History of the Central Bank

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover the history of the central bank, including the debate surrounding its development, as well as its advantages and disadvantages.

Our discussion breaks down as follows:

1. Central Bank: Early Debate
2. The Free Banking Era
3. Common Currency and the Central Bank

1. Central Bank: Early Debate

One of the last straws that led to the Revolutionary War in the United States was when England attempted to place the colonies under the control of its own Bank of England.

Therefore, many of the founding fathers, like Thomas Jefferson, were very opposed to any type of central bank. At the same time, though, there were others, like Alexander Hamilton, who recognized the need for a central bank.

In today's lesson, we are going to discuss some of these conflicting views, meaning opposition to and support for, the central bank.

Throughout the 1800s, control went back and forth from a centralized banking system to a system like the one that Thomas Jefferson wanted, that gave states the rights to regulate their own banking.

We did have a First Bank and Second Bank of the United States. There were charters for each of these. However, there was also a free banking era, characterized by the idea that states should have the rights to regulate their own banking.

2. The Free Banking Era

Now, during this free banking era when states had the right to regulate their own banks, there were some issues:

- Banks lent out too much money
- Different banks issued different currencies
- Bankers printed more money, causing inflation
- Bank runs and panics
- Wildcat banks (called thus because they were located on the edges of settled areas; they often failed)
- Fraud, where banks were cheating customers
- Civil War

> EXAMPLE During the Civil War, the official currency issued was called "greenbacks." However, at the same time, the Confederacy issued their own currency backed by cotton, which became completely worthless as the South was losing the war.

So, when banks were lending out too much money, this involves the concept of**reserves**, which are a portion of deposits required to be held by a bank. Reserves are usually kept to maintain reserve requirements, as set by the Fed today.

However, back when states were regulating their own banking systems, they either did not have reserve requirements--meaning they did not require their banks to hold a certain portion of funds on hand--or they were all different. So, this notion of reserves really varied during the free banking era.

TERM TO KNOW

Reserves
A portion of deposits required to be held by a bank; reserves usually are kept to maintain reserve requirements, as set by the Fed

3. Common Currency and the Central Bank

Now, people began to realize a need for a common currency, since each bank could print and issue its own currency. It was difficult to know the value of any given bank's notes.

Here is an example of a private bank note, the result of a bank printing its own dollar. It does not look anything like our dollars today, and it looked different from other bank's dollars because they were all printing their own notes.

Currency traders at that time could actually make a living by traveling back and forth between cities and trading currency.

> EXAMPLE For example, a currency trader could purchase an Atlanta currency in New York City at a discount, then travel to Atlanta and use it to purchase currency that was printed in New York at a discount. The only reason that this was possible was that it would take weeks for people in one city to find out about a bankrupt bank in another city far away. Therefore, it was possible to purchase currency at a discount, and sell it and trade it.

Since every bank's notes were different, it was difficult for people to buy anything when they were traveling any kind of distance. It was not necessarily difficult for people who remained in one place all the time, but for anyone traveling, it was hard because of the information gap, or the length of time it took for people to get information.

Therefore, people realized that a **central bank** could issue a common currency for everyone to use, and this would no longer be a problem. A central bank is defined as a central banking authority that is typically charged with the regulation of money supply and interest rates.

TERM TO KNOW

Central Bank
A central banking authority that is typically charged with the regulation of money supply and interest rates

SUMMARY

Today we learned about the **early debate** among the founding fathers surrounding the need for a **central bank**. We learned about the problems that occurred when our country did not have a centralized bank, during the **free banking era**. All of these problems led to the recognition that a **common currency and central bank** would be needed.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Central Bank

A central banking authority that is typically charged with the regulation of money supply and interest rates.

Reserves

A portion of deposits required to be held by a bank; reserves usually are kept to maintain reserve requirements, as set by the Fed.