

This is a brief history of money and banking in the United States.
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1. What is money?

Prior to the development of money. People would barter. They would directly exchange a commodity or service for another commodity or service. This was very cumbersome and limited the prosperity of the group. For example, if I wanted a steak for dinner I would have to find a rancher or butcher who had a brick building or chimney that they needed and wanted to have repaired.

Eventually, people began to use various commodities as an intermediary to facilitate exchange. Many different items have been used.

The use of gold or silver coins has been a preferred form of money dating back to at least 650 BC. These coins have been very successfully used as money for several reasons:

They are useful and desirable by themselves (for jewelry and other purposes). Their supply is limited – but not too limited. (So as to keep a steady supply – little inflation/deflation). They are highly divisible. They can be made homogenous – so that they all look the same and can be made into exact quantities. They are durable and lasting yet still portable.

Therefore, money is simply something that we use as a medium for exchange. Money represents a commodity. It could be said to be an idea back by confidence. (You have confidence that your money item will continue to have value or be redeemable for some specific commodity .) We expect money to be backed by a commodity in case confidence fails so that we retain some value (i.e. not get ripped off).

The early American colonies used a variety to items as money. Massachusetts in 1640, for example, the legislature enacted a law making grain at different prices for different sorts legal tender for payment of all debts and taxes. Up until 1645 Virginia officially used tobacco as currency.

Since the original United States colonies were British, the official money in use was the English system of money based on the pound. (Which was originally literally a pound of

silver). The Spanish Dollar was also widely used during this period and was thus adopted by the US government as the basic currency for the new nation.

“The “dollar” began in sixteenth-century Bohemia, as a well liked and widely circulated one-ounce silver coin minted by the Count of Schlick, who lived in Joachimsthal. They became known as Joachimsthalers, or Schlichtenthalers, and human nature being what it is, they were soon popularly abbreviated as “thalers”, later to become “dollars” in Spain. When the United States was founded, we shifted from the British pound currency to the dollar, defined as approximately 1/20th of a gold ounce, or 0.8 silver ounces.” [Rothbard: The Case against the Fed.]

From the Spanish Dollar we also get pieces of eight. The coin was literally cut into as many as eight pieces. The smallest piece 1/8th was a bit. Two bits were then a quarter and so on.



One of the reasons for the Spanish Dollar’s popularity besides its weight and quality was its milled edges. These were the grooves cut into the edges which prevented criminals from shaving silver off the edges and thus debasing the coin.

Overall, there was a variety of items used for money in the colonies as well as a variety of currency from different colonies and coins from various nations.

In 1775, the Continental Congress began issuing the “Continental Dollar” as a way to pay for the revolution. A continental was to be exchangeable for one Spanish milled Dollar or the equivalent value in gold or silver.



The plan was that congress would print the bills and use them to purchase supplies and material for the war effort. The states were then supposed to levy taxes and collect the bills in payment of the taxes and thus retire them. However, not only did the states not levy those taxes, but they also began printing money of their own. The result was that a tremendous amount of money was printed with no actual value to back it up.

In 1775 they issued \$6 million worth of these continentals and put them into an economy which at that time was circulating only about \$12 million. This was a 50% increase in the money supply in just one year. By the end of 1779 (a period of just four years) they had issued the staggering amount of \$242 million worth increasing the money supply by more than 20 times. (Added to this was the fact that they were easy to counterfeit and the British also printed them up and distributed them all over the place.)

To give an example of the effects of this, the cost of common labor in Boston soared from 3 shillings a day to over 60 shillings a day in just two years. By the end of 1779 it took \$1680 in continentals to purchase one Spanish Dollar.

The massive inflation of the continental created havoc. It would be one thing if you could just refuse to accept them which many people did. However, if you didn't accept the bills as payment for a purchase or debt you ran the risk of being branded as an enemy during a time of war – not a light thing at all. States were pressured to make it

legal tender and force people to accept it. In Virginia for example, if you refused to accept it they would cancel the debt you were owed.

Naturally, the inflation led to calls for wage and price controls which were put in place in the New England states in 1776 and 1777. These price controls only exacerbated the problem by causing massive shortages of commodities and labor. In 1777 a letter from someone in Boston stated, "We are all starving here. People will not bring in provision and we cannot procure the common necessities of life." In June 1778 the Continental Congress finally put and end the price controls.

Throughout the war, the Continental Congress kept saying that the notes would eventually be redeemed at full their full face value and that it was derogatory to the congresses honor for anyone to spread rumors to the contrary. In March of 1780, Congress announced plans to redeem the notes at one-fortieth of its face value. So much for Congresses honor.

The continental became so worthless that they were used to line the boots of soldiers to keep out the cold. For decades afterwards, a worthless piece of paper money was referred to as a "shin plaster" and the phrase "not worth a Continental" was used into the 20th century.

The case of the Continental is an excellent example of a governments use of the printing press to finance a war along with its resulting inflation and covert confiscation of wealth from the people.

The lessons of the Continental dollar were so painful that when the founders wrote the Constitution they specifically forbade the printing of paper money. Congress was granted the authority to coin money and regulate its weight and quality. No authority was given to print money.

In 1792 with passage of the Coinage Act, Congress established the Dollar as the basic unit of currency for the United States back by gold or silver. For quite a few years you could (except in times of government interference) redeem any paper dollars for gold or silver.

In the late 1800s vast amounts of silver we mined in the Western US and this resulted in greater and greater discrepancies between the values of gold and silver. In 1900, Congress passed the Gold Standard Act which defined a dollar as 25 and 8/10 grains of gold. This set the dollar at \$20.67 per ounce of gold.

The gold standard was suspended during World War I. In 1933 in the Emergency Banking Act, Roosevelt confiscated the gold of the American people and made it illegal to "require payment in gold or a particular kind of coin or currency, or in an amount of money of the United States measured thereby." Therefore any provision in a public or private contract promising payment in gold was nullified and gold could not be used as a yardstick to determine how much paper money was owed.

For foreign exchange, the valuation of \$20.67 per ounce of gold was devalued to \$35 per ounce of gold in 1934.

After World War II, at a conference in Bretton Woods New Hampshire, a monetary system was started whereby the Dollar would be tied to gold at \$35 per ounce and all other currencies would be tied to the US dollar and thus indirectly to gold.

In 1963 the words "WILL PAY TO THE BEARER ON DEMAND" were removed from all newly issued currency. In 1968, the redemption of pre-1963 Federal Reserve notes for gold or silver officially ended. The Coinage act of 1965 removed all silver from quarters and dimes, which were 90% silver prior to that point.

In Sept 2004, it was estimated that if all the gold held by the U.S. government were again required to back the circulating US currency, gold would need to be valued at \$2800 per ounce.

As you can see, government action has greatly influenced money itself.

2. What is banking?

Since the beginning of time there have been those who loan out money for a fee. However, "banking" in the sense of lending of the savings of others began in England in the 1600s. Merchants had been in the habit of storing their surplus gold in the king's mint for safekeeping.

That habit proved to be unfortunate, for when Charles I needed money in 1638, shortly before the outbreak of the civil war, he confiscated the huge sum of £200,000 of gold, calling it a "loan" from the owners. Although the merchants finally got their gold back, they were understandably shaken by the experience, and began depositing their gold in the vaults of private goldsmiths instead of with the King.

The warehouse receipts of the goldsmiths soon came to be used as a substitute for the gold itself. These receipts themselves became money.

By the end of the civil war, in the 1660s, the goldsmiths fell prey to the temptation to print fake warehouse receipts not covered by gold and lend them out and thus began the modern era of fractional reserve banking.

As Rex covered earlier, fractional reserve banking is simply the action of issuing more receipts and loaning them out than there is money (or a commodity) in the bank (or warehouse) to back them up. Essentially, money was counterfeited and printed up out of thin air.

In contrast to this, suppose that you owned a grain elevator. You stored corn and wheat for farmers in your warehouse. You took in grain and gave the farmer a receipt for his crop. The farmer could sell the receipt to someone else if he wished. You wouldn't care who owned the grain and would deliver it on demand to who ever presented the receipt. The receipts could act as money as they represented an exact amount and quality of a commodity in the warehouse.

Since the amount of grain in your elevator ebbed and flowed and wasn't claimed all at once, you might be tempted to print up fake warehouse receipts and sell or lend them out. After all, there is no difference between this and regular banks right?

Well, when this was done in the 1860s in the US and ended up causing price disruptions and bankruptcies in the wheat market the practice was rightfully outlawed.

Unfortunately, during mid 1800s, while the courts ruled against the grain men, they ruled in favor of the banks. Oddly enough, the courts ruled correctly that the granaries did not own the contents of their warehouses and ruled wrongly that the banks did own the deposits in their warehouses and could do with them as they wished. The courts then allowed the banks to practice fractional-reserve warehousing while prohibiting the granaries from doing the same thing. The only difference being that the banks obviously had a better lobbying operation and political connections than the granaries.

The only thing which has kept the banks semi-honest has been the threat of a bank run. This, as seen in the movie "It's a Wonderful Life", a bank run is when the depositors all line up and demand their money back at once. The bank, not having the

money (of course) has to fold. A bank could also fail by having other banks attempt to redeem bank notes or checks for more deposits than the bank holds.

3. How did banks and money evolve to the current state?

You would think that such things as the threat of bank runs would keep banks honest and they would practice nearly 100% reserve lending. However, instead of working towards the end of sound money and honesty, banks have worked to get around the problem of the bank run by organizing into monopolistic cartels and enlisting the power of governments.

car·tel (N) an association of manufacturers or suppliers with the purpose of maintaining prices at a high level and restricting competition: *the Columbian drug cartels*. From the New Oxford American Dictionary.

a. Government power:

The banks would use the power of government to stay in business even when they were bankrupt. Throughout the late 1700s and into the 1800s there were many instances of bank runs. Bank notes were required to be backed by specie (which is gold, silver or copper coins as opposed to paper money.)

When banks could not redeem their notes for coins, the US government in many instances failed to enforce the contracts of the banks with the people. In other cases, as the value of bank notes (paper money) declined due to the actions of the banks by inflating their money, the government passed laws requiring people to accept the paper money at face value.

In early 1800s banks would establish branch banks in distant locations. They would then issue notes in these branches which could only be redeemed for specie in the main office. The banks issued a lot of notes and since transportation was difficult in those days they did not expect to have to redeem very many notes. Finally, business were started that would buy up these notes from people at a discount and take them to the main office for redemption.

These "note brokers" had a very difficult time getting the notes redeemed. Even when they filed suit in court they most often lost. Laws were passed in many states to prevent note brokers specifically from being able to redeem their notes for coin. Public relation campaigns were run against the note brokers and they were blamed for many bank failures in the early 1800s.

As an aside, one of the reasons that the note brokers ran into resistance in certain areas was that the people were divided into two groups which were both against the actions of the brokers: the bank shareholders – who often were the leading people of an area and the common people who owed the bank money and were fearful of having their loans called in.

b. Banking cartels:

Through a cartel the banks could give or lend each other money to stave off a bank run. Member banks would also clear each other's checks and loan each other money in such a way to prevent one bank from causing another member bank from failing. This is one of the major functions of a central bank.

There have been three central banks in the United States.

The first Bank of the United States: This bank was started in 1791 by Alexander Hamilton as the first Secretary of the Treasury under George Washington. The bank was given a charter by congress for twenty years.

With the creation of the Bank of the United States also came an expansion of commercial banks. In the five years following the establishment of the bank, inflation caused by the banks' creation of millions of dollars caused prices to raise 78% by 1796.

The bank was bitterly opposed by several founding fathers, including Thomas Jefferson who saw it as an engine for speculation, financial manipulation and corruption. Its charter was not renewed by congress in 1811.

The Second Bank of the United States was chartered by congress in 1816. From its inception it created massive inflation. By 1818 it had printed over 19 million dollars worth of notes with only 2 million in specie to back it up. The bank also spurred an expansion of commercial banks and resulted in an expansion of the money supply by over 40% in just two years.

This tremendous expansion of money created a boom of unequaled proportions. However, by 1818 the bank realized that with the enormous inflation of money and credit, aggravated by massive fraud, it was in real danger of going under and of being illegally unable to sustain specie payments. So, over the next year the bank dramatically contracted the money supply and credit and purchased millions of dollars

of specie from abroad. The bank contracted its contribution to the money supply by nearly 50% in one year. This resulted overall all in the total money supply being deflated by nearly 30% by the end of 1818.

The massive inflation and then sudden deflation brought about the nation's first major boom-bust cycle. This resulted in a massive rash of defaults and bankruptcies of businesses and manufacturers. Prices rose with the inflation and crashed with the deflation. The great fall in prices aggravated the burden of debt and resulted in even more bankruptcies. One historian noted that by the dramatic contraction of credit, "The bank was saved, and the people were ruined."

Out of the bitter experiences of the panic of 1819 emerged the beginnings of the Jacksonian movement, dedicated to hard money, the eradication of fractional reserve banking in general and the Bank of the United States in particular.

As the 7th president of the US, Andrew Jackson fought what came to be seen as a war against the bank and vetoed congresses re-charter of the bank. Amongst other reasons, Jackson stated that the bank exposed the government to control by foreign interests, exercised too much control over members of Congress and mainly served to make the rich richer.

To the leaders of the bank Jackson did not mince words when he stated:

"Gentlemen, I have had men watching you for a long time, and I am convinced that you have used the funds of the bank to speculate in the breadstuffs of the country. When you won, you divided the profits amongst you, and when you lost, you charged it to the bank. You tell me that if I take the deposits from the bank and annul its charter, I shall ruin ten thousand families. That may be true, gentlemen, but that is your sin! Should I let you go on, you will ruin fifty thousand families, and that would be my sin! You are a den of vipers and thieves. I intend to rout you out and by the eternal God, I will rout you out!"

In his statement explaining his veto of the bank re-charter, Jackson said:

"It is to be regretted that the rich and powerful too often bend the acts of government to their selfish purposes. Distinctions in society will always exist under every just government. Equality of talents, of education, or of wealth can not be produced by human institutions. In the full enjoyment of the gifts of Heaven and the fruits of superior industry, economy, and virtue, every man is equally entitled to

protection by law; but when the laws undertake to add to these natural and just advantages artificial distinctions, to grant titles, gratuities, and exclusive privileges, to make the rich richer and the potent more powerful, the humble members of society-the farmers, mechanics, and laborers-who have neither the time nor the means of securing like favors to themselves, have a right to complain of the injustice of their Government. There are no necessary evils in government. Its evils exist only in its abuses. If it would confine itself to equal protection, and, as Heaven does its rains, shower its favors alike on the high and the low, the rich and the poor, it would be an unqualified blessing. In the act before me there seems to be a wide and unnecessary departure from these just principles. "

To give you some idea of the power of the bank: In 1833 Jackson decided to pull the governments funds out of the bank. He knew that his secretary of treasury was favorable to the bank so he appointed him to be Secretary of State. His replacement, William Duane, deliberately delayed. After waiting four months, Jackson replaced him. The third man, Roger B. Taney, complied. The Second Bank had lost its largest depositor. Congress then censored the president for this act.

To fight back, Nicholas Biddle, the president of the Bank decided to shrink the money supply and cause a recession in 1834 by calling in loans and not issuing loans in an effort to force Jackson to accept a re-charter bill. However, the re-charter bill died in Congress and its charter expired in 1836. The bank finally failed in 1841.

While Jackson did manage to kill the Second Bank of the United States, he was unfortunately not able to end fractional reserve banking and the economy continued to have booms and busts.

The United States did not have another central bank until the founding of the Federal Reserve Bank in 1914. Which Charlie will tell you about. After the panic (i.e. bank runs) of 1907, the major bankers wanted another central bank and began to promote the idea and lobby for it. Interestingly enough, in 1907 Jacob Schiff, the head of a major New York bank said, "unless we have a central bank with adequate control of credit resources, this country is going to undergo the most severe and far reaching money panic in its history."

The new central bank which was supposed to create financial stability, provide emergency credit in times of crisis and give us an "elastic" money supply was slipped

through congress in December 1913 while most members were away for Christmas and immediately signed into law by Woodrow Wilson.

Since then, as you know, we have continued to have major economic booms and busts including the biggest depression ever in the 1930s. Also since 1913 due to the inflation of the Federal Reserve, the dollar has lost 95% or more of its value.

4. Conclusion:

In looking over the history of money and banking in the United States it becomes clear to me that fractional-reserve banking, central banks and legal tender laws have created massive wealth and power for a small minority and have been the cause of unnecessary upset, war and trouble for the vast majority of people.

Thomas Jefferson is quoted as saying:

“If the American people ever allow the banks to control the issuance of their currency, first by inflation, and then by deflation, the banks and corporations that will grow up around them will deprive the people of all property, until their children wake up homeless on the continent their fathers conquered. The issuing power of money should be taken from the banks and restored to Congress and the people to whom it belongs. I sincerely believe the banking institutions having the issuing power of money are more dangerous to liberty than standing armies.”

Finally, the question comes up: What is the proper supply of money?

Well, think about this: What if the gods that be suddenly overnight decided to answer everyone’s prayers and give everyone twice as much money as they now have. That would be great right? Well, unfortunately you would find that prices would double just like that and you would not have any more purchasing power than you did have – even though you had doubled your money.

In real life, things would be a bit different, some people would rush right out and buy stuff with their new money and they would gain from current prices. As more people went out to buy stuff – creating more and more demand the prices would go up. Those

people who saved their money would be hurt the most as they would get no advantage at all.

So, based on this I see that a steady money supply would reward savings. Prices might fall to attract more business thus rewarding saving even more. As more money was saved, more could be profitably invested to create more wealth.

The current system of inflation rewards consumption and penalizes savings. Thus getting us into the insanity of the current "credit crisis."

It is my believe that:

1. The US Government should issue its own money as dictated by the constitution.
2. Money should be backed by some commodity such as gold or silver so as to keep the money supply fairly steady and prevent inflation and deflation.
3. There should exist competing currencies. There should be no monopoly of the money object itself.
3. Banks should not be allowed to practice fractional-reserve lending.
4. If the above were implemented there would be no need for any central bank.

A good start to accomplish this is to support the following 3 bills introduced by Ron Paul:

H.R. 2755 Repeal of the Federal Reserve Act

H.R. 2756 Honest Money Act

H.R. 4683 Free Competition in Currency Act

You can view text of each of these bills a www.govtrack.us – just type the bill number in the search field.