existence. Since the Federal government was not really involved in financing the economic growth of the nation, the remarkable stability of the federal debt contrasts with the spendthrift behavior of the states, counties and cities.

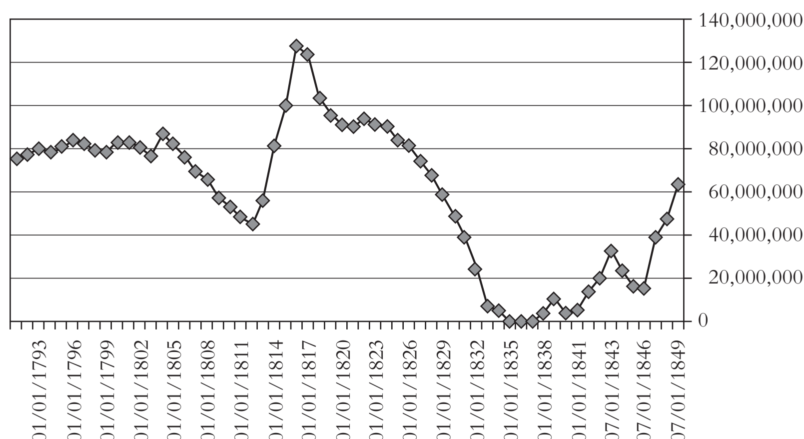

Figure 1.1 U.S. Federal Debt/Annual 1791–1849 ($)
Source: U.S. Treasury

Figure 1.1 shows the total federal debt of the United States from 1781 through 1849.

States such as Louisiana defaulted on loans, evaded their debts and delayed settlement with creditors until the twentieth century. Many foreign investors had believed, incorrectly, that the success of New York and other Atlantic states in building profitable canals and other commercial infrastructure would be repeated in the western and southern states and territories. The states themselves, especially in the south and west, seemed genuinely to have believed in the growth story. But in fact, looking at both the federal and state debts, the United States was a heavily indebted, rapidly developing country with neither organized financial markets nor even a common currency, and with a seriously dysfunctional central government.

When the overheated economy and related financial crisis first started to boil over in the late-1830s, many European banks refused to lend further to the U.S. government or the various states, putting intense pressure on the small nation's liquidity and political unity. This stress was relieved by the issuance of various types of fiat currency and debt securities. In states such as Michigan and Indiana, the number of banks dwindled as first private institutions and eventually

the state-chartered banks were wound up and closed. Regarding the financial situation in the Midwest, Willis Dunbar and George May noted in their book, *Michigan: A History of the Wolverine State*:

> The speculation in Michigan land values of the early thirties, for example, was fantastic. The enormous note issues of the banks were obviously out of proportion to their resources. And the internal improvement programs adopted by the states were far beyond their ability to finance. The nation was importing, primarily from Great Britain, much more than it was exporting, and piling up a steadily mounting debt to British exporters and manufacturers. A day of reckoning was inevitable.[19]

Washington had not played a direct role in encouraging the accumulation of debt by the states. The national Congress refused to support any needed infrastructure improvements such as roads, canals, and port facilities, and the failure to make progress on the more basic issue of a national currency made the situation in the American financial markets inherently unstable. When added to this structural deficiency the renewed political ascendancy of Andrew Jackson and the proponents of the Jeffersonian, anti-federalist view of banks and currency, set the stage for not merely a crisis at the end of the 1830s—but for a catastrophe. When the crisis finally occurred, it turned out to be one of the worst economic and financial meltdowns seen in Western society up to that time and was compounded by unresolved political issues in Washington.

By the middle of 1837, unemployment was widespread and thousands of companies and banks had failed as the money supply contracted. This was due in part to events in Washington and, more important, to a growing antipathy toward banks and paper money among the public. Bad paper money was literally shunned by the mass population, and the issuance of bonds likewise dried up. By the start of the 1840s, only official U.S.-minted coins and other types of specie were in broad circulation as Americans avoided privately issued paper notes and debt.[20] In effect, all of the float or credit in the economy was gone. Americans were forced to operate on cash or barter terms. Imagine leaving one's house every morning needing to generate cash or goods via sales, services, or barter every day in order to survive. Most Americans in the

1840s lived with no access to cash or credit, except as provided by commercial exchanges with other people.

The Age of Andrew Jackson

Much of the terrible suffering experienced by the country in the late 1830s owed itself to one factor more than others: the rise a decade before of Andrew Jackson, the Tennessee war hero and political outsider. The arrival in Washington of this former Indian fighter and hero of the War of 1812, known as Old Hickory, signaled the end of the political dominance of Virginia in American politics. Jackson had lost his first bid for the presidency to John Quincy Adams of Massachusetts in the election of 1824, even though the Tennessee native won a larger proportion of the popular vote and also the plurality of votes in the Electoral College. But Jackson still lost the election.

In the so-called "Corrupt Bargain," Senator Henry Clay, a Whig from Kentucky and long-time enemy of Jackson, threw his support to Adams in the vote in the U.S. House of Representatives, ensuring the election of Adams but also making the election of Jackson in 1828 a virtual certainty. Clay was appointed Secretary of State by President Adams as the quid pro quo for his support in the House. Clay himself sought the presidency on four occasions, but he repeatedly underestimated the popular support for the man who had defeated the British Army at New Orleans in spectacular fashion—albeit several weeks after the United States and Britain had agreed to peace. News traveled slowly in those days.

Jackson's succession to the presidency in 1828 followed an unremarkable political career, but was notable as the first time that a southerner swept into power in Washington on a wave of popular support. In a sense, Jackson was the first modern president because his victory marked the earliest instance where an American presidential candidate was actually chosen by the popular vote rather than as the result of the internal selection process dominated by the nation's founders and their descendants. In fact, to complete the picture of upset, Jackson's running mate, John C. Calhoun of South Carolina, had served as Vice President under the incumbent President John Quincy Adams.

The 1828 presidential campaign was a vicious affair, as might be expected when an established order is ended. Jackson was opposed by most of the nation's newspapers, bankers, businessmen, and manufacturers, especially in the Northeast, but still won 56 percent of the popular vote in 1828. Thus began the Jacksonian Age.[21]

The period of Andrew Jackson's presidency was in political terms one of the most difficult in American history, with northern and southern interests competing with new western states for political advantage, even to the point of secession from the Union. Against this contentious political backdrop, Jackson and Congress fought bitterly over many issues, but none of more consequence for the economy and the U.S. financial system than the renewal of the Second Bank of the United States.

With its charter set to expire in 1836, Jackson began in 1830 to attack the Second Bank and proposed instead that a new government bank be set up as an arm of the Treasury. The Whigs led by Clay decided to re-authorize the Second Bank early and were able to get the measure passed by both houses of Congress during the summer of 1832, but the legislation was vetoed by President Jackson on July 10, 1832. He objected to the bank as being unconstitutional, aristocratic, and, most important, because it failed to establish a sound and uniform national currency. The lengthy written discussion of President Jackson's objections to the Second Bank is one of the great libertarian statements against big government and the power of moneyed interests in American history. It also predicted many of the problems caused by the creation of the Federal Reserve System 80 years later. The final paragraph of the Jackson veto message reads:

> Experience should teach us wisdom. Most of the difficulties our Government now encounters and most of the dangers which impend over our Union have sprung from an abandonment of the legitimate objects of Government by our national legislation, and the adoption of such principles as are embodied in this act. Many of our rich men have not been content with equal protection and equal benefits, but have besought us to make them richer by act of Congress. By attempting to gratify their desires we have in the results of our legislation arrayed

> section against section, interest against interest, and man against man, in a fearful commotion which threatens to shake the foundations of our Union. It is time to pause in our career to review our principles, and if possible revive that devoted patriotism and spirit of compromise which distinguished the sages of the Revolution and the fathers of our Union. If we cannot at once, in justice to interests vested under improvident legislation, make our Government what it ought to be, we can at least take a stand against all new grants of monopolies and exclusive privileges, against any prostitution of our Government to the advancement of the few at the expense of the many, and in favor of compromise and gradual reform in our code of laws and system of political economy.[22]

Even then, the supporters of a central bank were numerous and outspoken. Ralph C. H. Catterall, the great historian of the Second Bank, said of Jackson's veto:

> Jackson and his supporters committed an offense against the nation when they destroyed the bank. The magnitude and enormity of that offense can only be faintly realized, but one is certainly justified in saying that few greater enormities are chargeable to politicians than the destruction of the Bank of the United States.[23]

But Claude G. Bowers, a historian sympathetic to Jackson, defended his action:

> Even among the ultra-conservatives of business, the feeling was germinating that Jackson was not far wrong in the conclusion that a moneyed institution possessing the power to precipitate panics to influence governmental action, was dangerous to the peace, prosperity, and liberty of the people.[24]

The veto of the reauthorization of the Second Bank was not the end of the matter, however. The debate over the bank and the nature of money played a significant role in the 1832 landslide re-election victory of Jackson against the party formerly known as the Whigs, and now called the National Republican Party under Henry Clay.

That debate would continue for years as the Senate censured Jackson for his efforts to remove the government's funds on deposit with the Second Bank. But Jackson was adamant that the bank had to go and he was willing to let his political fate be governed by that one issue. In September 1831, President Jackson told Treasury Secretary Louis McLane that he did not intend to pull down the bank merely to set up a new one.[25]

Despite Jackson's strong view on the matter, he could not disregard many voices, even in his own cabinet, who supported renewing the charter of the Second Bank. Yet Jackson remained strong in his conviction that the central bank was a monster that was unconstitutional and concentrated power "in the hands of so few persons irresponsible to the electorate," wrote Marquis James. The great biographer of Jackson continued: "Nor was this all. With deep and moving conviction, the message gave expression to a social philosophy calculated to achieve a better way of life for the common man."[26]

In one of the examples of how personal political battles contributed to the economic problems of the nation, Nicholas Biddle, the head of the Second Bank and a foe of Jackson, fought the President to the last in defense of the Second Bank. When Jackson gave notice that the Treasury would no longer deposit its cash in the Second Bank, Biddle started to withdraw funds deposited with state banks around the country in an effort to discredit Jackson. Specifically, Biddle would present notes drawn upon state banks and demand payment in gold, a move that had the effect of draining liquidity from those communities and generating enormous anger at Biddle and the Treasury. So great was the antagonism generated by Biddle's attempt to hurt the U.S. economy (and thereby wound President Jackson politically) that almost a century later, when the U.S. Congress debated the creation of the Federal Reserve System, the state bankers still referred to the predations of Nicholas Biddle and the Second Bank as a reason for opposing the legislation.

Biddle was one of the great financial minds of the early days of the United States, but he was also a formidable political operator who was not afraid to use the media and lobbying on Capitol Hill to defend his institution. Together with Clay and other supporters of the Second Bank, they mounted a vigorous but ultimately futile defense.

The economy eventually slowed and the financial markets began to weaken as the Second Bank withdrew hard currency from the economy, but President Jackson struck back. In the fall of 1833, he directed that the Treasury withdraw its deposits from the Second Bank, a move which began his famous confrontation with Henry Clay and the Senate, and doomed the Second Bank of the United States to extinction.

Both Clay and Biddle, it seems, believed that hard economic times would help their battle with Jackson and the Democrats, who used the fight over the bank to win the 1832 election. Both men miscalculated badly and Jackson won re-election with 76 percent of the vote, the largest margin since George Washington and James Madison. The pro-Jackson forces likewise prevailed in the 1834 mid-term contest—even as Biddle did his best to "bring the country to its knees and with it Andrew Jackson."[27] The political battle over the Second Bank of the United States between Clay and Jackson distracted the country at a very crucial juncture of American history. The United States would go nearly three quarters of a century without a central bank of issue for its currency until Congress established the Federal Reserve System in 1913, but the immediate impact was the most severe economic crisis the nation had seen since its beginnings.

When the Second Bank closed its doors in March of 1836, the United States was left with no common currency and what credit the bank had provided to the economy was withdrawn. There was no central provider of liquidity for banks, nor any deposit insurance. Only the private shareholders of state-chartered banks were available to support the liquidity and soundness of private depositories. This lack of a currency system and of a mechanism for managing the liquidity needs of banks had been felt earlier in the century, when the Second Bank of the United States called in its loans in 1819 and triggered the Panic of that same year in the ensuing scramble for liquidity. But as with most public issues, the national Congress was largely indifferent to the needs of the nation, preferring instead to defend regional and states' rights from threats, real and imagined.

The defeat of the Second Bank of the United States was not the end of Jackson's reactionary agenda. President Jackson refused to allow the resources of the federal government to be used for financing the

construction of roads and canals, and instead retired the national debt and distributed the surplus accumulated in the Treasury. By attacking the Second Bank and at the same time pursuing a very conservative fiscal policy, Jackson created the circumstances for the Great Panic of 1837. Since there was no central bank, the withdrawal of public debt by the Treasury amounted to a deflationary reduction in the nation's money supply. In addition, the retirement of the federal government's debt encouraged states and their banks to issue paper currency in large amounts, which fueled land purchases and speculation. Done in the midst of a growing speculative bubble based on land purchases, the Jacksonian fiscal measures helped to reduce liquidity in banks and worsen the lack of credit in an already cash strapped society. Yet even with what amounted to a tight money policy from Washington over eight years of Jackson's presidency, the speculation that gripped the nation during the early part of the 1830s was just coming to a boil when Jackson left office in the early part of 1837.

As one of his last official acts, Jackson issued the Specie Circular, another hard money and anti-debt initiative, which required that purchases of government land be paid for in coin or *specie* rather than bank paper. By requiring that payments for taxes, duties, and/or the purchase of federal land be made in gold coins, the Treasury was in practical terms draining reserves from the banking system and causing it to shrink. This compounded the fact that the Second Bank of the United States under Biddle had been calling in its loans. This third fiscal action by Jackson, following the closure of the Second Bank and the retirement of the government's debt, was implemented by his successor, President Martin Van Buren, and further exacerbated the liquidity crisis in the United States.

The Panic of 1837

As Jackson travelled home to Nashville in the spring of 1837, he observed that bank notes were trading at a steep discount to face value and farmers were paying 30 percent for credit—all the results of his earlier executive orders. Some bankers, traders, and particularly land speculators clamored for President Van Buren to "strike down the

iniquitous Specie Circular" requiring that hard money be used in the purchase of federal land or payment of federal taxes. But Jackson wrote to Van Buren:

> My dear sir, the Treasury order is popular with the people everywhere I have passed. But all the speculators, and those largely indebted, want more paper. The more it depreciates the easier they can pay their debts . . . Check the paper mania and the republic is safe and your administration must end in triumph.[28]

Unfortunately for President Van Buren, Jackson's devotion to hard money was at odds with the needs of a growing nation. With the drain of currency caused by Jackson's Treasury order, as he called the Specie Circular, and the resultant increased stress on the economy, a lack of confidence in the state banks was widespread around the United States. The resulting financial crisis in 1837 caused many banks to fail over a period of several years. This panic was followed by a sharp economic contraction around the world that would last until 1841. To no surprise, President Van Buren was defeated in the next general election.

One of the more significant and mischievous contributions that President Van Buren made to the country's financial development was the creation of an independent Department of the Treasury. In 1837, in a special message to Congress, President Van Buren proposed that the finances of the federal government be formally "divorced" from those of the state chartered banks. This proposal caused considerable political controversy. The Congress passed The Independent Treasury Act of 1840 and then repealed it in 1841. In 1846 Congress adopted the same proposal again. The official goal of the legislation was twofold: to ensure the independence of the banks in the country and also to support the value of the currency. Neither of these goals were met.

In practical terms, the Treasury became a "bank of issue" and a de facto central bank, refusing to accept notes issued by private banks and issuing its own notes in competition with the state banks. The creation of the Independent Treasury had a negative impact on the U.S. economy by draining reserves from the banking system and effectively reducing the supply of money available to Americans for commerce.

By segregating the gold reserves of the government in the Treasury's own vaults and not keeping these funds on deposit with private banks, the Independent Treasury served to exacerbate the structural deficiencies in the U.S. economy for decades afterward. In the years up through the Civil War and thereafter, the fiscal operations of the Treasury were an important factor in the ebb and flow of the supply of money available to support the American economy.

By the 1840s, hundreds of banks existed in America and all of them were printing private bank notes and making loans based solely on their own resources, mostly gold and foreign currency held as reserves. With the demise of the Second Bank of the United States in 1836, only state-chartered banks existed and the United States remained dependent upon limited minting of specie, foreign currency, and barter as means of exchange. During this period, known as the Free Banking Era, state bank chartering standards were not very stringent, and many new banks were formed and failed, but the free banking era was also one of great expansion in the U.S. economy. The Federal Reserve Bank of San Francisco described the period:

> State Bank notes of various sizes, shapes, and designs were in circulation. Some of them were relatively safe and exchanged for par value and others were relatively worthless as speculators and counterfeiters flourished. By 1860, an estimated 8,000 different state banks were circulating "wildcat" or "broken" bank notes in denominations from ½ cent to $20,000. The nickname "wildcat" referred to banks in mountainous and other remote regions that were said to be more accessible to wildcats than customers, making it difficult for people to redeem these notes. The "broken" bank notes took their name from the frequency with which some of the banks failed, or went broke.[29]

In reaction to the collapse of the Second Bank of the United States, New York became the first state to adopt an insurance plan for bank obligations. Between 1829 and 1866, five other states adopted similar deposit insurance schemes in an attempt to stabilize their banking systems. But these modest early attempts at enhancing bank safety and soundness were not effective in controlling the emission of paper currency and forestalling liquidity crises such as the great Panic of 1837.

The Congress authorized a Third Bank of the United States in 1841, but President John Tyler vetoed the measure, leading to rioting outside the White House by members of his own Whig Party.[30] The idea of a central bank issuing paper money was sufficiently popular in Washington and among the business circles that exerted influence in the lobbies of the Capitol. But Tyler, who succeeded to the presidency upon the death of William Henry Harrison, who died after just a month in office, vetoed the legislation creating a Third Bank of the United States twice during his term on states' rights grounds.

The defeat of the Third Bank of the United States also marked yet another political defeat for the Republican leader Henry Clay. As before, Clay had personally championed the idea of a central bank, and as before, he had lost. With the death of Harrison, a retired general and respected member of the Whig Party, Clay believed that a new central bank was assured. But the populist opposition to the idea of a central bank, or even any banks at all, was too strong. President Tyler instead used the bank issue to assert his political independence from Clay and the Whig leaders in Congress.

When Tyler's Whig cabinet resigned over the veto of the bank legislation, Tyler was left with only the venerable Daniel Webster as Secretary of State. Webster knew the political and economic issues in the debate over a central bank as well as any member of the Senate. He had opposed the First Bank in 1814, but then helped John C. Calhoun fashion a compromise that eventually passed by the Congress. Years later, acting in his capacity as a lawyer, Webster represented the Second Bank before the Supreme Court in *McCulloch v. Maryland*, when the high court upheld the implied power of Congress to charter a federal bank and rejected the right of states to tax federal agencies. The ruling in *McCulloch v. Maryland* also recognized the implied powers clause of the Constitution, an evil event that greatly expanded the power of the Congress generally and especially regarding money and debt.

"A disordered currency is one of the greatest political evils," Webster is reported to have said in one of the great arguments ever made by an American for sound money. He continued:

> A sound currency is an essential and indispensible security for the fruits of industry and honest enterprise. Every man of

> property or industry, every man who desires to preserve what he honestly possesses, or to obtain what he can honestly earn, has a direct interest in maintaining a safe circulating medium; such a medium shall be a real and substantial representative of property, not liable to vibrate with opinions, not subject to be blown up or blown down by the breath of speculation, but made stable and secure by its immediate relation to that which the whole world regards as permanent value.[31]

Tyler and Webster appointed a new cabinet comprised of southerners and without any supporters of Clay, whose political era essentially ended with this last battle in the nineteenth century over a central bank.

As discussed in the next chapter, Washington remained largely oblivious to the financial problems facing the nation's economy until the Civil War. Tyler's advocacy for states' rights also meant a strong resistance against using federal revenue to bail out the states from their debts. Clay was particularly keen on giving the new, heavily indebted western states the right to revenue from public land sales, a measure Tyler refused to support. Even though Martin van Buren was defeated in 1840, the influence of Jackson and the public's strong distrust of banks generally gave President Tyler the will to oppose a measure strongly supported by his Whig Party. The Whigs subsequently expelled Tyler. When he left office in 1845, the government received taxes and paid interest in specie, but the rest of the economy was fueled by the rapid growth in paper currency that was, to one degree or another, convertible into gold or silver.

The Gold Rush

The debt crises in the various states of the mid-1840s would quickly be forgotten in 1848 when gold was discovered in California. Within months of the discovery, tens of thousands of people were headed west, overland across the Great American desert, by sea around Cape Horn, or through the jungles of Panama and Nicaragua. The tiny Spanish port of San Francisco was turned almost overnight into a boom town of some 25,000 inhabitants and continued to grow to bursting and beyond with the vast influx of humanity from all corners of the globe.

By 1870, the population of San Francisco had reached nearly 150,000, but this statistic only begins to describe the huge movement of people and resources from the Eastern United States to the other side of the continent. So great was the influx of humanity into California that the territory was organized into a state, held a constitutional convention, and petitioned Congress for statehood in less than two years. California was admitted to the Union as a free state via the Compromise of 1850, the fastest process of accession to statehood of any U.S. state.

The production of gold from the mines of California served to stimulate economic activity in the United States and around the world, resulting in increased imports from Great Britain and other nations, and a steady increase in prices. The influx of new supplies of gold increased the money supply of the United States which, by definition, was still governed by the amount of gold in circulation. But a great deal of gold would eventually leave the United States for destinations such as Britain and other countries to pay for imported goods. More important, the Gold Rush pushed wages and prices higher, even after the initial surge of migration from 1848 to 1852 slowed. Long after the allure of the Gold Rush had faded, wages and prices in distant California remained higher than in the rest of the United States.[32]

But despite the idealized view of the Gold Rush, the fact was that most of the 49ers who made the trip to California did not become rich. Making the trip to California to pan for gold was akin to playing the lottery, which meant that the vast majority of participants were losers in financial and human terms. A significant portion of the participants in the Gold Rush died attempting to reach California or due to violence in the gold fields. Those who ventured north to the Yukon in pursuit of gold faced even steeper odds, as described so beautifully by Jack London in books such as *Call of the Wild* and *White Fang*.

The more enduring, long-term impact of the Gold Rush was to create an alternative to the Puritan, conservative notion of hard work and saving that characterized the early days of the United States with the "American dream" of instant wealth achieved quickly via opportunism and speculation. More than simply a description of the social and economic changes that occurred in California as a result of the discovery of gold, the Gold Rush and eventually the American dream became synonymous with the ability to get a fresh start in life and,

with hard work and most important, luck, earn enormous wealth. From the 49ers in the 1850s to oil prospectors half a century later to movie producers and technology start-up companies in the twentieth century, the get-rich-quick image of the American dream became an important fixture in the nation's psyche that would color public attitudes toward money, debt, and the role of government. The American dream was not merely about helping all Americans meet their wants and needs, but to meet them immediately. As H.W. Brands wrote in his classic work, *The Age of Gold*:

> "We are on the brink of the age of gold," Horace Greeley had said in 1848. The reforming editor wrote better than he knew. The discovery [of gold] at Coloma commenced a revolution that rumbled across the oceans and continents to the ends of the earth, and echoed down the decades to the dawn of the third millennium. The revolution manifested itself demographically, in drawing hundreds of thousands of people to California; politically, in propelling America along the path to the Civil War; economically, in spurring the construction of the transcontinental railroad. But beyond everything else, the Gold Rush established a new template for the American dream. America had always been the land of promise, but never had the promise been so decidedly—so gloriously—material. The new dream held out the hope that anyone could have what everyone wants: respite from toil, security in old age, a better life for one's children.[33]

The Rise of Bank Clearinghouses

Another significant development in the history of the American monetary system prior to the Civil War that deserves attention is the creation of private clearinghouses around the country to help banks manage their payments and liquidity. In 1853, when the Clearing House Association began operations in New York, it was located in a single room in the basement of 14 Wall Street. Created even before the National Banking Act was enacted by the Congress a decade later, the

New York Clearing House was a mechanism designed to reduce the cost of clearing claims between banks in the same city.

Twice a day, the banks would total their debits and credits with each member of the clearinghouse, and then settle the difference in cash—or special notes drawn on the clearing member. This basic, non-specie extension of credit between the members of the association was another response to the demise of the Second Bank of the United States and effectively made the clearinghouse a quasi central bank to its members.[34]

The advent of clearinghouse models in many cities around the United States during the mid-1840s and 1850s was an important development, a uniquely American model of mutual risk taking and liquidity sharing that provided an important degree of efficiency to the financial markets without government support. But the credit that could be provided to members was limited by the willingness of the other party to take the special currency, created for members of the association, known as "loan certificates." The clearinghouse in one city did not yet interconnect with its counterpart in another city. This left the movement of credit from one market to another, one city to another, to the limited channels of correspondence between individual banks. But the fact of the private bank clearinghouses provided an important source of liquidity for banks that was not available from other sources.

JP Morgan, it must be said, was not a member of the New York Clearing House until well into the twentieth century and instead cleared all of its transactions with other banks "over its own counters," in the market vernacular of the day. This essentially meant that the House of Morgan wanted the other banks in the New York market to stand in line like everyone else in the lobby of JP Morgan. It also meant that the most prominent and creditworthy bank in the United States was not part of the collective clearing mechanism in the most important city in the country and thus only extended credit to other banks on its own terms.

While the clearinghouse model served to provide liquidity to member banks during the crises of the nineteenth and early twentieth centuries, it was not nearly a sufficient solution to the problems of liquidity that dogged the U.S. markets during economic downturns. There was always a competitive aspect to the relationship among

clearinghouse members, to paraphrase Charles Goodhart, a chief economic adviser to the Bank of England. The case of the Building & Loan Society in the Frank Capra film *It's a Wonderful Life* featuring James Stewart epitomizes the example. When a solvent bank required short-term liquidity support, the other members of the clearinghouse might be tempted to withhold their aid and thereby kill a competitor. Goodhart notes, however, that the politically controlled central bank is not the solution to this problem of competitive conflict, since the prejudices and conflicts of the political world are far worse than even those found in the banking sector.

The political corruption and incompetence displayed by the Fed and Treasury during the financial crisis of 2008 seemingly supports Goodhart's judgment. It is, after all, the legal and regulatory limitations imposed by government that created the problems of liquidity and risk with which private banks must contend, argues Richard Timberlake of CATO Institute:

> Governmental dispensation of monopoly powers over note issue, governmental imposition of legal reserve requirements, governmental prohibition of post notes and option clauses, governmental prohibitions of interstate and (often) intrastate branching—in sum, governmental interference with all of the machinery of banking that would have allowed banking to function as free enterprise, was what made the problem that the clearinghouse institution successfully abated.[35]

The clearinghouse model in the United States was an attempt by private industry to address the problems of liquidity and payments that burdened the young country in the mid-1800s. Unfortunately, the already fragile U.S. financial system would next be thrown into the stress and uncertainty of the Civil War, a terrible period that altered the nation's financial system forever.