

# The Free Banking Era and Online Currencies

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## **Abstract**

The purpose of this paper is to observe reasons (1) why there was such a spike in small banks during the Free Banking era from 1837 to 1863 and why there was a spike in, more importantly, alternate currencies and then glean from them (2) the patterns explaining such behaviors. Then the paper will look at (3) the important similarities between the alternate currencies of that time, and the online currencies on the modern day in order to establish the fact that they match in such ways that it is possible that they truly are alternate currencies. Additionally this paper will (4) also explain that the online currencies could react the same way as the alternate currencies of the Free Banking era. Finally (5) the paper will use those similarities to show how the alternate currencies of now might just react in the future based off the history of the Free Banking era.

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In 2009, a developer by the pseudonym of Satoshi Nakamoto created Bitcoin, an online currency that was designed to be an alternate currency. As of March 2013, the “monetary base” of this decentralized digital currency was evaluated to be equivalent to 360 million United States dollars. And since that time, many other different alternate currencies have been and are being implemented: Ripple Monetary System currency, Linden Dollars, Ven currency, etc. In the present, the American dollar continues to depreciate. According to Dan Bernstein in “Currencies: Dollar Continues to Weaken,” “The dollar continues to slip. ‘The big move is in the euro/dollar,’ said David Gilmore, a partner at Foreign Exchange Analytics in Connecticut. Strong concerns last week about the slowing growth of the U.S. economy, as well as the continuing uncertainty because of the presidential election, pushed the dollar significantly lower. Those influences continue to impact the foreign exchange market as the fall in the dollar expands against most major currencies. As this dollar continues to weaken, these alternate currencies may appear to be a prominent replacement. However, this relationship between a centralized currency and a large amount of smaller (if not profitable) alternate currencies has been seen before in the form of an event in the United States that started in 1837 called the Free Banking era. The Free Banking era ended in 1864 because of the introduction of a National bank. This paper will draw the parallel between the Free Banking era and the relationship between the alternate online currencies and the United States dollar and, more importantly, extrapolate the future of such alternate online currencies. This paper will argue that modern online currencies are truly alternate currencies and that they will face the same fate as the privately issued alternate currencies during the Free Banking era.

First, this paper will observe the history of the Free Banking era and before, as well as the history of the National bank. The National Bank, (created at the urgings of Alexander Hamilton in 1791) represented the worth of the dollar, both in the Gold Standard and the backing of the government; but if the National Bank was somehow removed or the dollar depreciated due to problems in the National bank, the amount of alternate currencies (and usually private banks issuing those notes) would always rise.

An event just like that occurred when President Andrew Jackson opposed the concept of a National Bank and advocated for the complete removal of it from the United States. Andrew Jackson claimed that the bank needed to be removed because it made the rich richer, it had too much control over the members of Congress, and it favored certain families. Thus, the (Second) National Bank was removed 1836, and Andrew Jackson worked so hard to have it removed, that the (Third) National Bank of the United States would not occur until 1913. And it was during

this time of no National Bank that here entered the Free Banking era (1837-1862). During this time called the Free Banking Era, banks were no longer directly connected by a central bank; instead, they were state-chartered or individually-instituted.

In the era of Free Banking there was little if no federal regulations, for barrier entries were low, and all banks were free to compete for banking, deposits and loans. For example, some say people were able to “shop” for money. The concept of “shopping” for money is meant by the fact that there were many banks in small areas, like shops, and these banks would compete with each other to have normal people invest or save in them, like shops. People would consider each bank and have to choose which they would go to and invest or save in. This time of market interaction was under what people call “laissez-faire” (this is a term for an economic environment in which interactions between markets and parties, such as banks, are free from federal intrusions such as tariffs, government subsidies, etc...).

However, this environment was unstable, and consequently banks and privately issued notes occasionally collapsed, leaving the remainder worthless, and unsupported. The instability was due to the fact banks were using their uninsured and technically unsupported monies in real-life interactions. According to “The Free Banking Era: New Evidence on Laissez-Faire Banking” by Arthur J. Rolnick and Warren E. Weber, “There is a long and costly history in U.S. banking of instability, bank panics and major disruptions in economic activity. Most date these problems back to the free banking era when there were no federal regulations, when entry barriers were low, and when bank were many and ‘free’ to compete for deposits and loans.”

The people required a centralized currency after the unstable event of the era. There was a “solidification” of the standard American dollar thanks to the National Bank Act of 1863. And thus the value of that standard dollar once again went up, and was backed by the government once more, causing the appeal of the alternate currencies to greatly diminish and finally caused those banks that issued such private notes to disappear altogether (Weber, July 2006). As one can see, this era was, as said above: chaotic. With currencies being privately issued, the interactions involving that currency became unsound and volatile. This condition ultimately led to the alternate currencies replacement by a more sound, centralized, and government-backed dollar.

It may seem like the Free Banking era and its myriad of alternate currencies might have been a response to a specialized economical change (the forceful revocation of the Second National Bank), and it may seem like it might have never come again. But if in truth, it is very clear that alternate currencies are rising once again in present times. However, the privately issued notes

of then have now been replaced by the alternate online currencies. There is, for example, Bitcoin which was created in 2009, as said in the introduction to this paper, by a pseudonymous developer by the name of Satoshi Nakamoto.

Bitcoin is, just like privately issued notes of the Free Banking era, an alternate currency (this paper will discuss this declaration in a later paragraph). However, just like the many currencies during the Free Banking era, there are certain drawbacks that parallel those notes of old. Here are the points that are closely related, as well as the differences.

First, just like those alternate currencies of the Free Banking era, Bitcoin and most other modern alternate monies are limited. Bitcoin is an electronic, currency whose value is based solely on trust and the value of other standard currencies; it is trapped inside the domain of electronics. One cannot buy any product of substance (such as apples from a grocery store, or a phone from an electronics store) with Bitcoin, for this alternate currency is not something one can hold. The boundaries (and limitations) of the electronic currency is within a domain; just like the alternate currencies of the Free Banking era were trapped in a domain (a county or a state).

Another characteristic that these modern currencies share with the privately issued notes of the Free Banking era is the unusual “value.” According to Gavin Anderson, the recent president of Bitcoin – Nakamoto retired, in the interview by Russ Roberts from EconTalk, “If you really think about it, money is all about trust.” The true value is in the scarcity, or trust as Anderson declared, the opposite reference to the United States dollar bill. However, this means that there must be some control on the way Bitcoins are created. This electronic currency is actually based off a special algorithm that increases the amount of Bitcoins over time, but at such a speed that it retains its value over all the standard global currencies that are inflating as well. With the Bitcoin inflating at a certain rate and with scarcity at a good percentage, the value of Bitcoin is appreciable. Anderson asserts that, “We trust that money is hard to counterfeit so that when we get a dollar bill from a merchant we are not getting something we take to the bank and the bank says: No, that’s not a real dollar bill, sorry. Trust is huge.”

Just like Bitcoin, those alternate currencies of old were all about trust and distrust. As said previously, most of the banks had to be backed by gold (or sometimes even silver); otherwise, the money would be worthless and people would consider it as such. The main value concept for these notes was, as Gavin Anderson said above: trust. These alternate notes were to be backed up by gold and silver, but one always had to be careful. According to the article “The Free Banking Era” by Rhab Hendrik, “Wildcat banks were open[ed]... by dishonest bankers who intended to defraud the public by issuing banknotes far in excess of what they plan to redeem

and specie which is gold or silver.”

Another example of this trust issue is the Ripple Monetary System. This alternate currency is electronic notes that have a protocol for an open decentralized money system that is based off a computer-to-computer and peer-to-peer distribution system. This system is like the two alternate currencies mentioned above. The value is in bank obligations (the Ripple Monetary System monies) that are transferred from one person to another, the trust must exist between the people in the social network that are transferring obligations from one to another; otherwise, this entire monetary system has no value. So, just as Bitcoin and the Ripple Monetary System face trust issues as of now, any new inspiring bank firm of the Free Banking era had to gain trust of the people, to make them believe that the new alternate money being released into their society was backed by valued specie.

Given the many similarities of the online currencies of today, with the alternate currencies of the Free Banking era, one could understand that there is the possibility that future outcomes might be similar. After 26 years of small amounts of unstable alternate currencies circulating through communities and counties, the Free Banking era came to an end. This event was due to the Civil War. The debt created from this war forced President Abraham Lincoln to create another standard (but fiat) currency over the myriad of other alternate currencies. It is important to note, though, that the Third National Bank (despite the fact it is important to the value of the standard, national currency) was not chartered until 1913, almost 40 years later.

When the national, standard dollar was weak (usually this would happen when the main currency was without a head or a central order, like a national bank) alternate currencies would rise up to attempt to take the dollar's place. Alternately when the dollar became strong again, the same currencies would disintegrate and, finally, disappear altogether. One could see this as a possibility for alternate currencies of today, since the now-long-gone alternate currencies of the Free Banking era and the online currencies of the modern day share many characteristics: size, restrictions, and values. It would make sense that these currencies would follow the same path since they stemmed for the same reasons: a devaluation of the standard and main currency. The United States dollar bill (the standard currency of today) has suffered in the years since 2007 (for a recession struck in 2007, and the United States has been recovering since), and the dollar bill has dropped in value over the course of the decade. According to the article “Grand Illusion – The Federal Reserve” by James Quinn, “The CPI on January 1, 1914 was 10.0. The CPI on January 1, 2009 was 211.1. This means that a man's suit that cost \$10 in 1913 would cost \$211 today, a 2,111% increase in 96 years. This is a 95% loss in purchasing

power of the dollar... prices have risen 683% since 1964.”

As it seems, the dollar's devaluation is apparent and alternate currencies have sprung up about this chaos of depreciation, however, if the Federal Reserve and the Government takes action in some way to appreciate the dollar to the value it was before the recession, the dollar will once again appear stable and orderly; thus, the dollar will become once again a staple in the many markets and a trustworthy currency. And, just like the many privately issued notes in the Free Banking era, the alternate currencies of the modern day will slowly disappear and become inactive as the dollar becomes the icon of spending in all areas of the markets.

In late 2011, gold began a 7 percent decline in value after its “new record” high in September 5, 2011, and in the quickly following year of 2013, the gold value plummeted. According to Larry Swedroe in “Is Gold's Drop Just the Beginning,” “Gold has now fallen to just over \$1,400 per ounce, and holdings of SPDR Gold Trust (GLD) hit their lowest mark since November 2009 [this year being 2013]... Clearly the momentum in gold is negative.” Momentum tends to reverse assets' value and overall “demand” in the long-term despite the fact it is a short-term phenomenon; and with momentum being negative with a new high achieved just 2 years before the momentum's occurrence, gold's future seems quite bleak in respects to returns and value.

Along with the drop in gold value, world currencies have lost the “momentum” of steady rate of inflation; in fact, the world currencies are now teetering on the edge of deflation, the enemy of markets. Deflation is the enemy of markets (to define the phrase) because of the way the higher value of money locks up prices and disturbs the responding demand in markets. According to Annalyn Kurtz in “The Global Economy is Losing Steam,” “Last week, the International Monetary Fund cut its outlook for global growth. It now believes the world economy will grow only 3.3% in 2013. Even that prediction is considered overly optimistic by other economists... Job growth waned... They're expected to prevent the U.S. economy from growing beyond 2% this year.”

With the two standard representations of value (gold and global currencies) diminishing, one might think that, according to most of the paper, the alternate currencies such as Bitcoin would flourish in such an event. However, as the opposition points out, Bitcoin specifically is not doing just that, it is actually decreasing just like the rest of the global economy and gold market.

According to Charles Wilbanks in the article “In Bitcoin We Cannot Trust,” “...when the value of one Bitcoin reached an all-time high of \$266 to a U.S. dollar, the digital money took a swan-dive. By late Wednesday, if you were still committed to the transaction [of buying a house with Bitcoins], your house would have cost you twice as much... Bitcoins just kept losing value.” This drop in value happened along with the plummet of gold worth and the erratic decreasing of

the global economy, and thus some might say that these all coincided, with the online currencies actually complementing the standard currencies in such a way they too were affected by decreases in worth.

This opposing thesis and its evidence might seem note-worthy, but there is also the possibility that that thesis is incorrect and that the evidence is using a correlation between three events that don't exist in reality. Despite the fact that the Bitcoin collapse seems to correlate with the hurt global economy and the gold crash, it actually might be a coincidence; in fact, the gold devaluation spiral actually happened a bit earlier (2011) than the specific time of the Bitcoin collapse (2013). And even though the Bitcoin collapse truly did match up with the slow decrease of the global economy, this could perhaps be just a coincidence.

In truth, there might have been other forces that could have caused the crash for Bitcoin. Investigations into the halving of the Bitcoin value in April of 2013 revealed a different explanation than the relationship of the world's standard currencies with that alternate currency: as of 2013, there was a major economical panic within Cyprus where the government simply became bankrupt and could not support the markets anymore. Thus, the nation asked for a bailout which its fellow European countries provided, however, due to the massive instability of the Cyprus economy, and the total dissolution of the national dollar for that country, people began to search for alternate currencies. This alone backs up a small part of this paper's thesis: the standard dollar becomes unstable; the online currencies take its place as alternate currencies, which would make them prone to the standard actions of alternate currencies. However, that is not the end of the story; people began to buy up large amounts of Bitcoins and thus the value of Bitcoin began to skyrocket because the purchasing power of that online currency became artificially shoved upwards. And just like the stock market crash of 1929, the bubble burst. Bitcoin was just that: a bubble. The true reason Bitcoin crashed was truly because it had become a bubble due to the Cyprus crisis, and that bubble had simply popped; it had nothing to do with the current state of affairs of gold values or global economies. According to Rick Bowmer in "Bitcoin Hits New High, Then Nosedives in Flash Crash," "Each 'coin' has been worth less than \$10 for most of the currency's history, but this week the value surged past \$200 - with the recent bailout crisis in Cyprus seen by many as one of the triggers of the surge. Wednesday saw a "flash crash," as the value dipped close to \$100..."

Thus, the opposition to this paper's thesis might not have enough merit in their case. For despite the fact that Bitcoin collapsed in value around the time gold's value collapsed as well, and the economic downturn, these might have been coincidences. It actually appears that there

was an entirely different explanation and there might not be a complementary relationship between them all. Additionally the Cyprus event might even strengthen a part of this paper's thesis with the representation of the fact that when the standard currency weakens, alternate currencies take its place. This event strengthened the evidence that online currencies like Bitcoin just might be relative to alternate currencies (like the privately issued notes of the Free Banking Era as discussed previously).

Additionally, when one observes the data of the deflation of the world economy and the depreciation of Bitcoin, one can draw out another important point. As stated beforehand, Bitcoin is an alternate currency, and thus is appreciates when the standard currency depreciates and vice versa. Thus, one can see this point being strengthened in light of these current events. When an economy deflates, it is true markets become distorted, but it is also true that the currencies within those markets appreciate in value. The global currencies appreciated sharply with the loss of momentum in the markets, and at the exact same time, the Bitcoin, and alternate currency, depreciated immensely. In light of these events it is obvious, without a doubt, that Bitcoin is not a supplements, but a substitute: an alternate currency.

So, in the end, the multitudes of privately issues alternate currencies issued throughout the United States during the Free Banking era are quite similar to the online currencies of today; consequently, they might just act in the same way as well. This paper discussed the Free Banking era, the similarities between the alternate currencies of then and the modern day, and finally extrapolated the patterns the currencies might follow due to the relationships of a similar time in history. This paper has attempted to prove that due to these similarities, correlations, and patterns between the online currencies and the Free Banking era currencies, the online currencies of today might just follow those currencies of the Free Banking era on the path of history: rise when the standard currency depreciates, and slowly disappear when that same currency returns, or a new, stronger main currency takes its place.



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