The Constitutional Law of Money

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Discussion Questions for Class 10

Free Banking – the High Tide of State Power

Readings:

Howard Bodenhorn, *State Banking in Early America* 183-208 (Oxford, UK: Oxford University Press, 2003).

Andrew Jackson and Ben Dyson, *Modernizing Money* 129-145 (London: Positive Money, 2013).

Morgan Ricks, "Regulating Money Creation." *Harvard Business Law Review* 1 (2011): 103-109.

Review: Richard Sylla, "U.S. Securities Markets and the Banking System, 1790-1840." *Review of the Federal Reserve Bank of St. Louis* May/June (1998): 96-97 [NOTE PAGES]

John C. Calhoun, "Remarks on the Bill to Authorize an Issue of Treasury Notes," Senate, May 18, 1838, in *The Papers of John C. Calhoun*, v. 14 293-303 (1981).

Background:

The demise of the Second Bank of the United States and the continued ascent of state banking power changed the character of federalism, including the relationship of the state and federal governments. The United States had no bank-issued currency of its own. It relied instead on specie (gold and silver coin), state bank notes, and occasionally "Treasury Notes." State bank notes were supposed to be convertible to specie but there were periods when that guarantee was suspended. In addition, the federal government often accepted state bank notes in payment of taxes; it did not always cash those notes but held them as revenue. Treasury Notes were federal tax anticipation notes, basically bills of credit. Congress authorized the federal government to issue them when it faced a deficit. They could be spent directly into circulation or, when interest-bearing, they could be used to borrow specie or state bank notes.

The states were the center of monetary innovation from the 1830s to the time of the Civil War – and "free banking" was the big news. New York was one of the first states to adopt free banking and its example was influential. Despite its name, free banking was not private banking. To the contrary, free banking brought bankers and state governments together to develop a model each hoped would be mutually beneficial. The states wanted revenues and reliable liquidity in the market; bankers wanted stable and profitable methods of note issue. We read about how they attempted to engineer the winning strategy together -- Bodenhorn describes New York's free banking system in our readings.

(The “free banking” label came from the fact that banks could enter the system freely rather than procure a charter through special legislation.)

The architects of free banking intended that design to stabilize banking. As commercial banks increased during the 19th century, so also did the occurrence of financial runs and panics; by one count, the United States experienced 14 financial crises in the century before World War I. Barry Eichengreen, *Exorbitant Privilege* 19. The Jackson & Dyson and Ricks readings explore why banks are particularly susceptible to such events and why financial crises are so damaging. It is worth reviewing the last few pages of Sylla’s “U.S. Securities Markets” article for related reasons. Bankers lent funds into the capital markets for profit, but they did so in ways that were very short-term. That increased their ability to call back loans (“call loans”) quickly, should they face sudden shortfalls in their funding.

After exploring free banking, our last reading returns us to the predicament of the United States. In the late 1830s, the federal government faced a revenue deficit. It could borrow state bank notes to cover its spending needs or issue Treasury Notes. John C. Calhoun – the senator from South Carolina who adamantly defended slavery and supported the southern states’ rights to nullify federal tariff legislation – contributes a surprising comment here.

Discussion Questions:

1. Where did the model for free banking – the determination to base note issues on 100% collateral, generally public bonds – come from?

2. How could free banking contribute to a local program of economic development?

    a. How would free banking affect the place of corporations in American life?

    b. How might free banking have changed the way state inhabitants conceptualized banking?

3. What makes banks particularly vulnerable to instability, according to Minsky?
    a. What creates a boom? Assuming the boom is fueled by new issues of bank-issued money, is the boom good – or just the prelude to a bust?

    b. What is so bad about a bust? That is, what kinds of damage does a banking panic create?

    c. Can you think of any way to remedy the “inherent instability” of free banking?

4. How might the call loan market function to increase the resiliency of the banks? How might it increase the dangers of a bust?

5. How do you understand Calhoun's main argument against borrowing from state banks?

6. Why might Calhoun, who had become an adamant advocate of states' rights by the 1830s, have supported the power of the national government to issue its own currency?

7. What leverage, if any, does the United States have over the state banking system?