

MONEY AND THE CONSTITUTION

If the federal government only is permitted to issue money, coin or paper, then how could state banks issue money? State banks did not coin money, nor did they print any "official" national currency. However, state banks could print bills of credit in exchange for specie deposits. These notes would bear the issuing bank's name and entitle the bearer to the note's face value in gold or silver upon presentation to the bank. State bank notes were a form of representative money; they were not gold or silver, but they represented it. The notes were more convenient for conducting large transactions than their specie counterparts, and, more importantly for the extension of credit, could be produced easily whereas the gold and silver stock of the nation was relatively small and for the most part declining (Hixson, 12-13). The Supreme Court ruled in 1837 in *Briscoe v. Bank of Kentucky* that state banks and the notes they issued were also constitutional.

One potential problem with such a system is that banks may issue notes far in excess of their specie deposits. Customers appeared from time to time wanting to exchange their banknotes for specie. The banks, of course, made allowances for this by keeping some of the specie on hand at all times. If the specie/banknote ratio was too low, even a small unexpected increase in the withdrawal rate could force the bank into insolvency. Remaining depositors who had not withdrawn their specie would be left with worthless banknotes.

The public accounted for this risk of non-redemption by discounting the notes of banks that were considered risky. For example, a \$20 banknote issued by a bank with a reputation of redemption problems might carry a 5 percent discount off its face value. In other words, a local merchant might only give a customer \$19 worth of goods for a \$20 note with the difference compensating the merchant for the risk of accepting the banknote. Discounts on notes among functioning banks ranged from about 95 percent for the riskiest banks to zero for banks with a high degree of public confidence. On the advent of the free banking era, there were 712 state banks in operation in the United States, each with its own currency (Kidwell, 59). Imagine the difficulty for a local merchant in tracking the riskiness and value of perhaps dozens of different banknotes in addition to the other concerns of his business.

Flaherty, E. A Brief History of Central Banking in the United States. From Revolution to Reconstruction - an .HTML project. (6/3/03) <http://odur.let.rug.nl/~usa/E/usbank/bank06.htm>