INFLATION: The Era of the State Banks
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# INFLATION:

## The Era of the State Banks

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I

THE economic development of the United States in the first half of the Nineteenth Century was marked by trial and error. Despite the uncertainties of states rights and the absence of constructive national economic policies, economic advances were made which at least equaled if not excelled those made in any other half century in our history.

The war of 1812 proved the strength and unity of the new nation. With the ending of this war the United States entered upon a new epoch. The previous years had been plagued not only by our own revolutionary war but by European wars of varying degrees of intensity and involvement. These struggles tended to shape the course of events everywhere. The return of peace in 1815, which endured almost without interruption for nearly five decades, allowed the country to devote its attention and energies to its own affairs and its economic development. European political events ceased to have the influence of earlier years on the affairs of the new nation. Independence had been attained. The nation, far removed from the disturbances which beset most European states, adopted a policy of isolation. It turned its back on the Old World, faced the West, and became absorbed in opening up and developing the vast resources of its public domain.

The problems connected with the opening up of the West—the vast area lying west of a relatively narrow strip along the Atlantic seaboard—became the dominant issues in the economic, political and social life of the pre-Civil War period. The desire to develop and exploit the resources led to the acquisition of territory and expanded the national borders to the far Pacific. The boundless opportunities offered in the new nation attracted both European immigrants and capital in steadily growing volume. Improvement in the means of transportation and communication helped to speed the development of the national resources and to break up the local or regional economy; both occupational and territorial divisions of labor were extended; domestic and foreign commerce were expanded; the forms of business organization were changed to facilitate large scale endeavors. It appeared that the only limits to the potential economic expansion was the ability of the promoters.

Finally, the national government was stronger and more certain than ever before. It was becoming a more important factor in the economic progress of

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the nation. It extended aid to private enterprise and itself engaged in economic activities; it served, to a limited extent, both as a regulatory and a controlling power in directing economic endeavors along lines both socially and nationally desirable. The combination of economic progress and stable government brought about the long-sought goal of political and economic independence.

II

It would be too much to expect that great progress in this period could be made without major economic disturbances. The entrepreneur was tempted by both quick and large profits; the government, frequently lacking experience in dealing with new issues and more often lacking adequate laws, was at times obliged to resort to makeshift and questionable measures. It is probable that the combination of circumstances attendant to the new government and the new republic in its attempt to attain the stature of a nation, is without parallel. Issues, practices, policies and objectives were, according to Old World standards, revolutionary, not evolutionary. Errors and indecision were normal expectancy.

The fiscal policies of the years prior to the war of 1812 were largely those of Alexander Hamilton and Albert Gallatin. Both revenues and expenditures were relatively small. By 1800 the budget was balanced. In the next year the Democrats came into power for an uninterrupted period of 40 years, and with them came different policies not only on public debt and taxation but also on tariff, fiscal and banking policies. The first United States Bank had been granted a federal charter in 1791, for 20 years, and the states continued to grant bank charters to local groups. The Bank was an invaluable aid to the Treasury. However, the charter was not renewed in 1811 and the nation was without a central bank until 1816. Taxation, the sale of public lands, and limited custom duties provided the bulk of the revenue for many years.

The war of 1812 strained the financial mechanism almost to the breaking point. There was no United States Bank to aid the Treasury. New England refused to supply her quota of men and money; loans rather than taxation provided most of the money for financing the war. The Treasury negotiated loans at six and eight per cent; interest bearing Treasury notes and legal-tender notes similar to the Civil War Greenbacks were also issued. Taxes were raised and excise taxes were added. Despite emergency taxes (which were repealed by 1818) the public debt by 1816 was about $82 million larger than at the outbreak of the war when it stood at $45 million.

The end of the war saw the beginning of the first significant depression in this country. From 1815 to 1821 the level of business activity was depressed, reaching panic proportions in 1819. The causes were immediately traceable to the currency inflation which followed the expiration of the charter of the First Bank of the United States and the resultant over-issue of paper by the state banks, which had greatly increased in number, except in the New England area. The second cause was due to a flood of imports and a great decline of exports. Money was tight; bank notes were discounted; specie payment was suspended by banks outside New England; security prices were at low levels. To make matters worse, there was depression in agriculture. This severe depression and financial panic brought many bank failures, a collapse in land values, much unemployment and forced sales. Commodity prices fell from 154 to 73, more than 50 per cent, and general distress was widespread. The chaos immediately following the war led to agitation for, and finally the chartering of, the second United States Bank, in 1816. Even though well-conceived, it was badly managed and for three years it contributed to the currency inflation.

The situation was an anomalous one: how could there be a depression in a period of currency inflation? It was due mainly to the fact that American manufacturing industries had been protected from foreign competition from the time of the Embargo Act in 1807 until the end of the war of 1812 in January, 1815. After 1815, domestic manufacturers were in competition with foreign goods. Although the tariff protected some goods—notably textiles after 1816 and iron after 1818—the price of domestically produced goods was above that of imported goods from 1815 to the end of the depression early in 1822 when things leveled off. The currency inflation affected principally the value of securities and real estate and made speculation in them possible. Bank failures were bound to follow, which added to the economic distress.

## III

The years between the post-war depression and the most severe of all the pre-Civil War disturbances—the Panic of 1837—were generally prosperous. The mild recessions that plagued the even secular growth were due mainly to crop failures or miscellaneous causes of less than national proportions. There were two counter forces at work during this period. First, the deflationary forces concurrent with reducing the public debt, and second, the inflationary pressures of almost unrestricted currency issue by state banks. The terrific sale of western lands brought unprecedented revenue to the Treasury in such amounts that the last cent of public debt was paid off in January, 1835; thus for the first and last time in our history the Treasury had a surplus and no debt to which to apply it.

History records the issues in the Jackson campaign over extending the charter of the second bank in 1836. State banks, which had grown in number to 506 by 1834, were busily engaged in issuing notes and opposing the central bank. By 1840, the peak number of 901 banks and $358 million in capital was reached and yet the peak in loans and in circulation had come in the panic year of 1837.

The affairs of the second United States Bank were really settled before the expiration of the charter in 1836, and the funds were distributed to the so-called "pet" banks by President Jackson. Very soon the prosperity of 1836 changed to a depression familiarly known as the Panic of 1837. Its cause is traceable to a number of factors, not the least of which was the failure of the governmental financial policy. A brief glimpse at the leading economic events leading up to the panic is in order. The railroads and canals were opening up new land areas. States were increasing in population and being admitted to statehood in the Union. The age of internal improvements and the possibilities of the future seemed unlimited. The ultra generous credit system of the government toward land purchases stimulated the feeling that the success of the future would make up for imperfections of the present. The market value of land rose much above the government selling price, and there was an eager desire to borrow money to buy land either for a quick resale or to hold for future appreciation and profit. The local banks made loans willingly on land as security; the purchase money in most instances was re-deposited by the government in the banks from which it originally came, where it again served as a loan to another or even to the same land speculator. Thus the loans were pyramided, and increased in amount from $137 million to $525 million in eight years (1829-1937) while the amount of money in circulation was more than tripling from $48 million to $149 million.

Another source of speculative funds came from abroad. Between 1830 and 1837 the imports of merchandise exceeded the exports by about $150 million and instead of the foreigners demanding specie in payment, they left substantially the entire amount for investment in the United States. Speculation was the common practice not only in Western lands but also in the lands of the South and Southwest. Real estate and commodities were speculated in everywhere. The inflationary and speculative pressures were retarded by failures of banks in

England which were reflected on the London Stock Exchange and on credit extended to those doing business with the United States. In addition, the distress was made worse by crop failures in 1835 and in 1837 which extended through 1838. Income and purchasing power of farmers and merchants alike were affected and everyone's credit was shaken. The tendency was to place the blame or the distress on the government policy which required specie (Specie Circular Act of 1836) to be used in payment for purchase of public lands. This was only one of the causes. The larger cause was the excessive issue of currency by the numerous issuing agencies.

Deflationary steps were taken such as contraction of currency from $217 million in 1837 to $147 million in 1843. Prices fell. Still worse was the fact that some sections were nearly deprived of circulating medium. The Treasury had to meet increased expenditures and since the public debt was nil the temptation was for Congress to engage in even heavier outlays. Heavy expenditures brought about annual deficits every year except 1839, from 1837 to 1843. The absence of adequate governmental controls over the money and credit elements in the economy was just as responsible for bringing on the troubles as was the absence of controls in helping to bring the nation out of the depression.

## IV

The slight revival in the few years after 1837 came largely from better crops and improvements in commodity prices. Yet this was not enough to put the nation in the prosperity column. The forces of deflation and depression were strong; recuperative powers were weak. At no time after the panic of 1837 were the high levels of 1836 reached until the year 1844. Bank failures were heaviest between 1837 and 1844 and lowest in 1844 and 1855. The number of banks, however, continued to increase from 696 in 1844 to 1600 in 1861. The forces of revivial after 1837 were never strong enough to keep up a sustained betterment of economic conditions for nearly a decade.

Throughout the 1840's recovery in one area or industry had counteracting forces in another; the benefits of a good wheat crop might be offset by a bad cotton crop. The foreign trade balance, year by year, was unpredictable, Pressure on the money market was eased occasionally by large specie imports, notably in 1847. Speculation continued but at an irregular pace. The war with Mexico (1846-1848) added to the economic disorder. The Panic of 1842, which was the second financial crisis experienced by the new nation, brought greater suffering to the South and West than did the Panic of 1837. These areas were slow in recovering. The states, counties and individuals alike were in debt. They had speculated heavily in the "unearned increment" of public lands; they had sponsored and financially aided the building of railroads, canals and public buildings; commitments had been made far beyond the capacity of the overtaxed citizens to pay. The burdens finally became so heavy that interest default and debt repudiation were practiced by several of the most hard-pressed states. The incautious money experiments at both state and national levels had produced certain beneficial physical results but in their wake a vast amount of turmoil and economic losses.

Early in January, 1848, gold was discovered in California. Then ensued several years of prosperity. Even though little gold flowed from California in 1848 the magic promises of gold started an upswing in business unmatched in the first 50 years of the Nineteenth Century. Active expansion in industry and in railroad building; generally good crops and rising commodity prices; rising wages; low unemployment; larger export trade prevailed until rudely stopped, albeit temporarily, in 1854 when a recession of considerable proportions slowed the feverish pace of the previous five years. Unrestrained speculation took a heavy toll; many banks failed; railroad frauds precipitated a stock exchange panic; money became tight; confidence in the securities of both new and old enterprises reached new lows. Again crops failed. A full year (1855) was required to regain lost confidence. By 1856, prosperity was restored; construction of railroads continued and the foreign trade balance was again favorable. This prosperity was to be short-lived; within a year's time the forces of depression were unleashed with devastating results.

The Panic of 1857 was a fruition of the confused monetary policies and practices of many years standing. Complete objectivity in monetary issues was beclouded by political prejudices and by indecision over rights of states and duties of the federal government. But the confused money situation did not seriously interfere with the general hopefulness of the future. Business expansion continued along its way even to the point of over-expansion and subsequent over-production. Farmers, noting the rising trend of prices, overplanted. Railroads pushed into barren areas largely on the promise of future profits; bankers invested and loaned eagerly. It was clear by the fall of 1856 that optimism was leading people to financial disaster.

Commodity prices, which had risen sharply from late in 1856 to the middle of 1857, fell almost as sharply and did not regain the levels of 1856 until the second year of the Civil War. The slump in certain European marts reflected in the New York markets and by August the foundations of the earlier prosperity gave way. A financial storm engulfed the banks in the larger cities. Clearing-house certificates (a last resort in financial crisis) were issued and gold from California tended to mitigate the acute period of the crisis. But great damage had been done and recovery was exceedingly slow. Most eastern banks closed in October, 1857. The depression lasted only a little more than a year yet it took a toll of over 5,000 failures with liabilities over $300 million. Revival was just getting under way when it was rudely interrupted by the opening cannonades at Fort Sumter, early in 1861.

A glimpse at only two elements—gold and currency—of the financial picture in the decade before the Civil War reveals the strongest of the inflationary forces. The amount of money in circulation had increased by $156 million and the amount of gold coined reached the staggering sum of over $376 million; of this amount $246 million was added to the money in circulation in the first six years after gold production really got under way, 1850-1855 inclusive. Gold exports were not significant mainly because other fields were feeding sums to Europe. The relatively high levels of industrial production were deflationary and tended to keep the wholesale price index within a narrow range of fluctua-

| Year | Production of gold [1] | Gold coinage [1] | Gold exports [1] | Money in circulation [2] | Wholesale price [3] index. All commodities |
|---|---|---|---|---|---|
| 1850 | 50.0 | 31.9 | 2.5 | 278.7 | 62.3 |
| 1851 | 55.0 | 62.6 | 4.8 | 330.2 | 64.5 |
| 1852 | 60.0 | 56.8 | 2.6 | 361.0 | 62.5 |
| 1853 | 65.0 | 39.3 | 1.9 | 402.2 | 66.4 |
| 1854 | 60.0 | 25.9 | 2.5 | 425.5 | 68.8 |
| 1855 | 55.0 | 29.4 | 1.2 | 418.0 | 68.9 |
| 1856 | 55.0 | 36.8 | 0.9 | 425.8 | 68.9 |
| 1857 | 55.0 | 32.2 | 5.2 | 457.0 | 68.5 |
| 1858 | 50.0 | 22.9 | 7.6 | 408.8 | 62.0 |
| 1859 | 50.0 | 14.7 | 3.6 | 438.9 | 61.0 |
| 1860 | 46.0 | 23.4 | 1.5 | 435.4 | 60.9 |

(All sums in millions of dollars)

[1] A. B. Hepburn, *A History of the Currency in the United States*, N.Y., Macmillan and Co., 1915, p. 70.
[2] Bureau of Labor Statistics, *Historical Statistics of the United States*, U. S. Department of Commerce, 1949, p. 274.
[3] *Ibid* p. 234.

tion despite the money inflation. All things considered, the extraordinary characteristic of the decade is its relative stability, despite the great disturbance of 1857. The worst was delayed to the following decade when war's dislocations changed the whole statistical picture.

The financial troubles that plagued the nation for the three decades from 1830 to 1860 brought, in time, many permanent improvements. They were, nevertheless, dearly bought in terms of lost savings, business failures and shattered hopes. The ventures of government into the banking field in the first and second United States Banks probably scored more gains than losses, but by no means could the banks be regarded as unqualified successes. The specie circular of the Jackson administration contained loopholes. The aim of curbing land speculation was attained only in a limited degree; the deflationary results did greater harm than the credit control feature did good. Only the Independent Treasury Act of 1846 proved to be of substantial and lasting value and underwent no fundamental changes until merged with the Federal Reserve System in 1913.

State banks did the banking business after 1836. The curse of banking in this period was the lack of uniformity and the laxity of enforcement of the state banking laws. In the East, notably in New York and Massachusetts, banking was vastly better than in the West where it was notoriously bad. In an era when speculative mania was at its height, the remarkable thing is that inflation and business disorders were not greater. After the Panic of 1857 there was an awareness that something must be done to make sure that money, "the great wheel of circulation," as Adam Smith called it, was controlled at the source of issue, and that the banking structure was tied together and strengthened. Inflation, while pronounced in certain years of this half century, was by no means as detrimental to the forces of economic development as the promiscuity of the circulating medium and the instability of the financial institutions. The half-century points up in sharp relief the need for uniformity in the policies and operation of financial institutions which deal in money matters, and for diligent control of both money and banking institutions. When measures to control the institutions of money and banking were finally taken they were the result of an extreme national emergency. Considering the circumstances of trial and error in which our financial institutions evolved, they functioned reasonably well. National achievement appears to be directly related to the success of the institutions which serve the people.

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> . . . 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 rain, 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. . . .Many of our rich men have not been content with equal protection and equal benefits, but have besought us to make them richer by act of Con gress. By attempting to gratify their desires, we have in the results of our legislation arrayed section against section, interest against interest, and man against man, in a fearful commotion which threatens to shake the foundations of our Union. . . .
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> —*Jackson's Veto of the Bank of the United States Bill, 1832*