FREE MONEY: HOW DISTRUST SEVERED GOVERNMENT'S ROLE IN BANKING AND WHY THE CIVIL WAR REUNITED IT

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THESIS

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ABSTRACT

The presidential election of 1832 revolved around a single issue: The Second Bank of the United States. Over its 15 year existence, the bank had developed into a symbol of the perceived cronyism between the country's aristocratic class and the federal government. By vetoing the national bank's charter for renewal four months before the election, Andrew Jackson's landslide victory over Henry Clay signaled citizens' growing distrust of the power held by the federal government and the behemoth bank it created to manage its deposits. With the Second Bank of the United States dismantled, state-chartered and privately owned banks proliferated and the banking industry became subjected to the same market forces all industries operated under. This thesis provides a brief history of banking in the early republic in order to understand how the Second Bank of the United States came about. It then deconstructs and examines how the free banking system operated and how it altered the relationship between the federal government and its citizens. Finally, it uses John Locke's arguments for why individuals decide to abandon the liberty-maximizing state of nature and form civil society to explain why citizens allowed the federal government to take control of banking again during the Civil War.

Introduction

Two years after winning the Nobel Prize in Economics, Friedrich Hayek published a book titled The Denationalization of Money. The book, first published in 1976 and later revised and enlarged in 1978, put forth an argument that advocated dissolving government's role in managing a national currency and establishing a system of private currencies issued by various banks and private businesses that would compete for consumer acceptance in the open market. A radical notion at the time and probably just as far-out to many people today, a system like what Hayek proposed existed in the United States for a significant amount of time at the onset of the American Civil War. This period of time is referred to by most economic historians as the Free Banking Era.

While not as widely debated today, the first hundred years of the United States' history was marked by intellectual and political battles over what role government should play in regards to the nation's monetary and financial system. Some believed the federal government should have complete control the nation's currency, some thought it should have zero control, and some fell somewhere in between these two camps. With the election of Andrew Jackson in 1832, it was clear that citizens wanted the federal government to keep its hands off the nation's banking system. Only thirty short years later however, with the Civil War raging on, the federal government was once again in total control over the nation's monetary system. How could the role of the state shift so drastically over such a short period of time? And what caused its duty to shift in the first place? These questions can be answered by examining the historical and political events leading up to these changes and juxtaposing them with the explanation given by John Locke in his Second Treatise on Government about why individuals enter into civil society and form governments. These dramatic shifts in responsibility over a short period, while puzzling at first, resulted because of the constantly fluctuating degrees at which citizens' desire liberty on the one hand and security on the other.

Setting the Stage

The development of the early monetary system in the United States is a complex topic and involves a variety of interacting factors. Due to the abruptness in which the American Revolution started, the American colonies had to quickly devise a way to pay its soldiers and for the necessary equipment, food, supplies, and other expenses necessary to finance their rebellion. In general, nation-states have three ways of generating revenue: tax its citizens, borrow from other nations or print their own currency. One of the main reasons the colonies declared independence was because of their hostility towards British taxes. This reality, in addition to the fact that the colonies hadn't established any sort of bureaucratic mechanisms to collect and enforce such taxes, ruled out the possibility of levying a tax to finance the war. At the same time, convincing other nations to lend the colonies money was next to impossible since the colonies were rebelling against the biggest military power on Earth and had no means of raising revenue to eventually pay back any loans they received.[1] This left the continental government with only one option for financing the war: printing their own currency.

While they broke political ties with Great Britain during the American Revolution, the American colonies also severed monetary entanglements with the nation.

[1] Baack, Ben. "Forging a nation state: The Continental Congress and the Financing of the War of American Independence." *The Economic History Review*54.4 (2001): 639-56. Web.

The Continental Congress printed its own national currency known as the "Continental" to pay soldiers and merchants for supplies and individual states printed their own local currencies to finance their own expenses. The use of a fiat currency, or a currency not backed by a tangible asset, was something that had not been implemented successfully before without the backing of a monarch or strong central government. The currency issued by the Bank of England was backed by gold reserves and the might of the British Royal Navy. The next most popular currency at the time, the Spanish dollar, had a long history of standard uniformity and milling characteristics. During the American Revolution however, both the new Continental Congress and each individual state issued their own paper currency that was not backed by specie or military might but rather a different, more abstract notion: faith in the rebelling colonies. This meant that the use of these notes to do business, exchange goods and services, and conduct all forms of economic transactions required a large amount of trust on the part of citizenry. They had to trust that the notes would retain their value, which meant trusting that the Continental Congress would show restraint in issuing new notes. They also had to trust that their rebellion would be successful and that Great Britain would fail to suppress the rebellion, reestablish control over the territory, and reinstate the British pound as the monetary unit of exchange. The Continental currency, known as the "continental," ultimately did depreciated in value over the course of the American Revolution because it was over-issued by the Continental Congress and because there was an influx of counterfeit bills put in circulation by British printers in an effort to sabotage the war effort. In fact, the Continental currency depreciated so much because of the amount of notes in circulation that the phrase “not worth a continental” gained widespread use throughout the colonies to refer to something of no value.

Despite the monetary chaos, the American Revolution was a success but after the last battles were fought a decision about the country’s currency had to be made by the Founding Fathers. The experience with runaway inflation that resulted from the over issuance of Continentals had lasting effects on both the country’s leaders and citizens’ attitudes towards paper money which is reflected in the United States Constitution. This skepticism is displayed in Article I Section 8 of the document which states that Congress shall have the power to coin money, regulate the value thereof and of foreign coin as well as in Article I Section 10 which declares that states may not issue bills of credit nor make anything but gold and silver legal tender. In the same vein, the federal government was restricted in its abilities to emit bills of credit and instead was only given the power to borrow money on credit.

The experiment with issuing its own fiat currency during the American Revolution sparked a debate amongst the Founding Fathers about whether a centralized institution such as a national bank should be created to issue currency on behalf of the nation or if it was possible to implement a monetary system that was not managed by a monarch or strong central authority. And if such a system was possible, was it something to be desired? This question was the basis for the split amongst the Hamiltonian Federalist and Jeffersonian Anti-Federalist political parties that formed during the nation’s inception. Anti-Federalists did not trust a central bank, and large banks in general, because they believed they advantaged business and governmental interests at the expense of average citizens while Federalists believed that a central bank was necessary to strengthen the financial standing of the young nation. After successfully gaining independence from Great Britain, the new nation had to decide how much central authority they were willing to tolerate and the issue of what institution or institutions, if any, would be responsible for controlling the nation's money was a significant component of that because the amount of influence it could wield required trusting that body to perform its duty impartially and in the interest of all citizens.

The debate about who should be responsible for issuing currency in the newly formed United States stems from two fundamental desires that John Locke points out exist in civil society: the longing for liberty and inclination towards security. After having just defeated the most powerful country in the world in terms of economic and military might with an inexperienced, underfunded, and disorganized collection of farmers, merchants, and craftsman, the early Americans were understandably skeptical about receding power back to a centralized institution or government, no matter how much it might represent their own interests. At the same time, they acknowledged that there needed to be *some* institution put in place to protect the liberties and new nation they had fought to establish.

In the early days of the republic, citizens were politically divided in regards to banking because banks and the credit that they issued were tools used to win elections. As early as 1800, less than twenty years after the American Revolution concluded, banks had been politicized and used to favor certain political parties. This is exemplified by looking at the history of banking and electoral politics in New York from 1783-1800. Up until 1800, New York had been a Federalist political safe-haven because the only two banks that operated in the state, the Bank of New York and a branch of the First Bank of the United States, had boards of directors stacked with Federalists.[2] This meant that these banks were generous in lending credit to their own party's campaigns and strict about lending to Republican candidates. That all changed though when the Manhattan Company, a water company with a Republican board of directors, was granted the right to use its surplus capital with "broad latitude" which effectively transformed it into a banking institution. With this new power, the Manhattan Company lent credit to Republican merchants, tradesmen, and politicians which contributed significantly to the fruition of the Republican Revolution of 1800 that put an end to the Federalist controlled government. As noted by James Cheetham, a republican pamphleteer, "Federalism retained its domination until the establishment of the Manhattan Company: after that event its empire became dissolved."[3] This observation lends itself to the notion that banking and lending of credit typically takes on partisan form. It advantages one group at the expense of another, which is why a faction of early didn't trust and desire a central bank. Despite the First Bank of the United States being chartered and re-chartered in the early days of America, the question of central banking began to spill into national politics during the mid to late 1820s.

Andrew Jackson's Bank War

With the election of Andrew Jackson in 1828, it was clear that much of the country had a growing desire to limit the power of the federal government because they

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[2] Murphy, Brian Phillips. ""A Very Convenient Instrument": The Manhattan Company, Aaron Burr, and the Election of 1800." *The William and Mary Quarterly*65.2 (2008): 233. Web.
[3] Murphy, Brian Phillips. ""A Very Convenient Instrument": The Manhattan Company, Aaron Burr, and the Election of 1800." *The William and Mary Quarterly*65.2 (2008): 233. Web.

did not trust the established political and economic system. The backroom "corrupt bargain" that had awarded John Quincy Adams the presidency over Andrew Jackson in 1824 enabled Jackson to launch a campaign four years later that championed the average citizen over the wealthy elite. Despite a notable amount of mudslinging historically associated with this race, the main issues in the presidential election of 1828 revolved around the constitutionality of various federal policies proposed and enacted by Adams during the previous four years including the federal government's role in funding internal improvements and encroaching on states' rights. Once all the mud was thrown and the votes were tallied, Jackson was victorious.

If one doubts that Jackson's victory in 1828 did not reveal the nation's growing desire to lessen the power of the federal government's authority over economic and state matters, his re-election in 1832 decisively signals citizens' attitudes towards government authority. The main (if not only) issue the election revolved around was the Second Bank of the United States, which was seen as an arm of the wealthy, Northeastern aristocracy. Despite the bank's 20 year charter lasting through 1836, National Republicans introduced a bill to re-charter the bank in June of 1832, a few months before the election between Andrew Jackson and Henry Clay, the former Speaker of the House and Secretary of State who benefited from the corrupt bargain of 1824. The Republicans gambled on whether Jackson would risk his popularity going into the election by upholding his own convictions and vetoing the Bank's re-charter bill that passed both houses of Congress.[4] Despite the political situation put on him before the election, Jackson vetoed the Bank's charter for renewal and used it to gain public support for his re-election bid by portraying

[4] Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (131).

the bank as a malicious institution used to benefit wealthy elite at the expense of ordinary citizens. In the 8,000 word statement issued alongside his veto, Jackson stated that he was "deeply impressed with the belief that some of the powers and privileges possessed by the existing bank are unauthorized by the Constitution, subversive to the rights of the States, and dangerous to the liberties of the people."[5]

In particular, Jackson was concerned with the exclusive monopoly over the nation's banking system that the charter granted the Second Bank of the United States. He stated that "every monopoly and all exclusive privileges are granted at the expense of the public, which ought to receive a fair equivalent." One of these advantages was that it was responsible for receiving and maintaining all the deposits of the federal government including revenue generated from customs duties taken from foreign trade as well as sales of federal land in the West. Like other commercial banks, the Second Bank of the United States made money by issuing loans and collecting interest on them. With an enormous supply of deposits guaranteed to it by the federal government, it could loan out money much easier than other state and private banks that relied on the deposits of private individuals, corporations, or state governments. In addition to being the only bank the federal government could legally deposit its money into, the Second Bank's notes were the only notes accepted by the federal government for payment of federal taxes.[6] These two factors made the demand the bank's notes universal and helped to make it one of the biggest corporations in the entire country.

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[5] Andrew Jackson: "Veto Message," December 6, 1832. Online by Gerhard Peters and John T. Woolley, *The American Presidency Project*. http://www.presidency.ucsb.edu/ws/?pid=67040.

[6] *The Second Bank of the United States: A Chapter in the History of Central Banking*. Philadelphia: Federal Reserve Bank of Philadelphia, 2010. Web.

While the Second Bank did not directly control the nation's monetary policy, the large amount of deposits and constant demand for its notes allowed it indirectly control the money supply of state and private banks. By accumulating large amounts of other banks' notes in its vaults, the Second Bank of the United States could reduce the amount of credit these banks were capable of issuing by redeeming notes for specie to reduce the amount of deposits held within the bank. In the same vein, they could allow credit to expand by holding other banks' notes in their vaults or depositing specie into state and private banks, thereby allowing those institutions to issue more credit. The sheer size of the bank's balance sheet gave it a large rein of control over the inner workings of the nation's state and private banks.

In his veto message Jackson also expressed concern about the percentage of the bank's stock held by foreign investors and the advantages its re-charter would grant them. At this point in the bank's life, almost a third of its stock was held by foreigners, mostly in Great Britain.[7] Foreigners were interested in holding stock in the bank because it was one of the largest and most profitable corporations in the nation and paid out significant dividends on its stock, but the Bank's charter also advantaged foreign holders of the Bank's stock over domestic holders because foreigners were exempt from state and federal taxes on the dividends paid out to them.[8] Jackson feared the increasing amount of foreign holders of the Bank's stock would effectively "convert the Bank of the United States into a foreign bank," "impoverish our people in time of peace," "disseminate a

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[7] Andrew Jackson: "Veto Message," December 6, 1832. Online by Gerhard Peters and John T. Woolley, *The American Presidency Project*. http://www.presidency.ucsb.edu/ws/?pid=67040.

[8] Andrew Jackson: "Veto Message," December 6, 1832. Online by Gerhard Peters and John T. Woolley, *The American Presidency Project*. http://www.presidency.ucsb.edu/ws/?pid=67040.

foreign influence through every section of the Republic" and "endanger our independence" in the event that war should break out with a foreign nation whose citizens held a significant amount of the bank's stock.[9]

The growing amount of foreign holders of stock also concentrated the bank's power into the hands of a few domestic stockholders who were responsible for electing twenty of the twenty-five directors that served on the Bank's board (the other five were chosen by the Congress). "From all voice in these elections the foreign stockholders are excluded by the charter. In proportion, therefore, as the stock is transferred to foreign holders the extent of suffrage in the choice of directors is curtailed. Already is almost a third of the stock in foreign hands and not represented in elections. It is constantly passing out of the country, and this act will accelerate its departure. The entire control of the institution would necessarily fall into the hands of a few citizen stockholders, and the ease with which the object would be accomplished would be a temptation to designing men to secure that control in their own hands by monopolizing the remaining stock. There is danger that a president and directors would then be able to elect themselves from year to year, and without responsibility or control manage the whole concerns of the bank during the existence of its charter. It is easy to conceive that great evils to our country and its institutions millet flow from such a concentration of power in the hands of a few men irresponsible to the people." If such a concentration of power were to occur, a small group of stockholders would effectively control the entire nation's banking system with

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[9] Andrew Jackson: "Veto Message," December 6, 1832. Online by Gerhard Peters and John T. Woolley, *The American Presidency Project*. http://www.presidency.ucsb.edu/ws/?pid=67040.

no protections afforded to the states, citizens, or even the federal government, whose deposits were held in its vaults.

Besides the political and economic considerations, the bill to re-charter the Second Bank of the United States entailed, Jackson also rejected the Bank on constitutional grounds. Article 1, Section 8 of the United States Constitution grants Congress the power to "coin money, regulate the value thereof, and of foreign coin" under. Proponents of establishing a bank to handle the nation's money rely on the necessary and proper clause of the Constitution to justify its legality. Jackson disagreed with this justification however. In his veto message, he stated that, "Congress have established a mint to coin money and passed laws to regulate the value thereof. The money so coined, with its value so regulated, and such foreign coins as Congress may adopt are the only currency known to the Constitution. But if they have other power to regulate the currency, it was conferred to be exercised by themselves, and not to be transferred to a corporation." The twenty year length of the charter further diminished Congress' ability to use the power explicitly granted to it in the Constitution. As Jackson continues, "If the bank be established for that purpose, with a charter unalterable without its consent, Congress have parted with their power for a term of years, during which the Constitution is a dead letter. It is neither necessary nor proper to transfer its legislative power to such a bank, and therefore unconstitutional." By re-chartering the bank for an additional 20 years, the current Congress was giving away not only its own legislative authority to coin money and regulate its value, but also the legislative authority all Congresses elected twenty years into the future to the Second Bank.

Ultimately Jackson upheld the Second Bank of the United States as a symbol of the perceived relationship between the federal government and the aristocratic class in the United States during this time period. By vetoing the bill authorizing its re-charter, he literally and symbolically broke the ties between banking and the federal government and voters responded by electing him in a landslide over Henry Clay in 1832. Many shared his sentiment that "banking, like farming, manufacturing, or any other occupation or profession, is a business, the right to follow which is not originally derived from the laws."[10]

With the bill to renew the Second Bank of the United States killed, banking was on its way to becoming just that. Jackson's decisive victory in 1832 signaled that the country no longer wanted the Second Bank of the United to maintain so much control over the nation's banks but the bank's charter wasn't set to expire until four years later in 1836. Thus, to reduce the power of the bank until it's charter expired, Jackson began removing government deposits from the bank in September of 1833 and distributing them in a variety of state banks, which historians have referred to as "pet banks" since most of them were run and operated by members of his own political party.[11] [12]

All this activity in banking coincided with a massive expansion of the United States economy fueled by increasing demand for cotton by textile manufacturers in

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[10] Andrew Jackson: "Veto Message," December 6, 1832. Online by Gerhard Peters and John T. Woolley, *The American Presidency Project*. http://www.presidency.ucsb.edu/ws/?pid=67040.
[11] Wilson, Woodrow. *Division and reunion*. Place of publication not identified: Nabu Press, 2010. Print. (82)
[12] Baptist, Edward E. "Toxic Debt, Liar Loans, Collateralized and Securitized Human Beings, and the Panic of 1873." *Capitalism Takes Command*(n.d.): 69-92. Web.

Northern England.[13] These factories made clothes, bedding, and other cotton products that required importing raw material from the southern United States. In the 1820s and 1830s, the United States provided 80% of the raw materials for England's textile factories.[14] [15] New Orleans, which had become a massive port for exporting cotton to Europe, shipped over 225,000 bales of cotton alone in 1836, a 75% increase from the previous two years and between 1831 and 1836, the United States exported almost $71 million worth of cotton.[16] [17] This uptick in demand for cotton meant that cotton prices increased, incentivizing entrepreneurs, merchants, farmers, and bankers to move to the South and Western territories and begin growing cotton themselves. By 1830, the population of the Appalachian West was greater than the entire United States in 1790, and public land sales in Arkansas, Alabama, Mississippi, Louisiana, and Florida produced upwards of $20 million. The large amount of revenue the government was generating through these land sales allowed Jackson to pay off the federal government's debt obligations and begin generating a revenue surplus which he deposited into state banks.[18]

In the absence of the Second Bank of the United States, states began chartering banks to issue bonds on their behalf especially in the south where cotton was grown.

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[13] Lepler, Jessica M. "1837: Anatomy of a Panic." Order No. 3290956 Brandeis University, 2007. Ann Arbor: *ProQuest.* Web. 18 Apr. 2017.

[14] Lepler, Jessica M. "1837: Anatomy of a Panic." Order No. 3290956 Brandeis University, 2007. Ann Arbor: *ProQuest.* Web. 18 Apr. 2017.

[15] Baptist – ("by the 1830s, 80% of the cotton used by the British textile industry came from the southern U.S.")

[16] Lepler, Jessica M. "1837: Anatomy of a Panic." Order No. 3290956 Brandeis University, 2007. Ann Arbor: *ProQuest.* Web. 18 Apr. 2017.

[17] Lepler, Jessica M. "1837: Anatomy of a Panic." Order No. 3290956 Brandeis University, 2007. Ann Arbor: *ProQuest.* Web. 18 Apr. 2017.

[18] Wilson, Woodrow. *Division and reunion*. Place of publication not identified: Nabu Press, 2010. Print. (87)

Mississippi issued $15.5 million in bonds to authorize its own state bank, Florida similarly issued $3 million in bonds, and Arkansas, which had almost no residents, issued bonds. By the end of the 1830s, state-chartered banks in these southern states had issued over $50 million in bonds.[19] The influx of credit in these states didn't compare to Louisiana however, which had become one of the biggest trading posts in the country thanks to the increase in demand for cotton and its location connecting the Mississippi River to the Atlantic Ocean. In 1833, the Citizens' Bank of Louisiana was chartered with $12 million in bonds and only a year earlier $7 million was issued to charter the Union Bank of Louisiana. By 1836, New Orleans was the US city with the biggest density of bank capital per resident, totaling $64 million.[20]

The increase demand for cotton also invited European investors to extend credit to southern farmers which created a new breed of businessmen called "confidence brokers." These men helped coordinate international trade by providing financial information about local businesses to foreign investing companies like Baring Brothers in exchange for credit and introductions to other European financers whom also demanded their services. One of the most famous of these confidence brokers produced by New Orleans was Edmond Forstall, a merchant, tradesman, and banker who was one of Baring Brother's primary confidence brokers in the region. Through the information Forstall and confidence brokers like him provided, European investors invested their excess capital into American farmers and cotton related businesses thus expand the economic capacity of the entire country, especially in the South. The relationship between these confidence

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[19] Baptist, Edward E. "Toxic Debt, Liar Loans, Collateralized and Securitized Human Beings, and the Panic of 1873." *Capitalism Takes Command*(n.d.): 69-92. Web.
[20] Baptist, Edward E. "Toxic Debt, Liar Loans, Collateralized and Securitized Human Beings, and the Panic of 1873." *Capitalism Takes Command*(n.d.): 69-92. Web.

brokers and the investment firms whose decisions were based on the information they provided was built on trust. Groups like Baring Brothers were extending huge amounts of credit to continue the production of cotton, and getting accurate information from on the ground was essential to the success of their investments. If confidence brokers provided inaccurate information about the conditions of cotton production, banking credit, or any of the other factors used by investors in Europe to make decisions on where to lend money, the bonds of trust that held these business relationships together would break, the reputations of the confidence brokers would be tarnished, and they would miss out on the opportunity to make money.

If one were to pause and take a brief examination of the amount of new credit being created by state banks and the amount coming in from Europe, it would seem obvious that banks and investors were overinvesting in the production of cotton during this time period. In his article, *Toxic Debt, Liar Loans, and Securitized Human Beings*, historian Edward Baptist explains that farmers, investors, and merchants believed that this new developing system of cotton production and international trade also produced a safe guard to hedge against any downturns in the demand for cotton -- the commodification of human beings, or slaves. To them, slaves were not only a means to be used to cultivate and expand the production of cotton, but they were also a financial asset that could be bought and sold on the open market. What's more is that banks began to securitize these assets into new financial instruments, packaging them into securities that hedged against the risk of individual slaves dying, running away, or becoming unable to pick more cotton. For farmers, slaves were expected to produce enough money cultivating cotton to pay themselves, or else they could be generated into liquidity to pay off debts by being sold in the market. As Baptist puts it, slaves were the “ultimate hedge.”[21]

For hard money enthusiasts like Andrew Jackson however, the ultimate hedge of slavery did not provide assurance that the bonds and bills of credit coming in from England and being issued by newly created state banks would retain their value, so on July 11, 1836 he issued an executive order known as the “Specie Circular” which prohibited anything but specie from being used to purchase public land.[22] The current law only allowed for land to be purchased using specie-backed bank notes, but the President’s actions to accept only hard specie in exchange for land signaled his desire to restore the “true constitutional currency” because of his doubts that specie-backed banks had enough gold and silver in their vaults to cover the amount of credit they were issuing. At the same time, the Bank of England began cutting lending in the summer of 1836 as it began to realize the extent to which capital was flowing from its borders to the United States. With cotton prices in New Orleans peaking in 1834 and beginning to decline in 1836, private investors from both the Northern United States and Europe also began calling in their loans to American cotton farmers at the beginning of 1837.[23] State banks, especially in the South, who had issued credit to farmers suspended specie payments and began to call in their loans as well when they realized they had overextended themselves. By late March, the top ten cotton-buying firms in New Orleans collapsed because they couldn’t

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[21] Baptist, Edward E. "Toxic Debt, Liar Loans, Collateralized and Securitized Human Beings, and the Panic of 1873." *Capitalism Takes Command*(n.d.): 69-92. Web.
[22] Wilson, Woodrow. *Division and reunion*. Place of publication not identified: Nabu Press, 2010. Print.
[23] Baptist, Edward E. "Toxic Debt, Liar Loans, Collateralized and Securitized Human Beings, and the Panic of 1873." *Capitalism Takes Command*(n.d.): 69-92. Web.

meet their obligations to creditors that had called in their loans.[24] The resulting economic downturn known as the Panic of 1837 was devastating to the United States economy. Those who had specie in private hordes refused to deposit it into banks because of the uncertainty associated with the panic. This resulted in a diminished amount of credit available to lend out to businesses.[25] It also effected retail business because merchants were no longer able to make change for smaller transactions.[26] The result was that merchants issued their own paper money that represented smaller denominations of dollars.

The effects of the Panic of 1837 began to be felt around the country as Martin Van Burren, Jackson's vice president during his second term, came into office after winning the election of 1836. Those against Jackson's hard-money policy advocated for the repeal of the Specie Circular and re-establishment of a central bank to relieve the hardship of the economic downturn by expanding the availability of credit. Van Burren maintained Jackson's hard money policy however and refused to repeal the Specie Circular and in fact brought it one step further by passing legislation that required the Post Office Department to only accept specie as payment as well.[27] The disarray of the nation's currency system can best be understood by comments made by South Carolina

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[24] Baptist, Edward E. "Toxic Debt, Liar Loans, Collateralized and Securitized Human Beings, and the Panic of 1873." *Capitalism Takes Command*(n.d.): 69-92. Web.

[25] Counterfeiters – ("As mentioned previously, panic swept the country the following year, and much of the coin vanished overseas in payment of outstanding balances; plenty more ended up in private hoards or in banks, which suspended specie payments at the same time to protect their dwindling stocks of gold and silver.")(191)

[26] Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (191)

[27] Wilson, Woodrow. *Division and reunion*. Place of publication not identified: Nabu Press, 2010. Print. (93-94)

Senator John C. Calhoun's comments before abstaining from voting on a bill repealing the Specie Circular. He stated that the currency was so "incurably bad, so that it was very doubtful weather the highest skill and wisdom could restore its soundness." Instead of delaying the inevitable collapse of currency, they believed it was better to let the economy run its course and readjust itself.

Free Banking Era

The Panic of 1837 ushered the United States into what is known as the Free Banking Era. This period is characterized by free competition amongst various private and state-chartered banks in the absence of a national central bank. Because there was no national law regarding banking and no central bank to enforce it, the rules and regulations regarding chartering of banks varied from state to state throughout the country.

Like all banking systems, the free banking system relied upon and required trust amongst market participants in order for it to operate effectively. The participants needed to be trusted for financial transactions to occur, however, fundamentally shifted under this new system and became decentralized. Instead of needing to trust the central bank's monopoly on public credit and issuance of bank notes, trust shifted and was dispersed to private individuals, private banks, and private bank notes, effectively moving commerce from the political sphere to the civil sphere. This produced several other features that are uncommon in a system of centralized banking. The most obvious of these is the increased number of bank notes in circulation.

Because banks' primary functions were to hold deposits and issue bills of credit, they had to issue bank notes that corresponded to deposits held within their vaults. Most customers would deposit their money in the form of gold and silver into a bank in exchange for a bank note, which could then be exchanged in the market with the guarantee that the note could be brought back to the bank and exchanged for the equivalent amount of specie. Using paper bank notes to conduct transactions has many advantages over using specie, the most obvious being that transporting and exchanging bank notes that represent specie in a bank vault is less costly in comparison with transporting and exchanging specie itself.

It is important to note that even this most basic economic function of putting one's money into a bank requires trust on the part of the depositor. The depositor must trust that the bank will fulfil its obligation and return the corresponding amount of specie when the bill is presented at some time in the future. This also means that the depositor must trust that the bank will not issue more bank notes than what they correspond to in their vaults. If this were to happen, if the bank were to issue, say, 100 bank notes to correspond to 50 ounces of gold in its vaults, then it would be impossible for the bank to fulfill their obligations to depositors. This same consideration applied to those accepting bank notes in exchange for goods and services. If a producer didn't trust that they could exchange a bank note for the corresponding amount of specie at the issuing bank or pass it off to another producer in a later transaction, it wouldn't be accepted.

Some states continued to require individuals or corporations to receive a charter from the state legislature in order to establish a bank within their borders. These charters established the conditions under which the bank was allowed to operate under. Other states passed general banking laws, more commonly referred to as free banking laws, which enacted general rules and restrictions on individuals and institutions wanting to establish and operate a bank. These general rules allowed for any individual to come into the market and establish a bank, so long as these rules were adhered to.[28]

Because each bank and its various branches were unique with their own customers and deposits, they required unique bills engraved to differentiate their bills from those of other banks. With over three hundred banks operating in the United States in 1830, this meant that at one time up to ten thousand different types of bank notes circulated throughout the country.[29]

The lack of a uniform currency within the free banking system led to the prevalence of counterfeiting throughout the country because individuals couldn't possibly determine the authenticity of every bill that was presented to them. While counterfeiting may have forced market participants to examine the bills they accepted more closely, the forged bills provided a way of expanding credit in the market. As noted in Stephen Mihm's book A Nation of Counterfeiters, Hezekiah Niles, the publisher of the popular financial magazine *Weekly Register*, stated that, "counterfeiters and false bank notes are so common, that forgery seems to have lost its criminality in the minds of many."[30] In fact, counterfeit notes accounted for some ten to fifty percent of the total currency in circulation.[31] These bills still could be used as a means of exchange though because those who accepted them as payment believed that they could be converted into specie, or the real money that they represented, if brought to the bank that issued them. And if market

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28 Weber (2006). New Evidence on State Banking Before the Civil War. 1. 07. *Federal Reserve Bank of Minneapolis Research Department.*

29 Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (3).

30 Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (6).

31 Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (6).

participants trusted that they could bring their bank notes back to the bank where they originated, then they would never need to. In most cases counterfeit bank notes would simply go through a long list of exchanges without ever being redeemed for specie since they were thought to be authentic.

Without the guarantee that all bank notes in circulation were authentic, bank notes traded at discounts or premiums depending on the geographic distance of the bank's location in relation to where transactions were being initiated. This is another unique characteristic of the Free Banking Era. As noted in a report put out by the Federal Reserve Bank of Minneapolis, "locally, bank notes could be exchanged at par because they were redeemable on demand. But once they circulated beyond the community of the bank of issue, the notes typically were exchanged at a discount."[32] Discounts placed bank notes were based on their confidence that the paper would be redeemed for specie.[33] This meant that merchants were more likely to accept bank notes that originated from local banks since they were more familiar with the people operating the bank, the bank's financial soundness, and the distinguishing characteristics of the notes versus notes that originated from banks that were less common in that area. In other words, local bank notes could be exchanged for their stated value because individuals trusted their local banks. Bank notes issued from banks that merchants were unfamiliar with would exchange for less than their stated value to hedge against the possibility of them being counterfeit.

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[32] Rolnick, Smith, and Weber. *Lessons from the Laissez-Faire Payments System: The Suffolk Banking System*. Federal Reserve Bank of St. Louis. May/June 1998. (105).
[33] Lepler, Jessica M. "1837: Anatomy of a Panic." Order No. 3290956 Brandeis University, 2007. Ann Arbor: *ProQuest.* Web. 18 Apr. 2017.

Indeed, the sheer number of different bills in circulation and the lack of knowledge of their origins made exchanging bank notes during this period less efficient than for shop owners, merchants, and other bankers than when the economy relied on uniform notes issued by the First and Second Banks of the United States. To ease these inefficiencies and increase trust amongst users of bank notes, a monthly pamphlet was published by currency exchange broker Robert Bicknell which contained a list of all the banks that issued notes throughout the country, a description of their bills including important features to distinguish their authenticity, and if there were known counterfeit bills in circulation. Bicknell's Counterfeit Detector was an essential tool used by merchants, shopkeepers, and other businessmen during this period to decrease the likelihood of accepting counterfeit bank notes.

Besides geographical distance, the role of a bank's reputation played a large part in determining the premium or discounts its notes circulated at. As noted in a report called *New York Free Banks and the Role of Reputations*, "reputations are important in markets in which products are differentiable by quality and those differences are not easily or costlessly discernable to potential purchasers."[34] Because there was never a guarantee that a note was not counterfeit, even with Bicknell's Counterfeit Detector, the role of a bank's reputation also played a crucial role in the exchange of bank notes. Bank notes issued by banks with name recognition and reputations for being redeemable would trade more easily and at a lower discount than those of banks of lesser status in the economy. This is because banks that developed reputations of being reliable were trusted more by participants in the market.

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[34] Haoupert, Michael J. *New York Free Banks and the Role of Reputations*. The American Economist. 38. 2. 1994. (69)

To alleviate the issue of bank notes circulating at premiums and discounts to one another, some banks formed partnerships with each other to create note-clearing houses. The most notable of these formed out of the Suffolk Bank of Boston in the 1830s. The Suffolk Bank formed partnerships with other banks in New England and agreed to accept the member banks' notes at par, or at face value, by implementing a regular clearing schedule in which banks would return the notes they accepted from other member banks in exchange for their own notes or corresponding specie. Again, the notion of trust between these financial institutions was essential for the system to operate. Trust however was continuously built up and maintained by regularly clearing each banks' notes with other banks. Being a part of the Suffolk system enhanced a bank's reputation and increased the value of their notes since consumers found them more desirable to own since they could be exchanged at par.

Greenbacks

Despite the hardship caused by the Panic of 1837, the United States operated under a free banking system for nearly thirty years and under eight different presidential administrations. Considerations to return to a centralized system of banking didn't start until the Union began accumulating large amounts of debt as a result of the Civil War. Under the free banking system, the federal government was unable to issue bank notes on its own behalf, and therefore was forced to borrow money with interest so that it could pay its soldiers and buy the necessary materials to suppress the Southern rebellion. With interest rates ranging between 24 and 36 percent, the notion that the federal government should be responsible for issuing currency once again became a topic of national debate.[35] As Salmon Chase, Lincoln's Secretary of the Treasury stated, "I never have entertained a doubt that it was the duty of the general government to furnish a national currency. Its neglect of this duty has cost the people as much as this war will cost them. It must now be performed, not merely as a duty but as a matter of necessary policy."[36] According to Chase, it was essential for the government to furnish a national currency in order for the Union to continue fighting the Civil War. Without such ability, the government would have to stop fighting or go bankrupt.

Initially, the problem of financing the war was solved when the federal government issued $50 million worth of Demand Notes, commonly known as "Greenbacks", that were backed by gold and redeemable on demand. These Demand Notes were put into circulation as the Union paid its soldiers and weapon manufacturers with them. Because so many Demand Note holders decided to exchange their notes for specie, the federal government saw a significant outflow of its specie holdings. Within six months, specie redemption was suspended and the notes instead began to bear interest. A year later, Congress passed the Legal Tender Act which authorized the issuance of another $150 million. While still operating alongside privately issued bank notes, the Legal Tender Act gave value to the unbacked paper greenbacks by making them legal tender which allowed them to be used to pay for public debts and import tariffs. These notes too depreciated over time however because citizens valued the coins and bank notes backed by specie that still circulated alongside them more.

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[35] Baptist, Edward E. "Toxic Debt, Liar Loans, Collateralized and Securitized Human Beings, and the Panic of 1873." *Capitalism Takes Command*(n.d.): 69-92. Web.
[36] Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (312)

In response to the depreciating value of these newly issued Greenbacks, Congress passed the National Bank Act of 1863 which marked the end of the Free Banking Era. The bill created a system of national banks throughout the country that issued the uniform currency that was backed by war bonds and securities issued by the federal government. These war bonds and securities were not backed by any tangible entity locked away in the government's bank vaults. Rather, like the continental currency used to finance the American Revolution, they were once again backed by the credit of the United States government. This was a significant shift in the nation's monetary system and overall conception of money and the state. As Stephen Mihm explained in his book A Nation of Counterfeiters, "The illusory promise of specie-backed paper had been superseded by something that rested on a far more abstract and transcendent notion: the credit of the nation."[37] In other words, the value of the government bank notes was tied to the market's confidence that the United States government would be able to pay its bills in the future. This caused the notes' premium in relation to gold to fluctuate based on the Union's successes and failures on the battlefield. For instance, the premium on gold in relation to greenbacks jumped up to 2.5 from its original value in 1864 when it was uncertain if the Union would be able to defeat the South.[38]

Besides the provisions that authorized the chartering of new national banks and the issuance of the new paper currency, the National Bank Act of 1863 also carried with it a 10% tax on the use of other, non-greenback bank notes. This tax made the use and accumulation of privately issued banknotes more expensive and made Greenbacks a more

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[37] Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (318)
[38] Price and Exchange Rate Determination during Greenback Suspension, 190

attractive means of exchange. The constitutionality of such the tax was taken the Supreme Court in 1864 in *Veazie Bank v Fenno* in which Salmon P. Chase, the former Secretary of the Treasury who had overseen the passage of the National Bank Act and was now Chief Justice of the Supreme Court, upheld it by ruling the tax as constitutional. Chase argued “Congress may restrain…the circulation as money of any notes not issued under its own authority. Without this power, indeed, its attempts to secure a sound and uniform currency for the country must be futile.”[39]

The introduction of a uniform currency issued and circulated by the federal government still carried with it the economic incentives to produce counterfeit bills. Unlike the previous free banking system of privately issued currency, the new greenback system declared counterfeiting a federal crime and created a new federal agency, the Secret Service, whose primary responsibility was to track down and prosecute individuals who attempted to produce counterfeit greenbacks. As explained in A Nation of Counterfeiters, “…a growing number of citizens wrote the headquarters [of the Secret Service] in Washington complaining about counterfeiters, identifying suspects, and supplying leads to investigators. These missives heralded an important shift in the relationship between ordinary people and the federal government. Rather than report bogus notes to law enforcement authorities or the publishers of counterfeit detectors, they looked to Washington to solve the problem.”[40] Once again, this altered the relationship of trust within economic exchange. Instead of having to trust the person exchanging the bank note, the bank that issued the note, or the person receiving the bank notes’ ability to

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[39] Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (358-359)
[40] Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (358)

identify counterfeits, those involved in an economic exchange had to trust the federal government and the Secret Service's ability to ensure that no counterfeit notes circulated throughout the country.

The adoption of the greenback depended on the federal government's intervention in the economy to make it the most attractive medium of exchange. The reality that the new system was enacted to finance the Civil War meant that the government had to convince its citizens' that the South's secession from the Union threatened the survival of their own government and therefore the security of themselves and their property. In a series of articles published in the *New York Times,* Senator John Sherman, a pro-greenback Republican, explained that under the new monetary system "government and the people…would for the first time become inseparably united and consolidated. The people would have acquired a new and direct interest in the support of the Government, because their currency would depend for safety on the maintenance of that government." To those who opposed the new national currency, Sherman stated that they were heretics of state sovereignty and "laid the foundation of the slaveholder's rebellion."[41] This infusion of the very existence of the nation depending on the adoption and widespread use of its fiat currency is something unprecedented up until this point in the United States' history and particularly interesting considering that its citizens overwhelmingly supported Andrew Jackson less than thirty years earlier because of his promise to separate the federal government from the banking system.

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[41] Mihm, Stephen. *A Nation of Counterfeiters: Capitalists, Con Men, and the Making of the United States*. Cambridge, MA: Harvard UP, 2007. Print. (333-334)

Locke

The implementation of the Greenbacks system and passage of the National Bank Act of 1863 fundamentally shifted the relationship between citizens and the federal government back to what it had been when the Second Bank of the United States operated. Thirty years prior, Andrew Jackson was re-elected with an overwhelming amount of support because he destroyed the Second Bank of the United States and severed the tie between the federal government and banking. This reality begs many questions. Why did the public want to sever the relationship between government and banking in the first place? Why would it reverse its desire and reinitiate the relationship? And why would it do so over such a short period of time? One way of explaining these actions is to examine the writings of John Locke and what he said about the relationship between individuals in state of nature versus a civil society.

According to Locke, all men are born in a state of nature, a state of *perfect freedom*, in which they are free to order their actions and dispose of their possessions and persons as they think fit "without asking leave, or depending upon the will of any other man."[42] This state of nature is also a state of equality in which no one has more power or privilege over others in that state. He goes on to explain that individuals leave this liberty-maximizing state of nature and construct governments because this state of perfect equality leaves individuals and their property open to being stolen, destroyed, or killed by others. As he explains, "though in the state of nature he hath such a right, yet the enjoyment of it is very uncertain, and constantly exposed to the invasion of others: for all being kings as much as he, every man his equal, and the greater part no strict observers of

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[42] LOCKE, J. *Second treatise on government*. Place of publication not identified: Publisher not identified, 1956. Print. (8)

equality and justice, *the enjoyment of the property he has in this state is very unsafe, very unsecure. This makes him willing to quit a condition, which, however free, is full of fears and continual dangers: and it is not without reason, that he seeks out, and is willing to join in society with others…for the mutual preservation of their…property*" (emphasis added).[43] In other words, Locke argues that the fear that accompanies the uncertain condition provided by the state of nature leads men to give up some of their liberty to ensure the safety of their property.

After winning the American Revolution, the colonists were in a society that resembled what Locke had described in his state of nature. While each person may have had differing degrees of wealth or social status, the overall structure of society at the time was one of maximum liberty – of equal ability to order their actions as they sought fit and dispose of their persons and property as they desired – because there was no longer a monarch with the authority to force them to order their actions or dispose of their property differently. At the same time however, there was also no monarch with the authority to protect themselves and their property from the invasion of others. The inner workings of what happened between the end of the Revolution and the time that the Second Bank of the United States was chartered and why it was is a discussion to be explored in a different paper, but the establishment of a central bank to manage the country's currency can be seen as a move intended to rescind some of the liberties won during the Revolution to maintain the long-term security of the new nation.

Thirty years later however, in 1828, as Jackson was mounting his campaign for President, the power being used by the bank was going beyond its original intent of

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[43] LOCKE, J. *Second treatise on government*. Place of publication not identified: Publisher not identified, 1956. Print. (65-66)

securing the liberties of the new nation, it was seen as giving preferential treatment to the upper classes of society and altering the relationship between individuals back to what it was in a state of nature, except under this system of government privilege the equality between individuals in the state of nature is removed. This preferential treatment causes the system to break down. As Locke explains, "the power of the society, or legislative constituted by them, can *never be supposed to extend farther, than the common good;* but is obligated to secure every one's property by providing against [the defects] that made the state of nature so unsafe and uneasy."[44] By providing preferential treatment to the banking community and economic elite in general, the system of centralized banking provided a motive for Jackson and the citizens that galvanized behind him to restore this equality by returning to a sort of "economic state of nature".

Indeed, under the free banking system participants in the marketplace are in a relationship which resembles Locke's state of nature. In it, they are free to order their actions and dispose of their possessions and persons as they see fit. When examining this through the lens of the free banking system, this means that individuals are free to accept or reject whichever currency they wish at whatever price they see fit. As Locke states, "The promises and bargains involved in bartering between two men on a desert island, or between a Swiss and an Indian in the woods of America, are binding on them even though they are perfectly in a state of nature in relation to one another; for truth and promise-keeping belongs to men as men, not as members of society."[45] In this state of nature, they are also more equal since the free banking system provided a greater equality

[44] LOCKE, J. *Second treatise on government*. Place of publication not identified: Publisher not identified, 1956. Print. (68)
[45] LOCKE, J. *Second treatise on government*. Place of publication not identified: Publisher not identified, 1956. Print. (13)

of opportunity to open a bank by removing the need for being issued an exclusive charter by the state legislature. Anyone who met the guidelines laid out under the general free banking laws was able to open a bank and extend credit to whoever they wanted.

The desire for this liberty-maximizing state of nature in regards to citizens' economic affairs dissolved when the face of the South's secession from the Union however. Many Northern citizens perceived the South's secession as a threat to the stability of the nation's government, its ability to govern, and therefore its ability to protect their property. If states who disagreed with legislation and policies made by the federal government could dissolve their relationship with it then it's ability to govern disappears and would return the nation to the structure it had under the Articles of Confederation, which opens the possibility for disputes that would normally be handled in the chambers of the legislature to be handled on the battlefield, which is exactly what happened during the Civil War. To prevent such an outcome from happening, the Union was forced to abandon its monetary system in favor of a fiat currency that would allow it to spend the money necessary to pay for the war and keep the Union together. For this cause, citizens were willing to give up the liberty afforded to them under the free banking system and once again grant the government control of the nation's currency.

As demonstrated in this paper, it appears that citizens' desire for increasing amounts of liberty and security follows an ebb and flow pattern. At times, when it seems that the government has too much power or is benefiting a particular group at the expense of another, citizens respond by demanding more liberty. At the same time, when necessary, they are willing to rescind some of their liberty back to the government in exchange for protection.

While the Civil War had numerous effects on the United States in almost all areas of political, economic, and social life, the relationship between citizens and their government in regards to citizen's economic affairs was fundamentally shifted as a result of its reclamation of the responsibility to issue and manage a national, uniform currency to finance the war. These shifts in attitudes can be explained by examining where Locke writes about the state of nature and the reasons for forming civil society in his Second Treatise on Government. This responsibility of controlling the nation's currency had lasting effects on the structure of the nation since the free banking system was never restored once the war concluded. The United States remained on this fiat system of money until it was enhanced and continued with the establishment of the Federal Reserve some fifty years later in 1913.