

## **Medium of Exchange in American History**

- Specie (gold and silver)
- Private bank notes
- Checks
- Government bank notes
- Credit cards

## Colonial Era

The medium of exchange in the colonial era was coins, made from various metals, not necessarily silver or gold.

Money was scarce, and the lack of money impeded trade. From the point of view of the classical macroeconomic model, this claim is puzzling. In the classical model, the price level adjusts to make the real money supply equal the real money demand, so money is not “scarce.”

## Money Substitutes

Since money was scarce, money substitutes were used. In some places at some times, tobacco and wampum served as money substitutes. Indeed, the substitutes were money, since laws declared them to be legal tender, valid for the payment of debts.

(During World War II, cigarettes served as the medium of exchange for allied soldiers in prisoner-of-war camps.)

## Paper Money

During the Revolutionary War, the Colonial government printed paper money, the “Continental dollar,” to pay war expenses. This experience was the first widespread use of paper money in world history.

Overissue led to hyperinflation, and the Continental dollar became almost worthless.

## **Gresham's Law**

“Bad money drives out the good.” The more valuable money disappears from circulation, and commodity money is low quality.

**Ancient** Clipped coins

**Colonial** Low-quality tobacco

**Prisoner-of-War Camp** Low-quality cigarettes

**Today** Silver-coated coins with little silver content

## **Private Bank Notes**

Before the Civil War, private bank notes constituted the bulk of the medium of exchange. A bank would print up its own bank notes, and these notes would circulate as money.

The bank was obligated to redeem its notes in specie if a note holder presented it for payment, and was required to have a reserve of specie or government debt for this purpose.

## Profitability of Note Issue

A note issue is almost pure profit to a bank. It receives payment at the time of issue, and perhaps never needs to redeem the note. The revenue received is *seigniorage*.

Consequently overissue is likely, unless banks are policed to have reserves.

## Overissue in the West

On the frontier (west of the Appalachians), banks often had no backing for the money. Overissue of bank notes (issue that could not be redeemed) was common, and some notes circulated at a discount to face value.

Galbraith [2] sees the overissue as useful, as banks were the primary source of the credit needed for economic development.



## **Civil War**

Checks began to be used, which reduced the circulation of private bank notes.

## **Greenbacks**

The federal government printed its own notes, for the first time, to help pay for the war. The notes had green backs.

## **Gold Standard**

During the 1800's, America was on the gold standard. Bank notes could be redeemed for gold, and the price of money in terms of gold was constant.

## **Deflation**

After the Civil War, economic growth continued. Worldwide there were no important new gold strikes, and the production of gold did not keep pace with the economic growth. Gold became more scarce relative to goods. Its price rose, so the price of goods was falling in terms of money.

## **Populist Political Movement**

The Populist movement in the Midwest complained that banks and business in the East dominated the country.

As farmers were typically debtors, deflation raised the real value of their debts. The Populists sought inflation, to reduce the burden of debt.

## **Bimetallism**

Led by William Jennings Bryan, the Democratic candidate for President, the Populists advocated bimetallism, under which silver as well as gold would be the basis for money. Silver strikes in the West had made silver plentiful, so bimetallism would expand the money supply. Inflation would occur, since money would be less valuable.

Bryan lost the election. Gold strikes in South Africa, Russia, and Alaska increased the money supply. Inflation occurred, and bimetallism was never adopted.

## References

- [1] Milton Friedman and Anna J. Schwartz. *A Monetary History of the United States, 1867-1960*. Princeton University Press, Princeton, NJ, 1963. HG538F86.
- [2] John Kenneth Galbraith. *Money: Whence It Came, Where It Went*. Houghton Mifflin, Boston, 1975. HG231G35.