

BANKING AND
MONETARY POLICY:
1789 TO 1861

THE FIRST AND SECOND
NATIONAL BANKS

Rebecca Nicodemus

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Dr. Vernarelli

Introduction

This paper will discuss the monetary and banking conditions in the United States in the period between the establishment of the Constitution in 1789 and the beginning of the Civil War in 1861. It will focus primarily on the First and Second National Banks, the economic and political reasons for their existence, the reasons that prevented their renewal, and the results of their presence and absence.

The Colonial Period

In order to impart a good understanding of the First National Bank, I will first lay some groundwork on the conditions of the economy and the monetary system during the colonial period. This will help the reader to follow the thoughts of those who were dealing with the problems that existed at the time.

During the colonial period, the Americans were in a unique situation. In the decades before the Revolution, the American people became a people far removed from those in England. They had the land and resources to support themselves, as well as the independence and industriousness. However, the colonies had no unified system of money. Gold and silver coined in various European countries functioned as money or specie. (Tuttle, Perry, 111) Throughout this time and well into the 19th century, silver was the primary precious metal used for exchange. This was simply because gold was much more scarce than silver. (Tuttle, Perry, 113-114) Also, the mercantile relationship that the colonies had with England aggravated an already confusing monetary system. Mercantilism is the practice of having the mother country, in this case, England, use the colonies as a source of raw material, manufacture the actual goods itself, and then force the colonies to buy the finished good. This practice meant the money that did find its way into the Colonies was quickly shipped back to Europe as payment for these goods. As a result of this imbalance of trade and the lack of an entity to coin new specie in the colonies, money was very scarce. (Tuttle, Perry, 78)

In an attempt to remedy the situation, numerous private and state-chartered banks sprang up and began to print paper currency. These notes were essentially bills of credit saying that the buyer owed the seller such and such an amount of specie on demand. What would happen, then, would be that the notes would pass into circulation, and would eventually leave the immediate vicinity of the bank that issued them. At the new location, it was difficult to get some other bank to redeem the unfamiliar notes at their face value. Often, even if the notes were redeemed at their issuing bank, the bank would not have enough actual specie to back all or even a good portion of the notes it had issued. Consequently, paper money got a bad reputation as something rarely worth what it was issued for. (Hammond, 26)

As would be expected, the lack of money and the depreciation of paper bills of credit complicated exchange of goods, especially over long distances. Also counterfeiters or anyone who felt like establishing a "bank" could print paper bills and the people had little way of knowing what bills had real money to back them up and which did not. Making this an issue of concern to the government was the fact that many people could not pay their taxes, not because they were destitute, but because there simply was so little money in existence to pay with. (Tuttle, Perry, 112)

The Revolution

When the colonies began the Revolution in 1775, the hastily put together confederation of colonies united under the Articles of Confederation faced the difficulty of having to buy cannon and guns, uniforms and food, and provide pay to an army, with no money. For lack of a better solution, the Continental Congress authorized the Treasury to print its own bills of credit. (Hammond, 29) Of course, the government did not actually have the money to back the bills and, as had happened with other such issues, the bills were soon "not worth a Continental." This disaster ended in the government being in debt at the end of the war with no foreseeable way of paying it off or funding its other expenses. (Tuttle, Perry, 96-97)

few people had grasped the magnitude of it. The Industrial Revolution was just making a major impact on the most progressive European countries at this time. Throughout history every nation had had an economy made up almost entirely of subsistence farmers. This was because, obviously, the technology simply did not exist for mass production of goods or for efficient transportation of these goods. Also, remember that, in America, the cotton gin had been invented only in 1793; and that had been the sole reason the South was able to industrialize its cotton production. (Tuttle, Perry, 122) Hamilton foresaw that there would be fewer and fewer farmers who could exist practically independently of anyone else, and more and more merchants and businessmen who would get their needs and wants satisfied by purchasing goods and services from someone else. Obviously, if the economy were to trend this way, money was an absolute necessity for transaction of services. As the ease of transportation increased with the invention of steam power and railroads, the population grew, and new technology such as the cotton gin and textile mills made it easier to manufacture goods, there would be a greater need for a reliable medium of exchange that would be acceptable all over the country. (Hammond, 119-121)

On the other hand, Jefferson hoped that the nation would remain primarily agricultural. For philosophical and moral reasons, he believed that an agrarian lifestyle was better for the people. He felt that working the land made the people more industrious, honest, and down-to-earth. If the nation were to stay this way, money would not be such an issue. There would not be a large amount of exchange amongst the very large majority of the people. The only people who would put up a loud clamor for specie would be the merchants and businessmen. This kind of economy might very well be supported sufficiently by small private banks whose notes did not hold their value far from their place of issue. Or, if the states wanted, they could unify the banks across the state. Besides, Jefferson argued that the establishment of a bank was simply not Constitutional. (Hammond, 121)

Hamilton, meanwhile, was arguing in the Federalist Papers in the late 1780's that industrialization was not an enemy of agriculture, but rather was a friend. He said industrialization would raise the worth of land. He stated in no uncertain terms that industrialization was the only way that a nation could grow and raise its standard of living. Remaining in agriculture would result in no growth or incentive for innovation. Having established these statements as facts, Hamilton felt he had an indisputable reason for demanding a unified monetary system. He stated that every laborer in an industrialized economy works toward obtaining "the precious metals, those darling objects of human avarice and enterprise." (Hamilton, 121) Obviously, he meant by this that if men could work to obtain money and they needed money to get the things they needed and wanted, they certainly would work, compete, and innovate in order to obtain it. In addition to these observations, Hamilton pointed out the need of money just to pay taxes, and the utility of industry and a great volume of exchange in getting money circulating around the country. (Hamilton, 121-128)

Paper Money

Some mention has already been made about the issue of "paper money" or bills of credit issued in lieu of actual specie. Again, there were differing opinions on this issue. Although some still thought it was necessary, there was a general distrust of paper money in the late 1700's. Madison, for instance, described it as having "pestilent effects" and blamed it for ruining confidence among people, their "industry and morals," and causing debt that could never be paid. (Hamilton, 350-354) Remember, that the mentality of the time, unlike today, was that debt was something to be avoided as a moral evil. Madison called for an end to all paper currency, insisting instead that all debts be paid in specie, which had intrinsic value, and was acceptable worldwide.

(Hammond, 99) Neither was this just talk. In the Legal Tender Act of 1764, all paper currency had actually been forbidden for trade. This hurt the merchants and businessmen amongst the colonists who often literally had no real money

to trade with. (Tuttle, Perry, 89) On the other side of the argument, often, were these merchants. Engaged in trade as they were, money of some kind was essential. Bills of credit worked well enough and were certainly better than nothing.

The First National Bank

In 1791, Hamilton prevailed and a charter was put in place for a federally chartered bank. The bank was given authority to issue bills of credit, to act as the personal bank of the U.S. government, and to function geographically all over the nation. About 1/5 of the Bank's funds were provided by the federal government and the rest were provided by private individuals. The Bank's notes were legal tender for payment of taxes and debts, private and public. (Tuttle, Perry, 111)

The Bank did not directly regulate other private and state banks. Rather, it competed with them and sought to regulate the money supply indirectly. What it would do was, frequently, when it received bills of credit issued by another bank, it would demand that they be redeemed. This forced smaller banks to keep a ready supply of reserves and prevented the banks from issuing too many notes that they could not back. (Tuttle, Perry, 112) The original bank in New York (that the federal bank had been formed from) eventually had opened branches all over the East and South by the time its twenty-year charter expired. (Whittlesey, Freedman, Herman, 188)

The effects of this unification were quickly felt after the Bank's establishment and until 1811, the money supply was fairly stable and inflation was kept under control. The unification of the banks and indirect regulation by the central bank had given paper currency much more stability and regularity of worth from region to region. (Tuttle, Perry, 111) Naturally, this gave people greater trust in paper currency and helped to facilitate the exchange of goods.

1811 and the Second National Bank

In 1811, the charter for the First National Bank expired. Madison was serving his first term as President at the time and he had opposed the Bank all

along primarily because he said it was not Constitutional. Consequently, the Bank was not re-chartered in 1811. (Hammond, 120) Immediately after the expiration of the Bank, private and state banks immediately took off. Rid of this major source of competition, these banks were again able to print out more currency and make more loans without the fear of having to back large amounts of it up with specie. As a result, paper currency again lost its worth. (Tuttle, Perry, 113) The problem was aggravated by the War of 1812 which began in 1812 to and continued to the end of 1814. The same issue of funding a war with little money that had been problematic in the Revolution repeated itself, and the government ended up having to issue bonds to fund the war. (Whittlesey, Freedman, Herman, 189) This put the government in a rather embarrassing situation and Madison ended up changing his mind and supporting a Second National Bank charter in 1816. This Bank acted in very much the same capacity as the first one had, and the effects were very similar.

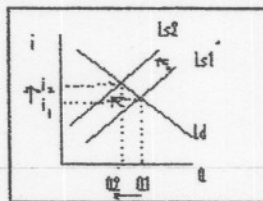
The 1830's and President Jackson

Although the Second National Bank had functioned well since its establishment in 1816, it had not ceased to be a source of contention in the 1830's. President Andrew Jackson, elected first in 1828 and again in 1832, was one of its fiercest enemies. One of the main reasons Jackson opposed the Bank was that he considered it a monopoly because it was in possession of all federal funds and it exercised a good deal of influence over all other banks because it was far larger and geographically covered such a large area. (Tuttle, Perry, 164) Jackson also stated that the bank gave an advantage to some sections of the country at the expense of other sections. By this, he was apparently alluding to the fact that much currency from the South and West moved East as a result of Southerners and Westerners trading with the East with currency, while the East traded with them often through credits rather than actual currency. So the West, especially, ended up, taking out loans for lack of currency. This Jackson wanted to discourage for reasons that are not clear. In 1832, Congress passed a bill authorizing the re-charter of the Bank

when it expired in 1836. However, Jackson vetoed the bill when it came to his desk. (Temin, 33-35)

Ruin of the Bank

Not only did Jackson veto the continuation of the Bank, he took action in 1833 to maim it by actually withdrawing the federal funds from the Bank and placing them in state banks. After replacing the Secretary of Treasury with a supporter, Roger Taney, well over half of the 10 million dollars that the federal government had deposited in the Bank was withdrawn in just the last three months of 1833, and money continued to be withdrawn throughout the next year. (Tuttle, Perry, 164) As if this wouldn't hurt the Bank enough, the Treasury issued drafts to several state banks that were now holding the federal funds. These banks quickly demanded that the draft notes be redeemed, and, in early 1834, the National Bank found itself paying out another quarter of what it had left of its federal funds. As was to be expected, the Bank had to severely cut back its loans and credits and such from lack of money. Accordingly, the number of loans and availability of borrowed funds fell dramatically and the interest rate rose. (Temin, 61-63)



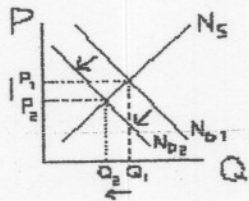
Decrease in Supply
of Loanable Funds

However, according to Temin, this contraction of money and loans did not produce panic as might have been expected in 1834. This was probably because, in 1834, there was an unusually large amount of specie circulating in the country. In fact the exchange rate so favored the American dollar as a result of the decrease in our consumption brought about by our diminished supply of loanable funds that American specie flowed back into America because of its low price abroad. It was profitable to obtain specie in Europe, and then sell it to the banks in America. (Temin, 68)

Absence of the Bank

Between 1834 and 1837, there was rapid inflation. This is traditionally attributed to the effective destruction of the Bank in 1834, although some would argue that this was not the reason. The fact that the Bank essentially dropped out of the picture so suddenly meant that the small banks were not going to be as responsible for redeeming their notes. So, there was a rapid expansion of banks and loans and currency. Or, more and more notes were printed and they again depreciated in value. Additionally, the banks took the federal notes as reserves and lent out more and more money, especially to speculators in land. Temin, however, argues that although inflation was due to the increased money supply (causing an increased demand for goods), the increased money supply was not due entirely to the destruction of the Bank. He claims, instead, that it was due largely to the increased specie, which he feels was due to Mexican silver and the change in the gold-silver ratio that caused silver to be more valuable than it was elsewhere. (Temin, 90-91)

In 1837, prices had risen so much that people began to panic that their money was too rapidly losing its worth. People wanted their notes redeemed as quickly as possible, and the banks promptly "suspended" redemption. Of course, this aggravated the panic, as people realized that the banks simply could not get their hands on enough specie to back up all the currency they had issued because it did not exist. What happened then was that a market independent of banks was formed, and notes actually became the good and specie the method of payment. The demand for notes fell and the price of notes fell until the worth of notes had fallen low enough for the available specie to cover. This ended the panic and banks were not afraid to resume normal operations again. (Temin, 117)



Shift in Demand for Bank Notes

1840's and 1850's

In 1846, an independent treasury was formed. Essentially, this was responsible for keeping government deposits only, not acting as a bank. It had nothing to do with business and individual demand for money, but it influenced banks and money supply to the extent that the money the government collected out of circulation was kept there. (Tuttle, Perry, 165) Throughout the 1840's, several states also experimented with statewide banking. In other words, a state-chartered bank would open branches across the state so that its issued notes would have wider circulation and be redeemable at par value at more than one location.

Free banking was allowed from the end of the Second National Bank in 1836 to the beginning of the Civil War in 1861. During this twenty-five year period, money supply was again very volatile. By the mid-1850's foreign coin was finally out of circulation in America. The discovery of gold in Georgia in the 1830's and in California in the 1840's caused a major shift in the supply of precious metal from primarily silver to primarily gold. When these discoveries were made the gold-silver ratio was raised from 15:1 to 16:1. However, this ratio was lower in the market, and gold soon became overvalued. This was why it was so widely circulated and had replaced silver almost entirely by the 1850's. (Tuttle, Perry, 161)

In 1838, New York set an important example in regulating banking when it passed the New York Free Banking Act. Before, it had had been

customary to obtain a charter from the state in order for a bank to open. Under these conditions it was often difficult to get a charter, but ,once it was obtained, the bank was often not regulated wisely. The Free Banking Act, however, allowed just about anyone to open a bank without a charter as long as they subscribed to certain laws and restrictions that applied uniformly to all banking institutions. One of these was the condition that some kind of security be presented when notes were issued. Many states followed New York's example and in states where the laws were well enforced the banks functioned pretty well. Many states, however, did not enforce the laws for securities to back up issued notes, and did not insist on a minimum amount of reserves. In these states, the old problems were encountered again, and notes depreciated. In fact, by 1861, there were literally thousands of different kinds of notes in circulation, and thousands of these were counterfeit. (Whittlesey, Freedman, Herman, 191-192)

This was the state of the banking industry from the end of the Second National Bank until the beginning of the Civil War when new federal legislation changed U.S. banking once again. The period during and after the Civil War will not be dealt with in this paper.

Conclusion

There are numerous other important acts, laws, policies, and practices that each played a part in the banking and monetary system during the period I have discussed, but which I was unable to deal with in the bounds of this paper. There are a few things, though, that we can definitively conclude. The first years of America's functioning as the United States were dynamic and formative. We have seen that there were two very different viewpoints on the federal government's role in banking and monetary policy that dominated the time. The period from 1791 to 1863 was split roughly equally between strong federal and strong state control and it is obvious that some form of unity was necessary in the monetary system. We observe that federal control in the form of the First and Second National Banks was effective, but not acceptable to

those who did not believe in strong federal power. We also see this in the volatility of the times when there was no federal control . However, it is still disputable whether there may not have been other ways to maintain stability of the money supply and control over inflation without as much central authority.

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