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The Fed's Predecessors in American History

by H.A. Scott Trask

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Before there was the Federal Reserve there was the second Bank of the United States (1817–1836). Since the late nineteenth century, historians and economists have lauded this institution for its salutary control over the currency, its regulation of the state banks, its prudent stewardship of the government's funds, and its example of a fruitful private/public partnership in the field of central banking.

Writing in 1957, Bray Hammond, in his now standard *Banks and Politics in America: from the Revolution to the Civil War*, described the second Bank as a noble predecessor for the Federal Reserve. Contemporary hard-money critics saw the bank in a different light. Their critique reveals an institution that was as inflationary as the state banks, frequently abused its power, did not prevent the destructive business cycle, and inhibited the emergence of a system of noninflationary private banking. It was an institution that behaved much as the Federal Reserve System does today.

The first Bank of the United States was chartered in 1791. The Federalists argued that a national bank was necessary to bolster the credit and assist the fiscal operations of the federal government. Three fourths of its capital was composed of government bonds. The paper-money banking system was still in its infancy then, and so little was said of the need to regulate the currency. In 1811, the Jeffersonian Republicans, now in the majority, did not renew the charter. A tie vote in the Senate was broken by the vice-president, the heroic George Clinton of New York. Clinton was a former anti-Federalist and a hard-money man. America's first experiment with a nascent central bank was over. However, the Madison administration would soon be proposing a second more powerful one.

The Background to the Chartering of the Second Bank

Congress declared war on Great Britain in June of 1812 ostensibly to vindicate "free trade and sailor's rights" but actually to seize Canada. The Madison administration decided to finance the war by borrowing paper money from the banks and individuals and printing interest-bearing treasury notes. Such financiering spurred an enormous inflation of money and credit, drove specie from the country, and helped create a classic Austrian-style boom. Not so in New England whose people opposed the war, refused to lend money (or state militia) to the federal government, and maintained a vigorous trade with the enemy (they traded overland with the British in Canada and offshore since the English navy exempted them from their American blockade).



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If people in the other states wished to buy British goods, *and they did*, they had to go through New England. As a result, her banks and merchants amassed specie, while the banks east of the Hudson tottered on the brink of insolvency; her currency was convertible ("hard") while the currency of the southern and middle states was composed of depreciating bank paper. It was only a matter of time before these banks would have to suspend specie payments, and when the British invaded the Chesapeake in August, 1814, they did so. With the only check on inflation removed, the banks expanded their issues, and writers began praising the flexibility, expansibility, and wealth-creating power of an irredeemable paper currency. The popular saying was that paper money was "as good as gold," nay even better, because cheaper.

While this era was for debtors "a golden age," the federal government found itself in acute financial embarrassment. The revenue was being collected in depreciated bank paper or treasury notes, and bonds could only be sold by offering enormous premiums. In addition, the merchants were complaining of the enormous "inequalities in the exchanges," meaning that they had to deal with differing exchange rates between every city and state in the Union. For instance, New Orleans bank notes were not current in New York City, nor were the notes of the "country" banks of Pennsylvania current in Philadelphia. This complicated the business of domestic commerce. The Madison administration proposed a second national bank to remedy these difficulties. Spokesmen named two essential objects. A national bank would boost the credit of the government, and it would provide a "uniform national currency." Of course, uniformity could have been realized by returning to the silver standard and bona fide specie payments, and reducing the currency, but there were few who mentioned this option.

Although the end of the war in January 1815 curbed the agitation for a new national bank, the Madison administration soon resumed its lobbying in Congress. They repeated their earlier arguments that without a national bank the government would have great difficulty raising money during a war or national emergency and that only the government could provide a sound national "circulating medium." They added two new arguments. A government bank could pressure the state banks to resume specie payments and curtail their excessive note issues. In the same year, the administration emitted \$20 million in treasury notes and encouraged the state banks to use them as reserves upon which to pile additional bank credits and notes!

Hard-money men gagged, and then pounced with savage fury on the proposal. Congressman Ward of Massachusetts pointed out the obvious. If the government wished to compel the banks to resume paying hard money, all it had to do was to refuse to accept the notes of nonspecie paying banks for the payment of import duties, the purchase of public lands, and the buying of government bonds. John Randolph of Virginia warned prophetically that instead of remedying the evils complained of, the new bank would only aggravate them. Perhaps the most memorable objection came from Senator William Wells, a hard-money Federalist from Delaware:

"This bill came out of the hands of the administration ostensibly for the purpose of curtailing the over issue of Bank paper: and yet it came prepared to inflict on us the same evil, being itself nothing more than a simple paper making machine; and constituting, in this respect, a scheme of policy about as wise, in point of precaution, as the contrivance of one of Rabelais' heroes, who hid himself in the water for fear of the rain. The disease, it is said, is the Banking fever of the States; and this is to be cured by giving them the Banking fever of the United States."

Despite these trenchant objections by hard-money Federalists and Old Republicans, the charter for the second Bank of the United States (B.U.S.) was passed by both houses of Congress and signed into law by President Madison in April 1816. The bank was capitalized at \$35 million, to be composed of \$7 million in specie and \$28 million in government bonds. (Clearly an unstated but powerful impetus behind the bank was to deliver a financial windfall for politically connected bond holders and to raise their price

in the market.)

However, when the bank opened in early 1817, its actual paid in capital included only \$2 million in specie and \$21 million in bonds. Stockholders had paid the rest in stock notes (i.e. promissory notes secured by their stock), which was already the customary way of forming bank capital. The bank was authorized to found branch offices throughout the union and by the end of the year there were 19 of them.

"More Bank Paper of the Same Sort:" The Record of the Second Bank

As if to confirm the fears of its opponents, the federal bank entered into a collusive agreement with the private banks of the Atlantic cities. The latter would agree to resume paying specie on February 20, 1817, on the dual condition that the branch banks would not require of them the payment of balances in hard money and would issue currency and make discounts to compensate for the modest curtailments being made by the city banks. Both groups seemed to think that a nominal resumption coupled with the partial substitution of national bank notes for state ones would restore public confidence in the currency and cure the evil of depreciation. In the words of Condy Raguet, then a hard-money Pennsylvania state senator, "the directors of the new bank fancied that if they could only persuade the city banks to *call* that a sound currency which was in reality an unsound one, the evil of depreciation would be cured." In other words, they thought the state of the currency was all about psychology, not economic law.

The directors adopted an even worse policy toward the southern and western banks. They encouraged them to inflate. The branches paid out their own notes and drafts when discounting, but they accepted local bank notes as payment. Merchants used federal branch notes and drafts, which were current everywhere, to purchase eastern manufactures while state notes supplied the local currency. The consequence was that huge balances against the state banks accumulated in the branch offices of the federal bank.

However, rather than return the redundant notes for payment, the branches retained them as a fund upon which they drew interest. The federal bank did *nothing* to compel the state banks to reduce their issues or credits or pressure them to resume actual specie payments. Many observers noted that the resumption of February 1817 was only *nominal*; as proof, they pointed out that most state bank paper continued to circulate below par. Even worse, the B.U.S. added to the already excessive quantity of money its own emissions. One critic estimated that in its first year of operation, the federal bank made \$43 million in discounts on a specie base of only \$2 million.

Condy Raguet brilliantly summarized the policy of the federal bank during its first year and a half of operation (1817–18). Almost at once, "they began to add to the mass [of paper money and credits] already redundant, by emissions of their own notes; and in the course of few months added to the mass of bank loans an amount greatly beyond the reductions which had been made. By this means the currency, although nominally convertible, was depreciated below its former low state, and was thrown back, instead of being advanced on the road of restoration." Instead of helping to reduce the excessive indebtedness, the bank worsened it. "This unwise procedure of replunging the people into the debts from which they had been partially extricated, and of involving others who had hitherto escaped, was continued for a time; but the dreadful day of retribution at length arrived."

Being one of the only true specie paying banks in the country, and finding its reserves all but depleted by mid-1818, the directors realized that they had to curtail lending and contract their notes to avoid suspending payment and thus losing their federal charter. Consequently, they called in loans and required balances due them by the state banks be paid in hard money or national bank notes. This curtailment policy precipitated the panic of 1818/19. In the words of William M. Gouge, a hard-money editor and political

economist from Philadelphia, "The Bank was saved, but the people were ruined."

The 1820s: A Period of Sound Money under Federal Bank Regulation? Not.

Historians cite the relatively low-inflation decade of the 1820s as an example of the successful maturing of the regulatory policies of the federal bank. They say the state banks were restrained from inflating to excess by the regular requirement that they pay their balances to the federal branch offices in hard money. Contemporary critics had a different view. They saw an institution whose objective was *controlled* inflation (i.e. a steady and consistent, but not unduly excessive, inflation of money and credit) and whose policy was *to protect* the state banks rather than restrain them.

The most comprehensive and detailed critique of the B.U.S. during this decade was found in William M. Gouge's enormously influential *Short History of Paper Money and Banking in the United States* (1833). Gouge began by pointing out that bank inflation during the decade was significant enough to produce a regularly recurring cycle of feverish business expansions followed by painful business depressions. The years 1821, 1824, 1827, and 1830/31 were boom times. The years 1822, 1825, 1828, and 1832 were times of contraction and crisis. He argued that given the nature of fractional-reserve banking, these cycles were inevitable regardless of the existence of preventive legislation or the regulatory powers of a national bank. "The evils produced by the system of paper money and moneyed corporations are of such a nature that they cannot be remedied by acts of legislation. When they come they must be endured. If we *will* have the system, we must bear its consequences." Likewise, periodic suspensions of specie payments were "necessary incidents" of a mixed currency system of paper and precious metal.

Gouge demonstrated how the federal bank continued to act with indulgence toward the state banks, refraining from pressing them for the settlement of bank balances. By this liberality, the banks of North Carolina, South Carolina, and Georgia continued to evade paying specie throughout the decade, as did many other banks in other parts of the country.

After 1822, the B.U.S. resumed the practice of lending its own notes or credits while accepting payment in state bank paper. The federal bank thus increased its own circulation while it brought the state banks under its power. In the two years previous to the panic of 1825, the B.U.S. increased its circulating notes by 105 percent while the state banks did so by only 57 percent. Again, during 1830–1831, it increased its circulation by 64 percent while the banks of New York increased their notes by only 29 percent and those of Pennsylvania by 21 percent. Thus, during both these periods, the very bank invested with the duty of regulating and restraining the other banks was inflating at twice their rate.

What's more, the enlarged issues of the federal bank were providing the state banks with a new form of paper reserves upon which they could discount and increase their circulation. Just as the "country" banks regarded the notes of the eastern mercantile banks as equivalent to specie, so did the state banks regard the notes and drafts of the Bank of the United States. Not only could they exchange them for specie at the branch offices, they could use them to pay balances (when demanded) owed the federal bank. Thus, in the words of Gouge, "Each extension of the business of the United States' Bank in exchanges, increased its circulation of branch drafts, and each increase of branch drafts, after the new mode of operation was fairly established, enabled the State Banks to increase their issues, by providing them with means to meet such demands against them as might be made by the United States Bank." In other words, the more the federal bank inflated, the more safely could the state banks do also.

Another method by which the B.U.S. sought to protect the general system of bank inflation was by buying and selling domestic and foreign bills of exchange. Condy Raguet took aim at the exchange dealings of the federal bank in an essay in his

brilliant journal *The Free Trade Advocate and Journal of Political Economy*. He began by arguing that a free and unfettered exchange market was "the best regulator of [national] currencies" and the tendency of metallic money to flow abroad during periods of inflation was *the only effective* check upon excessive bank issues. As a result, anything that disturbed the "natural" or "market rate" of exchange was pernicious.

In the previous issue, he had printed an anonymous essay by a distinguished gentleman who claimed to have intimate knowledge of the regulatory policies of the federal bank. (He revealed later that the author was none other than the president of the B.U.S., Nicholas Biddle). The author admitted that when the price of foreign bills was rising on the market, the bank would sell some of the bills it had previously purchased in order "to keep the exchange market easy and to prevent the excessive price of bills."

Yet, as Raguet pointed out, it was precisely the rising price of foreign bills (indicating that the demand for imports was outpacing the supply of exchangeable goods) that rendered the shipment of specie the most profitable remittance to Europe and caused the importing merchant to withdraw specie from the banks. Thus, the federal bank was acting to depress the only sure mechanism (the exportation of specie) for stopping an inflation-induced business expansion and reducing the excessive issues of paper and extensions of credit. Biddle had also boasted that his bank had acted to protect the nation's specie stock by withholding, or threatening to withhold, discounts and accommodations from merchants who were known to be shipping specie.

"We cannot therefore but conclude," wrote Raguet, "that the dealing in bills of exchange by the bank, upon the principles professed, removes the great check upon over-trading and over-issues of paper, created by the free competition of the exchange market." Raguet's brilliant analysis proved that the exchange and discounting operations of the federal bank were designed not to restrain the state banks from issuing to excess but to protect them while inflating by inhibiting the exportation of specie.

An incident during 1825, cited by Gouge, revealed how Nicholas Biddle strove to prevent suspensions of specie payments by the banks. Hint: it was *not* by pressuring them to maintain high reserves or avoid making risky loans. In the summer of that year, after two years of inflation, the banks were on the verge of suspending payments and the country was experiencing a financial crisis. To avert the impending catastrophe, Biddle rushed to New York City to dissuade "a gentleman" from making a large demand on the Philadelphia banks for specie in order to establish a bank in New Orleans. Banking reserves were so low they could not withstand the demand. Biddle persuaded him to accept federal drafts on New Orleans in lieu of specie. He thus saved the state banks, as well as his own federal bank, from catastrophe.

Political Machinations of the Federal Bank

In July 1832, when President Andrew Jackson vetoed the bill to extend the charter for the Bank of the United States another 20 years, Biddle sought to contract the economy to deny him reelection in the fall. When that failed and Jackson was reelected, Biddle continued to constrict credit for another two years in order to destroy Jackson's popularity and coerce a re-charter.

President Jackson had removed the government's deposits from the federal bank in 1833, and its federal charter expired in 1836. However, the bank obtained a state charter from Pennsylvania, and it remained an immensely powerful financial institution. Moreover, the president tried to make his bank so indispensable and popular that it would be re-chartered by a future Whig Congress. If deflation had failed as a political weapon, he would try inflation. During the enormous inflation of 1835–36, Biddle's bank led the charge, and when the inevitable reaction commenced in the spring of

1837, Biddle tried to reflate the economy by speculating in cotton and borrowing heavily in Europe. When the banks of New York called a banking convention in the fall of 1837 to set an early date for the resumption of specie payments, Biddle refused to attend, and he exerted all the influence of his bank to delay resumption as long as possible. Attempts to obtain a new charter failed, but Biddle's inflationary policies soon wrecked his bank and it closed its doors for good in 1841.

Conclusion

Could the Bank have performed its regulatory role faithfully under a different president, who was a monetary conservative instead of an inflationist? Gouge denied it. "The fault is in the system," he wrote. "Give the management of it to the wisest and best men in the country, and still it will produce evil." As a fractional-reserve profit-making institution, its natural and inevitable tendency was to inflate. As a quasi-government bank, its natural tendency was to preserve for the government the option of borrowing paper money to finance their wars. All governments would rather borrow than tax. Samuel Tilden, a hard-money federal senator from New York, put it well: "How could a large bank, constituted on essentially the same principles, be expected to regulate beneficially the lesser banks? Has enlarged power been found to be less liable to abuse than limited power? Has concentrated power been found less liable to abuse than distributed power?" Let the record of the Federal Reserve since 1914 bear witness.

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