When Banking Was 'Free'

From 1837 until the Civil War, currency issuance and banking were left to the states. Can this era offer lessons for today's cryptocurrency boom?

BY HELEN FESSENDEN

Few assets were hotter in 2017 than cryptocurrencies, including bitcoin. The surge was dramatic enough that New York Fed then-President William Dudley disclosed in November that the Fed was "starting to think about" offering a digital currency — although he quickly downplayed the chance of this materializing soon.

What's behind this boom? A central feature of cryptocurrencies is that they rely on "blockchain" technology, which, advocates claim, enables them to take on the functions of money and ultimately compete with conventional currency. Thanks to blockchain's open-source nature, anyone can design his or her own version of cryptocurrency and cater to market demand through "initial coin offerings" (IPOs for cryptocurrencies); today, there are more than 1,600 cryptocurrencies available. Based on a decentralized global network of computers, blockchain enables speedy, transparent, and cheap financial transactions that anyone, anywhere, can access with an Internet connection, without going through banks. It also allows its users complete anonymity — which means it's become a favored conduit for illegal transactions. The black market stigma is one reason why this market has cooled a bit in 2018; Bitcoin's trading price is now around $9,000, after spiking to $20,000 last year, amid rising regulatory pressure in Asia and elsewhere. Other concerns have emerged as well, including vulnerability to hackers and heightened scrutiny of coin offerings in regards to violation of investor-protection laws.

But many skeptics cite volatility as a chief hurdle preventing cryptocurrencies from fulfilling the functions of money — specifically, as a store of value, unit of account, and medium of exchange. What does this mean in practical terms? Investors can make or lose money on cryptocurrencies as a speculative asset, but this also means they serve poorly as a common and stable measure of the value of goods and services. Money's function as legal tender — to be liquid enough to be accepted widely — is also difficult. Cryptocurrency issuance is finite in that it's determined by how many computers and programmers are mining it rather than the macroeconomic goals of a central bank's monetary policy, and payments are accepted by only a fraction of vendors.

The idea of an "unregulated" currency, however, isn't new. Before the Civil War, the United States ran a vast natural experiment by leaving "free banking" to the states, even while other major economies were adopting central banking. From the demise of the Second Bank of the United States in 1836 until the passage of National Banking Acts of 1863 and 1864, the United States lacked a federal authority to issue and redeem banknotes, act as a fiscal agent for the federal government, or keep banknote issuance in check. Instead, banking was run by the states, and "free banks" could issue their own banknotes. But just how much did this amount to the kind of free-entry, highly decentralized currency competition that some cryptocurrency backers advocate today?

Back to the Future

Under the traditional narrative of this era, free banking had a poor reputation. The absence of national regulation was seen as one reason for the extreme booms and busts of the pre-Civil War years, as well as the high frequency of bank failures. Free banking is also often conflated with the term "wildcat" banking, which refers to short-lived (and sometimes fraudulent) banks in more remote regions where banknotes couldn't easily be redeemed. More recent scholarship, however, has suggested that true wildcat banking was in fact quite rare and that there were often multiple drivers behind banking and economic turmoil. Moreover, free banking wasn't one uniform model; rather, it was established in only 18 out of 32 states, with considerable variation. In general, free banking was less developed in the South, and in some cases, states formally adopted free banking but saw very few such banks established.

Notably, free banking didn't mean a complete absence of regulation. Instead, regulation was conducted at the state level, which was often idiosyncratic to each state's jurisdiction. And the design of regulation — which included requirements that banknotes be backed by particular assets — was one factor that helped determine a currency's stability. But perhaps an even more important and interrelated factor was liquidity. In states where participating banks ensured deep market liquidity in banknotes, such as New York, currency values were far steadier than elsewhere. It was in these cases where the banknotes came closest to fulfilling the basic functions of money, through their stable value and wide acceptance.

How did free banking work? "Free" meant "free entry": Anyone who could put up the required amount of capital could start a bank, which, once established, could issue its own notes. (This stood in contrast to state-chartered banks, which needed the approval of a state's legislature to be established.) The bank had to deposit with a state

authority a set amount of approved bonds that backed those banknotes. The bank would then earn interest on those bonds as long as their value matched the nominal value of the notes; in most cases, the bank also had to hold fractional reserves in gold and silver to honor note redemption. If the value of the deposited bonds fell below the notes' value, a bank had two options: either add more bonds to the deposit to make up the difference, or take the equivalent amount of notes out of circulation. If it didn't do that by a set time, it had to close and sell off the bonds to repay its note holders.

A $100 bank note issued around 1854 by the Quassaick Bank of Newburgh, N.Y., a free-banking state.

IMAGE: GIFT OF RICHARD S. SCHLEIN, NUMISMATICS COLLECTION, NMAH, SMITHSONIAN INSTITUTION

A major challenge was interstate redemption. If people held out-of-state notes and wanted to avoid interstate travel, they typically would sell those notes to a local "note broker" at a discount if they wanted to cash in those notes for gold or silver coin, or "specie." The discount rates reflected the broker's cost of redemption, consisting of the default risk of the issuing bank (related to its financial strength and the bonds that backed up the notes in their home state), as well as other factors like travel costs and local competition. As such, these rates varied widely. Some of this risk was made public through "banknote reporters," publications that provided data on banks' health as well as discount rates across states. Still, people who traveled across state lines often found that specie was easier to deal with; the Rutgers University economist Hugh Rockoff found, for example, that the amount of gold and silver in circulation rose considerably before the Civil War.

Success Stories

As one the first states to establish free banking, New York was the model that other states often followed. In 1837-1838, New York state-chartered banks began to acquire the stigma of political favoritism by the government, akin to President Andrew Jackson's "pet banks." To create an alternative, the state passed a free-banking law in 1838 that required participating banks to use state government bonds or relatively secure mortgages as collateral (they weren't required to redeem notes for specie until later). After some initial turbulence, this new sector stabilized, and by the end of that decade most New York banks had converted to free banking.

Research by economists such as Clemson University's Gerald Dwyer Jr., formerly of the Atlanta Fed, and the University of Minnesota's Arthur Rolnick, formerly of the Minneapolis Fed, has pointed to these changes as an important reason why New York free banks tended to survive longer than banks in other states, around eight years on average. And when they did fail, the losses borne by noteholders were often smaller than elsewhere, in some cases as little as 3 percent, thanks to the banks' relatively secure asset holdings. When taken out of state, New York banknotes also held their value, usually around 99 percent — far higher than other states — reflecting in part the stability of state bond prices and New York City's strengthening financial clout. By the Civil War, the success of New York free banking was one reason why New York City pulled ahead of Philadelphia in attracting bank business.

New England is another notable test case, even though free banking wasn't as widespread. Rather, it was home to an innovation known as the Suffolk Bank System (SBS), which presaged in some ways the structure of the Federal Reserve System. Established in the 1820s, the SBS was a private clearing consortium for banks that was managed by the Suffolk Bank of Boston. To join the consortium, member banks had to fulfill a collateral requirement with the Suffolk Bank by keeping a deposit amounting to 2 percent of their capital. In turn, every day, Suffolk accepted and net cleared at par all banknotes deposited by member banks. (Under net clearing, all debits and credits are tallied at once, which makes it easier for a bank to manage liquidity.) SBS banks were also required to redeem notes in specie. These notes circulated widely in New England (and occasionally even beyond), and bank failure rates were low, even during panics. For example, when Philadelphia banks suspended specie redemption from 1839-1842, notes of SBS banks were so popular they traded at a premium rather than a discount.

"In the SBS, banks could deposit other banks' notes at par in a central account that looked very much like the Fed," says Warren Weber, a former economist at the Minneapolis Fed. "Suffolk basically acted like a ledger and charged for that service — and even sometimes was willing to act as a lender of last resort."

The SBS is often considered a separate case from free banking, because it allowed any type of bank to join as long as it met the collateral requirement. Massachusetts, in fact, was home to a mix of state-chartered and wholly private banks and didn't have any free banks until 1859. But just as the New York law over time brought banks into the system that were, by selection, strong enough to meet the asset requirement, the SBS had a self-selection effect through its capital contribution requirement, as well as strong supervision. This group of relatively healthy banks, in turn, saw a lower bank failure rate than those in

other states. And as this consortium grew, it produced deep market liquidity in banknotes, providing a degree of currency stability and interstate redemption that most other states failed to achieve.

Mishaps in the Midwest

At the other end of the spectrum was Michigan, where many of the colorful tales of "wildcat banking" emerged. Like New York, Michigan was an early adopter of free banking (1837), but it took a different path in key respects. For one, it allowed a broader range of bonds, including those with backing in private-issue mortgages of dubious value. When these loans defaulted, many banks couldn't make up their collateral after liquidating their assets. The state also temporarily suspended specie payments early on, making it easy for banks to issue worthless notes. In turn, noteholders found they couldn't redeem their currency in full; Michigan notes typically lost 30 to 60 percent of their value in those early years. After a rash of bank failures, the state had only a handful of banks by the 1840s and remained widely underbanked.

In other cases, free-banking states saw the value of their notes decline due to factors beyond their borders. In Wisconsin and Illinois, for example, banks were allowed to use bonds from border and Southern states as collateral. When the Civil War began, those bond prices plummeted, as did the value of those banknotes. Another example was Indiana, where banks were hit in 1854 when Ohio passed a law banning all out-of-state banknotes, including those from Indiana; the measure was intended to make (higher-taxed) Ohio banking more attractive. Demand for Indiana bonds and banknotes sharply fell as a result, wiping out much of their value.

There were also broader problems across states that affected all banks, including the issuance of uneven denominations (which could make notes hard to use or break down out of state) and widespread counterfeiting. In the 1840s and 1850s, more generally, bank failure rates were high, often spiking during downturns and panics — although scholars still debate how much free banking played a direct role. One study of New York, Wisconsin, Indiana, and Minnesota found that about half of all banks in those states closed during the free-banking era, but that many of those failed banks still redeemed their notes at par — suggesting that banking instability tended to have multiple causes.

Overall, the performance of free banks improved over time. As Dwyer has noted, free banking was not perfect, but it also "was not the disaster portrayed by some." When Congress passed the National Banking Acts of 1863 and 1864, it took a page from free-banking laws by keeping the guarantee of bond backing — in this case, with federal government bonds backing notes issued by national banks. But Congress also ended free banking decisively by taxing notes issued by state and local banks out of existence. In short, just as the Second Bank's demise was a political decision at the hands of the Jackson administration, the end of free banking reflected a policy choice of the day rather than a failure of the free-banking model.

Back to the Present

What are the lessons from this era? Some banknotes in New York and New England did indeed come closest to fulfilling the functions of money under a regulatory regime, enforced by the government or the private sector. Given that the attraction of cryptocurrencies today lies in the fact that their issuance is not determined by government fiat and that they are not publicly regulated, then, this historical record might give pause to those who see them as a potential substitute for money. The free-banking era also illustrates numerous examples of failures, especially in the Midwest, due to idiosyncratic regulation. This history suggests that effective regulation should involve a way to ensure that a new currency enjoys stable liquidity. This was a clear challenge for some states before the Civil War and for cryptocurrencies today.

Policymakers have recently pointed to some of these features as constraints on cryptocurrencies' utility in the long run. Fed Vice Chairman for Supervision Randal Quarles noted in a speech last November that among the dangers posed by cryptocurrencies is that during crises, "the demand for liquidity can increase significantly, including the demand for the central asset used in settling payments."

"Even private-sector banks and certainly nonbanks can have a hard time meeting large-scale demands for extra liquidity," he added. "Without the backing of a central bank asset and institutional support, it is not clear how a private digital currency at the center of a large-scale payment system would behave ... in times of stress."

In a speech last March, Bank of England Gov. Mark Carney also underscored this point in a broader critique of cryptocurrencies, charging that they are "failing" as money for now. He warned that the inherently "fixed supply rules" of these currencies would run the risk of repeating another, less successful, historical experiment. "[R]ecreating a virtual global gold standard," he said, "would be a criminal act of monetary amnesia." **EF**

Readings

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