THE CHALLENGE OF CREDIT SUPPLY

American Problems and Solutions 1650-1950

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Designing a Currency with Credit

Beginning in 1775, the Continental Congress of the United Colonies created a "continental currency" to pay for the revolutionary war. A total of $226 million worth of continental currency (bills of credit) was printed by the end of 1779.[1] Though imperative at the time, the bills were not issued in the same manner that had made many of the colonial currencies of previous years successful. Despite having implicit power to tax from the Declaration of Independence, the Continental Congress did not collect taxes or issue regular securities to absorb them.[2] In its first issues, the Congress assumed that the state legislatures would absorb the paper through taxation in sufficient amounts to uphold its value. However, they did not levy taxes in 1775 or 1776 and the currency began to depreciate in 1777. In November of that year the Congress officially requested that the states collect taxes but they did not comply. By 1778-1779 the depreciation of the currency was severe. Further contributing factors in the depreciation were a growing lack of confidence in the union of the states and the high prices of goods caused by the war.[3]

Alexander Hamilton served as an aid de camp to General George Washington and managed the communications for army supplies. In this capacity, he saw from an administrative level the consequences of a weak Continental Congress. On a number of occasions between 1779 and 1781 Hamilton outlined his thoughts on the problems and solutions to the crisis. "The fundamental defect," Hamilton believed, was "a want of power in Congress." Congress had "descended from the authority which the spirit of the act" of 1776 had vested within it. Growing "diffident toward its own authority," it had bent to please the states. Having "scarcely left themselves a shadow of power," they therefore lacked sufficient means to answer the needs of the public.[4] The lack of power to put resources behind the currency was the main cause of currency depreciation, Hamilton wrote, not an intrinsic problem related to its quantity.

Hamilton had begun planning innovative financial arrangements to deal with this state of affairs in 1779. To restore and secure the government's ability to borrow for the success of the war he proposed a more permanent solution than annual loans, which were becoming increasingly difficult to obtain. Since private interests could make more of a profit by investing in trade than lending to Congress, he proposed turning future loans to Congress into a permanent fund. The fund would be directed so as to be beneficial to the investors in commerce, making it in their interest to uphold the value of the currency. "The plan I would propose," he wrote in the winter of 1779, "is that of an American Bank . . . under the denomination of 'The Bank of the United States.'" This plan, he said, would lead to a "restoration of paper credit, and establish a permanent fund for the future exigencies of Government." The Bank would benefit the government in loans for the war. Also, he wrote, it would "promote commerce, by furnishing a more extensive medium, which we greatly want in our circumstances. I mean a more extensive valuable medium. We have an enormous nominal one at this time. But it is only in name." Half of the Bank's capital was to come from a foreign loan and its notes were to replace the depreciating continentals as the main currency of the states.[5] As had been attempted under Blackwell, and as Pownall had explained the success of Pennsylvania's loan office system, Hamilton envisioned a currency that would be primarily lent into circulation for trade and commerce, with a built-in incentive for making good on the bills.

Meanwhile, the crisis deepened. That winter the Congress became increasingly conciliatory to the states. They urged the states to collect taxes and hoped the currency would increase in value if its quantity was increased no further. When depreciation continued, with the bills dropping to one-fortieth of their original value by the spring of 1780, the Congress made a drastic attempt to prevent further depreciation. On March 18, 1780, the Congress asked the states to collect $180 million of continental currency by April 1781 and deliver it to them for retirement. But the Congress redeemed the bills at a rate of only one-fortieth their face value. A total of $120 million was paid in by the states in this way over the year, for which the states were credited $3 million in specie.[6] The 40 to 1 measure failed to achieve its effect, and the remaining currency continued to depreciate. It dropped to one-hundredth its face value by the end of the year. It was a failure for which Congress was often chastised in later years, including by Hamilton. The credit of the Congress was severely damaged as it had essentially repudiated over $200 million of paper currency.[7] Congress also issued a smaller amount of bills bearing interest. This time the states were given most of the bills to distribute to creditors themselves and were asked to provide funds for payment of the interest. Congress was also forced to ask the states to collect more taxes to finance expenditures. The actions by Congress that winter signified a weakening of Congress' authority. Accordingly, in the Articles of Confederation ratified in March of 1781 the Congress was legally prohibited from levying taxes and was limited to making requests to the states.[8]

By the spring of 1781, the remaining continental bills became of little use in serving as a currency and were gradually removed from circulation. In their stead only the currencies of individual states and scarce specie circulated. There was a growing lack of currency with which to pay taxes. Congress's obligations mounted and the high prices of goods driven by the war's demands required the issue of more debt to buy them.

In response to the growing crisis, Congress asked the states on February 3, 1781 "to pass laws laying an impost (import duty) of 5%" on "all goods, wares, and merchandise of foreign growth and manufactures" imported into the states, and to vest Congress "with the full power to collect and appropriate" the amounts needed to pay the principal and interest on the debts of the U.S. This impost request was effectively an amendment to the Articles of Confederation ratified the following month. To strengthen its position, Congress replaced the finance committee with a single Superintendent of Finance on February 20, 1781. Robert Morris, a member of the Continental Congress from 1775-1779, was appointed to fulfill the post. Morris' plan was for the interest on Congress' debts to be its own responsibility and the expenses of the war to be apportioned among the states. A state of national accounts showing the balance of credits and debits between Congress, the states, and the public became one of Morris' chief tasks.[9]

Morris set to work on a plan for a National Bank three days after being appointed.[10] He saw bank currency lent into circulation as the best replacement for the discredited government paper. "There is no reason why paper should not pass equivalently with silver," Morris wrote, "if it be issued on proper funds, and with proper precautions, so that the demand for it be great."[11] On April 30, 1781, while Morris was composing a design, Hamilton wrote him a letter with his thoughts on the crisis and the solution. Addressing the depreciation of the currency, he said it was the result of a lack of confidence in the union and of active power in Congress. It was not a shortage of resources of the country, he said, as the country possessed ample commodities and labor. Building on his plan from the year before, Hamilton outlined his own example charter for a national trading and banking corporation that would enable Congress to obtain a permanent source of credit from individuals. He proposed that by uniting the wealth of private merchants and traders with the public, a sizable "mass of credit" could be established that would "supply the defect of moneyed capital." The plan would "offer adventurers immediate advantages analogous to those they receive by employing their money in trade, and, eventually greater advantages, a plan which will give them the greatest security the nature of the case will admit for what they lend." In addition, it would "secure the independence of their country" and spur the country's commerce and strength.[12] A dependable medium of non-depreciating bank notes would increase the quantity of the currency, trade and commerce, and the payment of taxes. One of the main factors of the depreciation of the earlier emissions of paper currency had been for lack of a close integration with economic demand, a factor which the Bank's currency would cure, as it would be issued through loans and discounts. The Bank would turn the pledges of commerce and industry into an accepted form of payment between individuals. The currency would obtain greater credibility as it became increasingly reflective of economic activity. "The tendency of the national bank," he wrote accordingly, "is to increase public and private credit . . . Industry is increased, commodities are multiplied, agriculture and manufactures flourish, and herein consists the true wealth and prosperity of the state." He called for new taxes to be deposited in the Bank, increasing the fund on which it would operate. The states would pledge to pay into a fund devoted to the interest payments on the required loans that the Bank would make to Congress for the war. He detailed a feasible manner for the existing and new debts of the states to be paid over a thirty-year period. This national debt, Hamilton wrote, would serve as a powerful cement of the Union, keeping up a necessity for taxation.

On May 17, Morris put forward a plan of his own with a much simpler design than Hamilton's and a smaller initial capital. Gouverneur Morris, serving as the assistant financier to Robert Morris from 1781-1784, wrote out its final language.[13] Congress approved the plan on May 26, as "the Bank of North America," to be chartered when subscriptions were filled. Morris remarked to Hamilton that day that receiving his letter had strengthened the confidence he had in his own judgment, as many points coincided with his own. He foresaw the establishment of "a paper credit that cannot depreciate." He said that although the Bank's authorized capital stock was much less than what Hamilton had proposed and less than it should be it was wiser to start small. After securing an amount of $400,000 it could then "be increased almost to any amount."[14] Similarly, Morris wrote to Franklin in July that the plan was to eventually increase its capital by an order of magnitude. Three days after Congress passed a resolution approving the Bank, Morris addressed the nation with an open letter. "To ask the end which it is proposed to answer by this institution of a bank is merely to call the public attention to the situation of our affairs," he wrote. He went on to describe the depreciation of the currency and the financial and contractual distress it had caused. Public credit had suffered and the needs of the U.S. demanded an ability to anticipate revenues. The continental currency had been a form of anticipated revenues, but a method now exhausted. Confidence in the government was lacking for it to obtain these anticipations as individual loans. However, an incorporated Bank would supply this necessity and make loans to the government in advance of taxes collected. "The use, then, of a bank is, to aid the government by their moneys and credit, for which they will have every proper reward and security," Morris explained.[15]

On July 13, 1781, Morris wrote to Benjamin Franklin explaining his new position as Superintendent of Finance and included a copy of the plan for the Bank of North America. "No Country is truly independent until with her own credit and resources she is able to defend herself and correct her enemies," he wrote. Morris described the problems of collecting revenue from the states and the over reliance on bills of credit. He referred to his work on the Bank of North America the previous month, telling Franklin that he was drawing from the "experience and example of other ages and nations." He hoped it would become a "principal pillar of American credit," making it possible to put private capital to use for the country and "bind" the moneyed class "more strongly to the general cause." Franklin responded later on November 5, 1781, writing in agreement with Morris's plans, adding that "all good patriots" should support him in his efforts. In connection with "our Bank," wrote Franklin, "I clearly see . . . the advantages that you show would arise from the operation."

That July Hamilton began publishing a series of short papers, under the title, *The Continentalist*. They argued the case for needed powers of Congress and supported Congress' February call for revenues from import duties, to which only half of the states had agreed. Hamilton developed a theme about avoiding the fate of other weak unions in history, such as the city states of ancient Greece and the Swiss Cantons. Congress' ideas, he wrote, were not those "enlarged and suited to the government of an independent nation." He said it had conceded, "the powers implied in its original trust," since by the Declaration of Independence it was stated that the Congress had "full power . . . to do all . . . acts and things which independent states may of right do." These included needed economic actions, which, Hamilton stressed, meant going beyond covering expenses for the war. He wrote:

> The separate exertions of the States will never suffice. Nothing but a well-proportioned exertion of the resources of the whole, under the direction of a common council, with power sufficient to give efficacy to their resolutions, can preserve us from being a conquered people now or can make us a happy people hereafter.

On August 30, 1781, in his fourth installment, Hamilton went into more specific detail on the need for funds to pay the debts and provide for the Bank of North America which Congress had established. The Congress, he wrote, “can neither have dignity, vigor, nor credit” by remaining entirely dependent on the occasional grants of the states. Credit was necessary for carrying on the war, as taxes year to year could not suffice. Hamilton referred to the newly approved but not yet chartered Bank and the needed components added to Congress’ powers if it was to serve the purposes he had in mind. He said that “the restoration of public credit” could be expected from Morris’s administration provided the federal government could raise sufficient taxes. The Bank would give the government “that durable and extensive credit of which it stands in need,” if, he wrote, Congress had “it in their power to support him with unexceptionable funds.” He said if the “practice of funding the debts” had been begun in 1777 then the depreciation of the continental currency and the loss of credit that accompanied it could have been avoided. The Bank was now the means, he wrote, “to prevent a continuation and multiplication” of the ill effects of depreciation.

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