

Federal Reserve Bank of Cleveland

# Fear and Loathing of Central Banks in America

by Michael F. Bryan and Bruce Champ

The history of money and banking in America reads like a novel, rich in political intrigue and colorful characters. Where students might expect an encyclopedic description of how each part of our financial system was carefully designed, they find a patchwork of institutions that has evolved in response to the pressing needs of our unique economic circumstances and political sensibilities.

Indeed, the story of the American financial system cannot be told without some appreciation for the great and continuing debate over the establishment of a large national bank—what we now call a *central bank*—that is in a unique position to influence a nation's money and credit. This is a story of how Americans' mistrust of power coexists, however uneasily, with the desire to promote efficiency in our payments system. In this *Commentary*, we recount the rise and fall of the Banks of the United States, our nation's early attempts at central banking and the precursors of the Federal Reserve System.

## ■ The (First) Bank of the United States

The American Revolution was a painful lesson in the importance of an effective national payments system. With only a loose coalition of state governments, the revolutionaries nearly lost their struggle against British sovereignty for want of credit. America's first Secretary of the Treasury, Alexander Hamilton—a man whose abrasiveness was as legendary as his intelligence—foresaw continued peril if the nation failed to establish a strong national bank. Such a bank could more efficiently collect and disburse government funds and aid in the issuance of government debt. Hamilton's efforts to place such powers in the hands of a central authority earned him a reputation as

a “monarchist.” Nonetheless, in 1791, at his prompting, Congress established the (First) Bank of the United States (FBUS) under a 20-year charter. The bank had initial capital of \$10 million, making it by far the largest bank of the time. Although the federal government provided one-fifth of its capital and appointed its directors, the bank was designed to be a largely private institution so that its management would have adequate incentive for maintaining its financial integrity. The FBUS thus established the “quasi-private” quality that would influence future incarnations of central banking in America.

Many, including the influential Thomas Jefferson, opposed the bank on the grounds that it was unconstitutional—the federal government was not expressly granted the authority to charter banks. But what underlay the constitutionality issue was apprehension over the enormous power this institution might possess. In the hands of the federal government, such power would almost certainly be used to the disadvantage of the states and, ultimately, of the republic. Indeed, because the FBUS acted as the federal government's fiscal agent, it continually received state banks' obligations. As their creditor, it could affect their lending power—when the FBUS redeemed notes, state banks lost reserves, reducing their lending potential.

The FBUS's bid for renewal of its 20-year charter was defeated in Congress by one vote. But it seems the bank was killed by uneasiness about its very existence, not by a belief that it had exercised its power to the nation's detriment. In fact, the FBUS was generally thought to have managed the federal government's growing fiscal resources effectively and to have provided some modest oversight to the expanding network of state banking

**The Federal Reserve System is America's uneasy compromise between our wariness of concentrated financial power and our desire to promote efficiency in our national payments system. In fact, the Federal Reserve is the nation's third attempt to establish a large national bank—what we now call a *central bank*—that is in a unique position to influence a nation's money and credit. This *Commentary* retells the story of the rise and fall of the two earlier national banks, the Banks of the United States.**

institutions that was becoming the backbone of the American financial system.

Without the FBUS, financing the War of 1812 was greatly hampered because loans had to be obtained from many small state banks. Not only was this process time consuming and cumbersome; it also produced a virtual blizzard of bank notes of widely varying quality. Relative to specie (gold and silver), state bank notes depreciated 20 percent to 25 percent in some regions. The notes' lack of uniform quality and recognition inhibited the national payments system, and merchants often accepted them only at great discount. The lack of a truly national currency made interregional transactions costly. In 1814, most state banks outside New England suspended specie payment, further hindering the war effort and the payments system.

This experience demonstrates the great dilemma of banking in America. Financial institutions, especially large banks that can influence the flow of national payments and credit, walk a fine line between our disdain for financial power

on one side and our desire to provide the nation with an efficient, secure financial infrastructure on the other.

## ■ The (Second) Bank of the United States

Initially opposed to the FBUS charter on constitutional grounds, President Madison ultimately came to support the formation of another (Second) Bank of the United States (SBUS). Madison believed that the absence of a large national bank made it difficult for the Treasury to raise the funds the federal government needed to operate. His Secretary of the Treasury went even further, suggesting that the bank could help establish a more uniform currency by reigning in state bank notes, and end national inflation by pressuring banks to exchange specie for bank notes at the request of note holders. The SBUS was established in April 1816, again with a 20-year charter. It was formed with \$35 million in capital and eventually operated 25 branches in the nation's major hubs of commerce.

The SBUS fulfilled many of its predecessor's roles, functions that are still associated with what today are called central banks.<sup>1</sup> It was a fiscal agent for the federal government, dealt in foreign exchange, issued money, and was in a position to influence the availability of credit. And again, the bank was created with both public and private qualities. Its primary function was to serve the public good by providing greater stability and efficiency to the financial system. But while it was subject to congressional oversight, it was organized largely as a private institution so that its directors would have ample incentive to manage its assets in a fiscally responsible manner. However, the SBUS may have suffered from an identity crisis. According to some of its critics, the SBUS may have occasionally lost sight of the public good in the interest of making profits for its stockholders.

The SBUS certainly could influence its own circulation, which made up around 25 percent of all notes issued by banks. But it also had indirect control over state bank note issuance. Through its role as the government's fiscal agent and its foreign exchange operations, the SBUS acquired a large quantity of state bank notes. When it desired, it could send the notes back to the issuing bank and demand specie, forcing the notes' retirement. The note redemption process led to a reduction in bank reserves and a

contraction of bank loans. In this way, the SBUS could dramatically influence state bank note issuance and loan-making capabilities, much as the Federal Reserve does today. Not surprisingly, many critics thought that this was too much power if put in the wrong hands. Indeed, the bank's early operations were widely criticized.

The bank's first president, William Jones, took a passive role in redeeming state bank notes. Not only did this policy imply that the bank had abdicated one of its public responsibilities, that of keeping state bank notes in check, it also put pressure on the balance sheet of the SBUS. Because it continued to redeem its own notes but not those of the state banks, its gold reserve evaporated. After managers of the SBUS's Baltimore branch were accused of embezzlement, Jones was allowed to resign in 1819 and was replaced by the more fiscally conservative Langdon Cheves, who quickly reversed Jones's policies. By that time, however, the economy had entered a recession.

Contemporary observers claimed that what had been a credit feast abruptly became a credit famine. Cheves's tight policies were thought to have aggravated the national recession and further exacerbated frictions between the SBUS and those who were still very much opposed to such a powerful institution. In response to the SBUS's restrictive credit policies toward state banks, state governments attempted to curtail the bank's power by taxing its operations. When the SBUS refused to pay Maryland taxes on its branch in Baltimore, a constitutional challenge to a federally chartered bank was finally brought before the Supreme Court. In a unanimous 1819 opinion, the Court ruled that the bank was a constitutionally valid instrument for discharging the duties expressly granted to the federal government.

The third president of the SBUS, Nicholas Biddle of Philadelphia, came from one of the most prominent banking families of the era. He enrolled at the University of Pennsylvania at age 10 but was denied a degree because of his youth. Princeton awarded him a degree when he was 15 and made him valedictorian of his class. Still too young for a professional pursuit, he studied law at home and eventually became secretary to General John Armstrong and later to James Monroe. Biddle was widely considered to be equally gifted, handsome, and arrogant.

President Monroe ultimately put him on the SBUS's board of directors in 1819, and Biddle was the near-unanimous choice to replace Cheves as the bank's president in 1823. Thinking far ahead of his time, Biddle claimed that an important role for the SBUS was to regulate the banking system and the overall availability of credit. During the banking crisis of 1827–28, for example, he conducted what may have been the first open market operation in government bonds, in an attempt to allow the money supply to adjust to the needs of trade. Under Biddle, the SBUS forced the redemption of state bank notes and expanded its own circulation in order to establish a more uniform currency. State banks responded with dramatic increases in their holdings of reserves relative to circulation.

State banks viewed the SBUS as an unfair competitor in the banking industry, perhaps correctly so. The bank had a virtual monopoly on holding government deposits. It also had a geographic advantage because it was not confined within the borders of any state. This geographic reach also enabled the bank to exercise a certain amount of oversight on the myriad small state banking establishments, thereby producing a more efficient, standardized monetary system.

Once again, the nation's uneasy truce with an effective but frighteningly powerful central bank came undone as the SBUS approached the end of its 20-year charter.

## ■ Andrew Jackson's Bank War

One can hardly imagine two characters outwardly more dissimilar than Andrew Jackson and Nicholas Biddle. Both geographically and ideologically, Jackson was as far from the eastern elite—including the influential Biddles of Philadelphia—as one could get. Born in the backwoods of Carolina and orphaned at 13, Jackson was largely self-educated. As a teenager, he fought and was wounded in the American Revolution; he rose to national prominence as a hero in the War of 1812. But Jackson shared at least one characteristic with Biddle: He was extraordinarily, perhaps defensively, proud. He is said to have defended his honor repeatedly on the dueling field.

Although the SBUS was not a major issue during the 1828 presidential campaign, it became one shortly after Jackson was elected. The first attacks on the bank took the form of complaints that its

branches in Lexington, Charleston, and Portsmouth had tried to prevent Jackson's election by denying his supporters access to credit. Biddle vigorously denied these charges, stating that as the bank must be free from political influence, so must it endeavor to stay out of the political process.

*We believe that the prosperity of the Bank & its usefulness to the country depend on its being entirely free from the control of the officers of the Government, a control fatal to every bank, which it ever influenced. In order to preserve that independence it must never connect itself with any administration—and never become a partisan of any set of politicians. In this respect, I believe all the officers of the institution have been exemplary* (Biddle, letter to Samuel Smith, December 29, 1828, in McGrane, p. 63).

President Jackson expressed his opposition to the bank on other grounds as well. He continued to question the bank's constitutionality, despite the Supreme Court ruling that upheld it. In a conversation with Biddle, Jackson stated,

*I do not think that the power of Congress extends to charter a Bank ought of the ten mile square. I do not dislike your Bank any more than all banks. But [I am] ...afraid of banks* (Jackson, between October 1829 and January 1830, in McGrane, p. 93).

He also publicly challenged the bank's effectiveness, saying, in his first State of the Nation address, "it must be admitted by all that [the bank] has failed in the great end of establishing a uniform and sound currency." This surprised Biddle, who asked the House Ways and Means Committee to investigate Jackson's allegations. The Committee's report "controverted the president's reasoning at every point, declared the bank was constitutional and expedient, that it had 'actually furnished a circulating medium more uniform than specie'" (Catterall, p. 198). Jackson, unconvinced, called the Committee's conclusions "feeble."

Some historians suggest that because the bank was run by an aristocratic elite, Jackson, as a champion of the common man, would certainly have viewed it as a threat to democratic ideals. In one historic exchange, Biddle tried to quiet the critics by telling a Senate committee that the SBUS obviously had never oppressed state banks as "[t]here are very few which might not have been destroyed by an

exertion of the powers of the Bank" (Schlesinger, 1946). Jackson interpreted this to mean, "The president of the bank has told us that most of the State banks exist by its forbearance!" (Veto Message to the Senate, July 10, 1832).

Changes in Jackson's cabinet early in 1831 briefly tempered his opposition to the bank, and a series of compromises between Biddle and Jackson ensued. Jackson made it clear that the bank should not apply for charter renewal until after the next presidential election, but he would not promise to approve the application. Following the advice of the National Republicans, Biddle decided to force the issue before the election, an action that almost certainly hastened the bank's destruction.

Congress approved Biddle's request for a new bank charter in 1832. Infuriated, Jackson vetoed the renewal. Although the charter was not renewed, it did not expire until 1836, and the next four years saw a bitter struggle between Biddle, who fought to save his doomed institution, and Jackson. It was a fight that historians now refer to as "the Bank War."<sup>2</sup>

After vetoing its charter's renewal, Jackson began removing government deposits from the SBUS, forcing it to contract loans; some blamed this massive loan contraction for the recession of 1834. Further, the demise of the SBUS cleared the way for rapid expansion of state banks and their note issue.

Immediately after the SBUS lost its national charter, the financial panic of May 1837 began. Banks suspended specie payment. Although payment was resumed briefly in 1838, 1839 brought renewed suspensions and more bank failures. The national deflation that ensued was to continue for nearly a decade. Although other factors greatly contributed to these developments, contemporary observers believed that a large national bank would have been able to ease these problems, if not to prevent them altogether.

## ■ America's Uneasy Compromise

From 1836 until the Federal Reserve System was established in 1913, the nation remained without an institution that served as the government depository and, at the same time, could influence the availability of money and credit so as to promote the public good. While the National Bank Act of 1863 and its

amendments eliminated the varied, inefficient circulation of state bank notes, the country's financial system continued to suffer from an inflexible allocation of credit. The system was plagued by repeated credit shortfalls and periodic financial panics (1873, 1884, and 1893). After the severe panic of 1907, calls for establishing yet another central bank intensified. By this time, the term *central bank* appears to have applied to a national bank that had monopoly power over a nation's money supply (a description that is still generally accepted today). Several European nations had already shown the usefulness of such institutions in managing their national money and credit systems, and many scholars thought such an institution would be especially useful in America, whose financial system was made up of diverse and geographically spread-out banks. It would seem that while America fears a large, powerful central bank, it finds the financial inefficiencies that exist without one even more distasteful.

But the same unease that had troubled the nation since the time of Alexander Hamilton resurfaced in the debate over the formation of the Federal Reserve. A central bank wields great financial power. In private hands, such a bank could enable banking interests to exert their influence over Main Street America. In government hands, the bank could be used for political ends. Like its predecessors, the Banks of the United States, the Federal Reserve was Congress' compromise between these two dangers. As a system of 12 independent banks supervised by a Board of Governors in Washington, D.C., the Federal Reserve is free from direct political influence, but it still is ultimately accountable to Congress. And while the system of independent banks has shareholders, all profits (except a modest dividend) are returned to the U.S. Treasury and the citizenry. Unlike its predecessors, the Fed's clear objective is to serve the public good, not to maximize the profits of its stockholders. It is a product of our unique and remarkable history.

## ■ Footnotes

1. The term *central bank* was largely unknown in the nineteenth century. One of its earliest uses appears to have been as a description of the SBUS. According to Deane and Pringle (1994), "In 1834, a French traveller in America is said to have referred to the Bank of the United States as a *banque centrale*. Forty years

on, Walter Bagehot used the term—in English—to describe a bank...that had a monopoly of the note issue throughout the country.” So while modern scholars will no doubt argue over exactly what constitutes the essential qualities that define a central bank, in one of its earliest uses, the term seems to have meant merely a large bank, centrally located amid a league of smaller banks with much more limited reach.

2. The battle over the SBUS was not merely a war of words. During his 1830 election bid, Missouri Congressman Spencer Pettis made public charges of impropriety against Nicholas Biddle. The accusations incensed Biddle’s brother Thomas, a U.S. Army Major Paymaster and director of the SBUS branch in St. Louis, and led to an unfortunate confrontation on the dueling ground. In a decision that virtually assured a disastrous outcome, the nearsighted Major Biddle chose the exceptionally short distance of five paces. Both men were mortally wounded in the exchange.

### ■ Recommended Reading

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