


THE POST CIVIL WAR FINANCIAL SYSTEM

Lecture 9
ECON 4524

To understand the period, you need to start with the Civil War:

- **As in most wars, the government has three ways to capture resources**
 - 1) taxes
 - 2) borrowing
 - 3) printing money
- **Morally which is right – who should pay for the war?**
 - Existing Taxes went up and new taxes instituted
 - Old taxes: tariffs, property taxes, license taxes, stamp taxes
 - New taxes: income tax and inheritance tax

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- **Taxes increased over the period**
 - **1862 – 10% of expenditures**
 - **1865 – 25% of expenditures**
 - **After the Civil War – government cut back on internal taxes, but tariffs remained high**
 - **Ratio of duties to value of taxed goods 1860 (20%), 1865 (40-50%) the ratio remained at a high level until 1913**

Borrowing

- **1) Primary technique of government financing**
 - a) rose from \$90 million in 1861 to \$2322 in 1866 (unadjusted for inflation)
 - b) sum was 2x what had been spent by investors to build railroads in 3 decades
- **2) sold bonds through private agent Jay Cooke, a banker from Philadelphia**
- **3) National Banking System (1863) – to become a national bank had to have certain % of assets as bonds**

Money Creation

- 1) Inflation is a tax on holding money
- 2) U. S. government suspended convertibility in at the end of 1861
- 3) Legal Tender Act of 1862 – print \$150 million (not redeemable) greenbacks
- 4) mid 1862 – print another \$150 million mid 1863 – print another \$150 million
- 5) Price level during the war April 1861 – Jan 1865 increased 2.3 times
- 6) Greenbacks at height of the war \$2.85 greenbacks purchased a gold dollar

Post Civil War

□ Money and Prices

- 1) money stock defined – coin, paper currency, plus bank deposits
- 2) grew at a rate of 5.3% a year from 1867 to 1914 while wholesale prices declined at 1.3% per annum
- 3) quantity theory of money
- $MV = PQ$
- GNP grew at 4% (not 6.6%) so velocity must have fallen

Velocity of money decreased (increase in money demand)

- 1) for a given increase in money income, need a larger increase in the stock of money
- 2) population increased
- 3) GNP increasing
- 4) Greater amount of market oriented activities
- 5) opportunity cost of holding money falls because money goes up in value in your wallet

Why didn't we increase the stock of money?

- **Answer: the economics of resumption**
- **Recall: the United States government suspended payment in specie but rather than change the gold dollar price (i.e., devalue) they shrunk the money supply to get Greenbacks worth what they used to be – deflation**

A Brief History of Resumption

- **1866 – Congress authorized Secretary of the Treasury McCulloch to implement monetary contraction (deflation), i.e. buy back greenbacks**
- **Deflation was unpopular with whom? (Debtors)**
 - 1) farmers
 - 2) businessmen
- **1868 – Contractionary monetary policy discontinued but silver coins no longer circulated because silver coins worth more as silver than the purchasing power of the coins**

“The Crime of 1873”



- **The Coinage Act of 1873 made the demonetization of silver official- the mint would no longer buy silver in exchange for coins**

Financial Panic in 1873

- **Congress (both houses) passed a bill to expand the issue of greenbacks**
 - 1) bill vetoed by President Grant
 - 2) organization of Greenback Party (1875)
 - 3) Greenback Party 1% of Presidential vote in 1876
 - 4) 1880 Greenback Party lost much of its force, merged with another political group the free silver movement
- **1875 Resumption Act – Congress declared that they would return to specie convertibility in 1879**
- **In the later 1870s the demand for gold increased and the supply of silver increased**

Why?



- **1. European countries went on the gold standard, dumped silver on the market**
- **2. New silver discoveries in the American West**

- **Consequence deflation price of gold up relative to goods.**
- **Hurt farmers and mining interests**

Free Silver Movement

- Followed in the wake of the Greenback Party
- Free Silver Movement Wins Two Victories
- 1) Bland – Allison Act of 1878
 - ▣ a) \$2-4 million silver purchased per month at market prices and some turned into coins
 - ▣ b) not enough to affect the money supply
- 2) Sherman Silver Purchase Act of 1890
 - ▣ a) in return for supporting McKinley Tariff Bill, -raised tariffs 48% - Congress passed alwa to purchase 4.5 million ounces of silver
 - ▣ b) caused monetary confusion and flight from silver people paid debts in silver – gov't gold stock drained
 - ▣ c) problem 1893 gold stocks fell below \$100 million and many feared a return to silver std.- financial panic
 - ▣ d) 1895 U. S. gov't went to J. P. Morgan to market U. S. bonds overseas – gold flowed in but this caused a bad public reaction because the gov't used private investment bankers

Presidential Election of 1896 – McKinley vs. Bryan

- Bryan: “Thou shall not crucify man on a cross of gold”
- 1896 started to emerge from depression and Bryan lost the election
- 1900 - U. S. officially went on the gold standard

Banking

- 1) 1860 well over 2,000 banks in operation
 - a) state chartered as well as private unincorporated
- 2) System changed with the establishment of the National Banking System why?
 - a) captive market for U. S. bonds – banks had to buy bonds equal to at least one-third their capital
 - b) banks deposit bonds with the Comptroller of the Currency and receive national bank notes
- 3) Reasonable idea that did not work
 - a) set minimum capital requirements which were too high for small towns
 - b) minimum reserve requirements for metropolitan area-25%; country banks – 15%
 - c) prohibit loans on the basis of real estate capital
 - d) # of state banks fell, # of national banks increased but not enough to offset the decrease
 - e) 1865 – 10% tax placed on state bank notes – drove state bank notes out of existence but did not kill off state banks
 - f) state banks on the rebound - # number of state banks began to increase in increase in 1869 and % of bank assets in 1870

Banking cont.

- 4) Problem – banking system susceptible to failures
 - a) bank panics usually happened at the peak of the business cycle
 - b) 2 cycles important business (3-4 years) and seasonal (farmers –spring; marketers of crop – fall)
 - c) seasonal – country banks draw down deposits they had made with city banks
 - d) city banks must lend less to meet deposit demands of country banks
 - e) business cycle demand to fuel stock market exchanges and commercial activity
 - f) ultimately what happened business failures and securities liquidation (fall in price of stocks) when people sense failure they run to banks for money – process feeds on itself
 - g) major panics; 1873, 1884, 1893, and 1907

Stimulus to Regulation following the Panics of 1893 and 1907

- **1) Aldrich-Vreeland Act (1908)**
 - **a) temporary solution – authorize emergency currency backed by loan and investment assets**
 - **b) establish National Monetary Commission which led to the passage of the Federal Reserve Act of 1913 and the Federal Reserve System**

The Federal Reserve System



- ❑ **12 Federal Reserve Banks: New York, Boston, Philadelphia, Richmond, Atlanta, Cleveland, Dallas, Chicago, Minneapolis, St. Louis, Kansas City and San Francisco**
- ❑ **No de jure central bank but de facto it was the governor of the New York Fed**
- ❑ **1935 went to a true central bank with the headquarters in Washington D.C. and a Chairman of the Fed**

The Bottom Line: How well did the Financial System Work?

- 1) U. S. grew real GNP 4% per annum in spite of the system
- 2) Government did do the right thing by retiring Greenbacks; did not crowd out private sector investment