

Hamilton's First Bank of the United States

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The Bank of England

DAVID
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TILL TIME'S LAST SAND

A HISTORY OF
THE BANK
OF ENGLAND

1694-2013

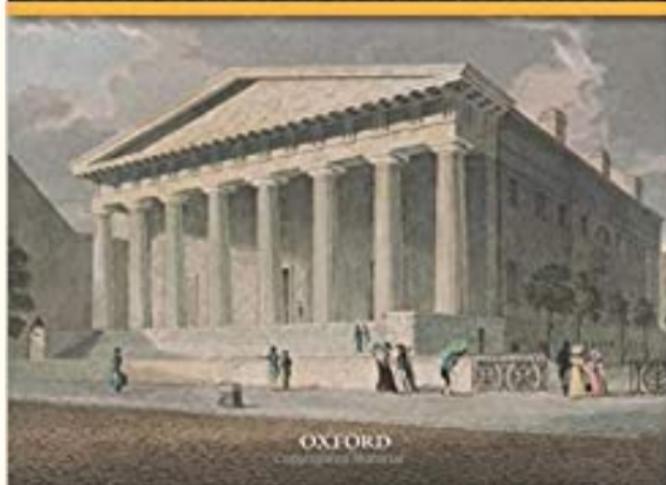
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ULRICH BINDSEIL

Central Banking before 1800

A Rehabilitation



The Bank of England

- Modern central banking starts when the Bank of England opens on July 30, 1694 (some predecessors in Italy, Dutch Republic, and Sweden).
- Its creation is closely related to the institutional changes brought by the Glorious Revolution of 1688.
- Its initial business is to fund the government with £1.2 million during the War of the Grand Alliance (1688-1697).
- It does so by printing paper notes rather than in specie.
- Thus, the Bank of England is an engine of credit from the start.



SEALING OF THE BANK OF ENGLAND CHARTER. 1694.

SIR JOHN HOUBLON.
Governor.

SIR JOHN SOMERS.
Lord Keeper.

MR. MICHAEL GODFREY
Deputy Governor.

The Bank of England and public debt

- Later, the Bank of England lent to the government directly or through the purchase of government debt (discounting).
- The Bank helped establish credible commitment on the part of the government by originating most of the loans.
- It thus provided oversight of the government, especially concerning payment of interest on the debt.
- Eventually, the Bank started managing the government debt directly and a range of government securities.
- By 1770s, the Bank handled 3/4 of the government debt for a fee and held about £11.7 million.

The Bank of England and private businesses

- In addition to lending to the government, the Bank of England made commercial loans, took deposits, and issued notes aiding and deepening financial intermediation in Great Britain.
- Its short-term commercial lending grew in importance over time.
- In London, payments are dominated by Bank of England notes. Probably, it kept £3 in gold for every £5 in notes issued.
- The Bank of England, however, was not an overly dominant force. It did not have a (total) monopoly on note issuance, and it did not act as a clearing house.
- The Bank of England became a banker to banks only gradually. Emergence of modern central banking is a long affair.
- Nonetheless, the Bank is extremely profitable since it opens, paying dividends of 7% or more.

Hamilton and the Bank of England

- In summary, the Bank of England was an essential element in:
 1. Managing the national debt.
 2. Issuing notes.
 3. Acting as a purveyor of credit to industry.
- Hamilton admires these functions and wishes to copy them by creating a similar institution in the United States: the First Bank of the United States (technically, *The President, Directors and Company, or the Bank of the United States*).
- In fact, Hamilton kept a copy of the charter of the Bank of England on his desk as he wrote his Bank Report to Congress.
- Also, the First Bank's creation is intimately linked with the funding of the debt we discussed in a previous lecture: interlocking system.

WINNER OF THE PULITZER PRIZE

BANKS AND POLITICS IN AMERICA

FROM THE REVOLUTION
TO THE CIVIL WAR

BRAY HAMMOND



Hamilton's plan

The financial situation in 1789

- The U.S. financial conditions are dire:
 1. Customs duties generate a mere \$162,000 and country is in default on Revolutionary War debt.
 2. No national currency.
 3. No national bank.
 4. Poorly developed financial markets and banking system.

A radical transformation

- By 1793, however:
 1. Customs duties are \$4.7 million; government can fund itself and pay interest on debt.
 2. Mint has opened and is coining gold and silver dollars, a common unit of account on a decimal basis that displaces foreign and local currencies (bimetallism, though, will cause many problems in the future).
 3. The First Bank of the United States operates with branches in several cities after having gathered \$10 million in capital with an initial raising of equity.
 4. Additionally, ten newly chartered state banks.
 5. 44 new business charters issued, compared to seven during the entire colonial period.
 6. Securities markets in Boston, New York, and Philadelphia price the \$63 million of national debt daily and value the National Bank's stock and state bank stocks.
 7. The financial system has survived financial panics in 1791 and 1792 (more later on these two panics).

An international comparison

- Historians tend to gloss over this, but at the time, there were only two other modern financial systems:
 - Dutch started around two centuries before.
 - Great Britain started around one century before.
- By 1793, the U.S. system has caught on. All within three years.
- It is historically impossible to find a modern, well-functioning economic system without a sophisticated financial system.
- Also, financial difficulties (especially in wartime) are common, but financial revolutions are rare.

Hamilton's intellectual background

- Hamilton is well-read in the economics of the time and is very familiar with the history of banking: Venetian, Dutch, and British.
- Probably related to his early life experience in St. Croix and New York City.
- Hamilton began working on his plans for the U.S. financial system around 1779.
- By then, Hamilton is already anticipating a Constitutional Convention to reform the Articles of Confederation.

“The tendency of a National Bank is to increase public and private credit. The former gives power to the state for the protection of its rights and interests, and the latter facilitates and extends the operations of commerce among individuals. Industry is increased, commodities are multiplied, agriculture and manufactures flourish, and herein consists of the true wealth and prosperity of a state.” Letter to Robert Morris (1781).



A precedent

- Just one year before, on July 17, 1780, Robert Morris has created the Bank of Pennsylvania, the first national bank, to finance the revolution and work as a *de facto* central bank.
- The Bank of North America superseded it in 1781. Robert Morris capitalizes it using loans from France and the Netherlands.
- However, the Bank lingers after the end of the war, becoming a regular commercial banks (bad relations with the Pennsylvania Assembly).
- After many mergers, today its legal “heir” is Wells Fargo.

A central bank for the United States

- Hamilton anticipates that the Bank of the United States would be privately chartered, funded by a combination of foreign debt and domestic equity.
- The government would be a part owner, receiving a share of profits, and the Bank would loan money to the government, facilitating the development of a market in public debt and bolstering the public finances.
- The Bank would issue notes, which would be redeemable in specie, thus stabilizing the currency's value.
- Notably, the Bank would not be a monopoly.

“Most commercial nations have found it necessary to institute banks and they have proved to be the happiest engines that ever were invented for advancing trade.” Letter to Robert Morris (1781).

- Hamilton goes on to publish six essays on his ideas in a New York newspaper in 1781 under the title “The Continentalist.”

A central bank as a foundation for U.S. financial development

- As we discussed before, restructuring the debt goes smoothly:
- Money is raised from increased import duties and some excise taxes.
 1. Tariffs kept relatively low; they are primarily for revenue not protection.
 2. Hamilton is also relying on the improved prospect for growth and the ability to raise additional debt to smooth future taxes as needed.
 3. It is here where the Bank of the United States becomes a crucial ingredient. The Bank is needed to fund the government and help develop financial markets so that debt can be easily subscribed.

Bank Report to Congress

- In December 1790, Hamilton issues the Bank Report to Congress, where he emphasizes three main advantages obtained by creating the Bank of the United States:
 1. It would deepen financial markets encouraging commercial activity and economic growth.
 2. It would provide loans to the government, especially in emergencies.
 3. It would facilitate the payment of taxes because Bank notes and deposits would increase money in circulation.
- The Bank would be privately chartered by Congress:
 1. Government retains 20% share.
 2. Raise \$8 million from private subscribers: Investors could pay for the stock with 1/4 in specie and the rest in U.S. government 6% consols.
 3. Some government oversight.

Implementation, I

- Congress approves the Bank, largely along sectional lines (39 to 20 in the House).
- Suspected (but not proven) that Madison agrees to support the bank in exchange for the new capital to be in the south (DC). Madison will regard his support for the bank as his biggest political mistake.
- On February 25, 1791, Washington signs the “bank bill” into law.
- Stock is oversubscribed by July 1791, and operations start on December 12, 1791.
- Headquarters in Philadelphia. Hamilton chooses Philadelphia, in part, to keep power in the North.
- The Bank opens branches in Boston, New York, Baltimore, and Charleston the following year.



Implementation, II

- States copy the idea, and 17 state Banks are chartered between 1791-1795, bringing the total to 20 by 1795 and 28 by 1800.
- Soon, we have a national banking network.
- Securities markets expand with exchanges in New York, Boston, Philadelphia, Charleston, and Baltimore.
- New financial sector helps spur U.S. economic growth to the 1-1.5% range. Especially, New England and New York.
- 20 years chart. It expires in 1811, and it is not renewed. Why?

The operations of the First Bank

The initial public offering, I

- The \$8m privately subscribed was the largest stock offering in the U.S. to date, and it was oversubscribed:
 1. 25,000 shares at \$400 each, with 20,000 being sold to the public on the first Monday in July (5,000 shares bought by the U.S.; it happens to be the 4th).
 2. 1,000 share maximum for any individual, with a down payment of \$25 and a schedule of later payments.
 3. Oversubscribed by 20%, so shares scaled down pro-rata.
 4. Widely distributed over the entire country. As much as 70% of the shares would be eventually owned by foreign investors.
- It appears the IPO price was too low. Madison makes that point in a letter to Jefferson.
- The initial subscribers obtained large profits at the expense of the Treasury, which could have raised a good deal more capital than it did.

The initial public offering, II

- Speculative bubble erupts, and then prices crash, resulting in a short-lived financial panic before the Bank even opens its doors.
- By early August, the share price or right to own the stock had increased ten-fold to \$250, implying a fully paid share was worth \$625, for a one-month profit of over 50%.
- Prices for a piece of scrip (the right to a share) topped out at around \$325 on August 11, fueled by notions that the return on the stock could reach 12% per year.
- Bank of New York curtails loans to speculators, and a panic sets in with prices plummeting to \$110 on August 15.
- Hamilton quells the plummeting by directing the Bank of New York to purchase stock and, in September, purchases more.
- This measure stops the free-fall in the share price, and it fluctuates between \$130-\$170 over the rest of the year.

Organization

- 25 directors elected by shareholders:
 1. Seven face reelection each year.
 2. Determine salaries of the officers and clerks.
 3. Supervise the supply of bank notes.
 4. Approve loan applications.
 5. Appoint the Bank President.
- Thomas Willing elected unanimously. Already President of the Bank of North America and partner in *Willing and Morris*. Strong Federalist, former judge of the Pennsylvania Supreme Court, and perhaps wealthiest person in Philadelphia.
- Semi-annual dividends.
- Cap on property held of \$15 million.



Branching

- Hamilton preferred no branching or at least waiting until the Bank was operating effectively.
- Board believes, instead, that branches improve profitability and information concerning any financial problems in the country.
- How would towns that did not get branches react? How would state-chartered banks react to a branch opening in their town?
- Thinking back then was that only one bank in a city would survive.
- On November 8, full board approves branches in Boston, New York, Baltimore, and Charleston to open the following spring.
- Richmond the following July, but there is significant local opposition, and Board reverses its decision.

The loan book

“A general circulation of Bank paper, which is to be expected from the institution lately established will be a most valuable means to promote pecuniary remittances from place to place.” Hamilton in his report on manufactures.

- Initial limit on loans to specie was 5 to 1 or 5 times capital. A very low leverage ratio compared to modern banking. Stayed pretty much in line with this directive.
- As part of a loan, the borrower received the Bank's notes or a credit to his account at the Bank. Loan was discounted at 6%. For example, if a merchant was granted a \$100 loan for thirty days, he would receive \$99.52. This is why loans are often referred to as discounts.
- Initial maturities on loans are set at 30 days, although the board had the authority to issue 60-day loans.
- Prefers business loans to personal loans or accommodations, but insider lending existed and may have been fairly widespread. Substantial uncertainty regarding the extent.

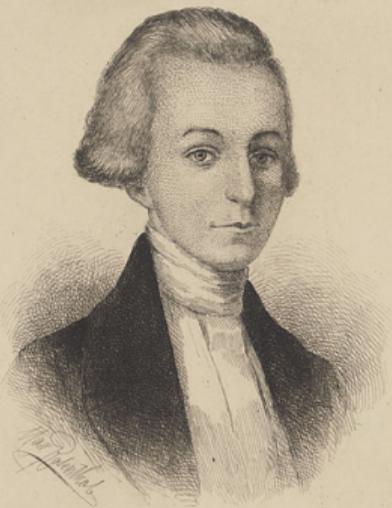
INSIDER LENDING

*Banks, Personal Connections,
and Economic Development in
Industrial New England*

NAOMI R. LAMOREAUX

The Panic of 1792

- Initially, the First Bank floods the market with credit but changes course in February 1792.
- This change causes a stock market crash, the first in U.S. history.
- The largest speculator was William Duer, whose financial company failed in March, paralyzing credit markets.
- Old friend of Hamilton: invited to work on *The Federalist* and in the Treasury, also related through the Society for Establishing Useful Manufactures.
- Once again, Hamilton orders the Treasury to purchase securities, and branches of the Bank are opened during the panic.



WILLIAM DUER,
Member of the Continental Congress.

Wm. Duer

Underpinning of the crash

- In December 1791, William Duer and Alexander Macomb try to corner the U.S. securities market secretly, including the stock of the First Bank and the Bank of New York (“Six Percent Club”).
- In particular, William Duer goes after the fixed-income market consisting of U.S. government securities.
- There is a schedule of payments investors must make for their shares in the First Bank, and those payments can be made in 6% U.S. bonds.
- This created a natural demand for bonds, and if you hold most of them, you can reap a sizeable profit as those bonds are sought to satisfy payments.
- However, with the Bank withholding credit, security prices drop by $\sim 25\%$ between January and April.
- The price fall bankrupts Duer, who used loans to purchase the security. He may have owed as much as \$500,000.

Consequences of the crash

- The crash may have resulted in \$3 million loss in New York.
- Changes in the rules to negotiate securities (collateral, etc.).
- Some evidence that First Bank was partly to blame as it starts restricting credit the previous February.

	Dec 29	Jan 31	Mar 9
Outstanding notes	134,268	886,684	891,873
Bills discounted	964,260	2,675,441	2,051,564
Cash on hand	706,048	510,345	244,371
Deposits			
Total	1,031,125	1,279,041	1,169,419
Individual	898,125	811,863	569,550
Government	133,000	467,178	599,869
Capital	496,550	993,775	993,775

Table 1: Balance sheets: Philadelphia December 29, 1791; January 31, 1792; March 9, 1793

Boom and bust, I

- The First Bank floods market in January 1792: \$964,000 in first two weeks of operation.
- Bank of New York stops accepting notes on January 26.
- Did the First Bank curtail lending in February?
 1. The next existing balance sheet that survived is March 9, 1792. The Bank did not renew almost 25% of the 30-day discounts from the end of January until March (\$625,000 in loans called in).
 2. There is evidence that the First Bank started curtailing issuance in mid-February (letters of the times).
- Why? The First Bank realizes it has been too aggressive, causing its notes to trade at a discount in Boston and for the Bank of New York to stop accepting its paper. Anything but a secure medium of exchange.

Boom and bust, II

- Spectre of paper being returned for specie. Between the end of January and March 9, almost \$270,000 of notes returned.
- Specie is flowing out too quickly.
- Additionally, branches were set to open in 2 months, and \$500,000 in seed money is needed for each branch.
- The First Bank needs to curtail the expansion of credit.
- Curtailment appears to be happening in Boston at the Massachusetts Bank and Bank of New York, but their actions were rather small compared to First Bank. They are much smaller in size.
- Fortunately, the 1792 financial panic did not lead to a recession. Similar to black Friday in October 1987, when the market tumbled more than 25% with no discernible economic effect.

Boom and bust, III

- The four branches open during the crisis. The main board elects local boards. The last to open is in Baltimore in June.
- Hamilton stems the crisis by injecting liquidity into financial markets in March. He also secures a new loan from the Dutch of 3 million florins, which calms fears.
- New York branch adds liquidity as well. And, in Philadelphia, First Bank resumes discounting to merchants in May following a large infusion from the Treasury in mid-April.
- It is possible that Hamilton coordinated the events.
- Safe principles would guide the Bank over the next 20 years.
- The financial machinations draw Jefferson's ire, and he and Madison attack Hamilton viciously.

“take up your pen, select the most striking heresy and cut [Hamilton] to pieces in the face of the public” (Jefferson to Madison)

The First Bank as a Treasury agent

- Initially, the First Bank's primary role is in assisting the Treasury, acting as its fiscal agent collecting tax receipts and making payments as well as transferring funds on its behalf:
 - Treasury earns interest on its deposits.
 - Transfers specie to foreign governments.
 - Lends directly to the Treasury. Initially, \$6 million was lent to the government.
- Also the Bank accepts its own notes as means of payment of taxes.

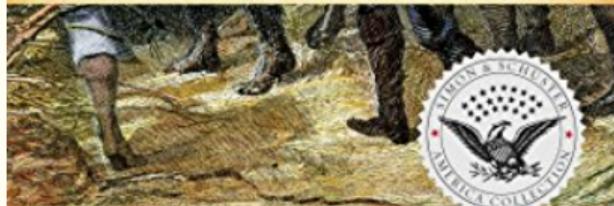
An Example: the Whiskey rebellion

- In 1791, the U.S. government imposes an excise tax on distilled liquors: “whiskey tax.” A good revenue source and one that Hamilton wants to avoid falling into the hands of the states.
- Why so problematic?
- Farmers in western Pennsylvania refuse to pay (similar to Shay’s Rebellion in 1786-1787 and Fries’ in 1799-1800).
- Washington tries to enforce tax more vigilantly in 1794, which leads to open revolt and riots from Pennsylvania to western Virginia.
- The U.S. sends in troops raising a militia of 13,000 troops. The overwhelming force suppresses the rebellion without a shot being fired.
- Government needs money and needs it quickly to put that many men in the field. Calls on First Bank for two loans of \$1 million dollars each.



THE WHISKEY REBELLION

George Washington, Alexander Hamilton, and the Frontier
Rebels Who Challenged America's Newfound Sovereignty



"The most compelling and dramatically rendered story of the Whiskey Rebellion ever written." —GARY B. NASH, Professor of History and Director of the National Center for History in the Schools, UCLA

WILLIAM HOGELAND

Author of Declaration

Additional borrowing

- Additionally, the loan is used to cover government shortfalls at the time and to build a fleet to send against the Barbary pirates. But the costs of the Whiskey rebellion are so large that shipbuilding is put on hold.
- Hamilton borrows another \$2 million to cover the payment on the initial loans, and the Bank raises funds by issuing \$2 million in 6% bonds.
- In total, the Bank lends \$5.5 million to the government during 1794 and 1795.
- This comes at the cost of issuing fewer private loans to private businesses.
- Evidence of “crowding out” comes from the decline in private deposits as these are drawn down to pay for existing loans.
- As well, the proportion of loans granted fell drastically, in Baltimore by as much as 2/3 (goes from \$1.22 of loans requested for each dollar lent to \$2.03 requested for each dollar lent).

The First Bank as a central bank, I

Dallas to Calhoun, 1815

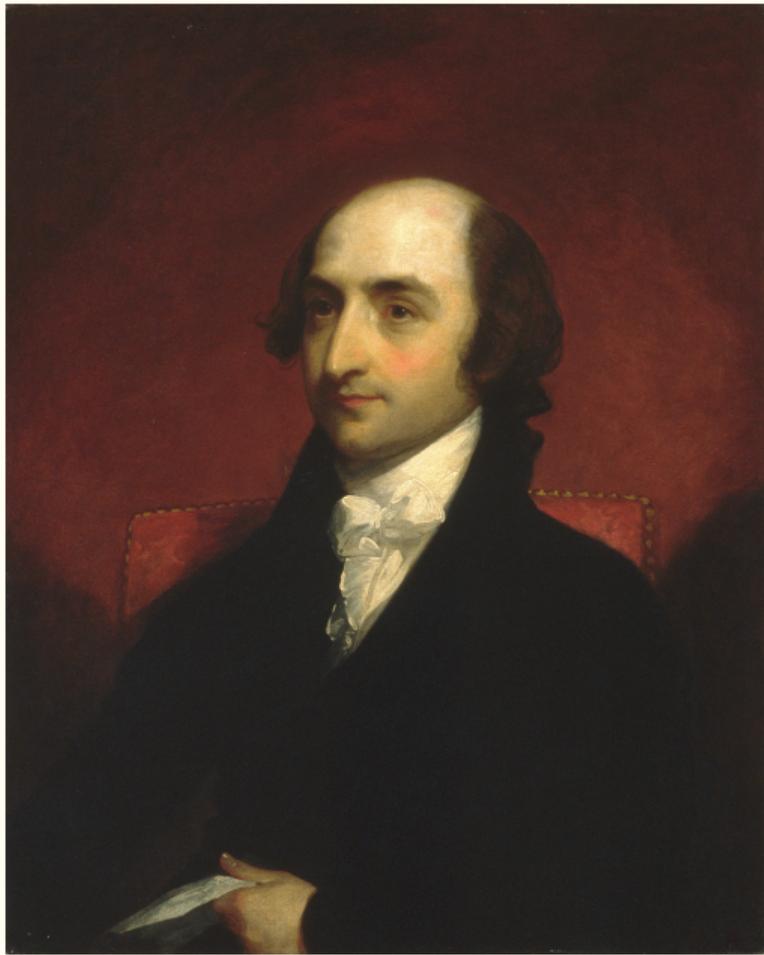
"[The Bank of the United States] ought not to be regarded as a commercial bank. It will not operate upon the funds of the stockholders alone, but much more upon the funds of the nation. Its conduct, good or bad, will not affect corporate credit alone, but much more the credit and resources of the government. In fine, it is not an institution created for the purposes of commerce and profit alone, but much more for the purposes of national policy, as an auxiliary in the exercise of some of the highest powers of government.⁵"

The First Bank as a central bank, II

- To be a central bank, there needs to be a banking system.
- At First Bank's inception, there were only three other banks: Bank of New York, Bank of North America, and the Bank of Massachusetts.
- By 1811, there are 88 banks. The U.S. moves to a fairly developed financial system in a very short time.
- The First Bank takes on a supervisory role by reigning in state banks that it believed were over-issuing notes. It would gather up state bank notes and tender them for specie, thus constraining further issuance.
 - Boston branch president (1807): "We are charged with doing injury to other Banks by draining them of their specie and retaining it by limitation of our discounts."
 - So sacrificing its own profits to ensure the stability of banking system.
- However, the First Bank does not act as a lender of last resort by lending to other banks in a crisis.

Overlaps between the First Bank and the Treasury, I

- Hamilton also promotes state banks, and the Treasury acts to some extent as a regulator asking for monthly statements of various bank accounts.
- Treasury under Albert Gallatin (1761-1849) reigns in the First Bank when it believes it is excessively calling in bonds from state banks.
 - “A complaint has been made that at Baltimore the drafts of the Branch Bank on the other Banks of that city have been unusually large & particularly draining...”
 - He tells the Baltimore branch to back off (following Hamilton’s precedent with the New York Branch).
 - Further, the First Bank is not truly independent. Hamilton and Gallatin clearly state that the Treasury can inflict great harm on the First Bank if it does not serve the government’s interest.
 - Indeed, some individuals were employed simultaneously by the Treasury and the First Bank.



Overlaps between the First Bank and the Treasury, II

- Lending to Banks is an activity of the Treasury, which demands adequate security that its loans will be repaid.
- During the yellow fever epidemic in New York in 1798, the Treasury made sure there was adequate liquidity by discounting acceptable paper.
- Treasury also boosts deposits to First Bank during the shortfall in specie during 1804 so that the Bank does not have to curtail lending.
- So, it is basically the Treasury that acts as the central bank using the First Bank as its instrument.

An economic assessment, I

- Government pays off \$1.2 million of the public debt by selling off much of its Bank stock.
- After that, the debt is repaid gradually.
- Jefferson begins depositing federal government funds in state banks.
- Bank lasts for 20 years, and the charter is not renewed during the Madison administration.
- By then, the U.S. has a well-established financial system that developed in a remarkably fast manner.

An economic assessment, II

- The First Bank is an integral part of the development of the U.S. financial system.
- Some of that is due to its tremendous size. Capitalized at \$10 million, which dwarfs the total capital of the \$3 million of the five banks already in existence.
- When it closed in 1811, it had as much specie in its vaults as all the other 89 banks combined.
- While not a full-fledged central bank, the First Bank takes on many of the responsibilities associated with central banking.
- Hamilton's blueprint for the economy turns out to be extraordinarily successful.
- Stephan Girard, the largest shareholder, acquires the headquarters and operates the bank using a Pennsylvania charter.

The political economy of the First Bank

RECONSTRUCTING
THE
NATIONAL
BANK
CONTROVERSY

POLITICS & LAW
IN THE
EARLY AMERICAN
REPUBLIC

ERIC LOMAZOFF

Opposition to the First Bank

- The argument for the Bank was hotly contested on economic and constitutional grounds.
- Thus, in 1811, the Bank does not have enough allies to renew its chart: tie in the Senate for its re-charter. Deciding negative vote: vice president George Clinton.
- Southerners in general oppose it:
 1. They consider the bank is anti-agrarian, with farmers at the mercy of city institutions.
 2. Ability to issue notes sparks fears of inflation.
 3. Also, southerners are worried about its size and, hence, potential monopoly power.
- Washington asks his cabinet whether he should veto the bank. Madison, Jefferson, and Randolph oppose it on constitutional grounds.
- Constitution does not grant the government the power to incorporate a bank: they argue that the Constitution is a document establishing a limited government.

Enumerated vs. general powers

- In the U.S. Constitution, there are:
 1. **Enumerated** powers: those powers expressly listed.
 2. **General** powers: those given to the government to serve the general welfare of the people.

General Welfare Clause, Article I, Section 8

“The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States;”

The Necessary and Proper Clause, Article I, Section 8

“The Congress shall have Power... To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.”

Jefferson's arguments

- Jefferson dislikes all corporations.
- Also, he argues:

Opinion on the Constitutionality of a National Bank, 1791

“...the foundations of the Constitution [was] laid on this ground that ‘all powers not delegated to the US by the Constitution, nor prohibited by it to the states are reserved for the states or the people.’ [10th amendment]. To take a single step beyond the boundaries drawn around the powers of Congress, is to take possession of a boundless field of power no longer susceptible of any definition.”

- Radically opposed to the idea: suggests to Governor Henry Lee of Virginia (the father of Robert E. Lee) that anyone who recognized the Bank in Virginia is guilty of high treason and should suffer death.

Madison's arguments, I

- Madison insists that Hamilton wants to use the government to establish the national bank as a corporation, a power that falls outside of Article 1, Section 8, as a power granted directly to Congress.
- Attorney General Randolph tells President Washington that he agrees with Madison's reasoning.
- Thus, Washington asks Madison to draft a veto in case he decides against the Bank.
 - Madison bases it on the Constitution not warranting the Act: the Constitution is a grant of particular powers, and the "necessary and proper" clause should not be considered as granting powers other than those consistent with "the incidentality to an express authority."
 - "Necessary and proper" can not mean unlimited discretion. At a minimum, a measure that comes within the meaning of a clause and "to means necessary to the end and incidental to the nature of specified powers."
 - The Bank bill is not a borrowing of money or a levy of taxes but the exercise of a power not enumerated.
 - It is impossible to discover within the Constitution a power to incorporate a Bank. Indeed the power of incorporation was rejected at the Convention.

Madison's arguments, II

- Madison worries particularly that a Bank bill is a usurpation destroying the main characteristic of the Constitution:

“To borrow money is made the end and the accumulation of capitals implied as the means. The accumulation of capital is then the end and a bank implied as the means. The bank is then the end and a charter of incorporation, a monopoly implied as the means. If implications thus remote and multiplied can be linked together, a chain may be formed that will reach every object of legislation, every object within the whole compass of political economy.”

- The argument appears different from Madison's own writings in Federalist 44, where he strenuously defends the necessary and proper clause.

Federalist 44, I (Madison)

The SIXTH and last class consists of the several powers and provisions by which efficacy is given to all the rest.

1. Of these the first is, the “power to make all laws which shall be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the government of the United States, or in any department or officer thereof.”

Few parts of the Constitution have been assailed with more intemperance than this; yet on a fair investigation of it, no part can appear more completely invulnerable. Without the SUBSTANCE of this power, the whole Constitution would be a dead letter. Therefore, those who object to the article as a part of the Constitution can only mean that the FORM of the provision is improper. But have they considered whether a better form could have been substituted? There are four other possible methods which the Constitution might have taken on this subject. They might have copied the second article of the existing Confederation, which would have prohibited the exercise of any power not EXPRESSLY delegated; they might have attempted a positive enumeration of the powers comprehended under the general terms “necessary and proper”; they might have attempted a negative enumeration of them, by specifying the powers excepted from the general definition; they might have been altogether silent on the subject, leaving these necessary and proper powers to construction and inference.

Federalist 44, II (Madison)

Had the convention taken the first method of adopting the second article of Confederation, it is evident that the new Congress would be continually exposed, as their predecessors have been, to the alternative of construing the term "EXPRESSLY" with so much rigor, as to disarm the government of all real authority whatever, or with so much latitude as to destroy altogether the force of the restriction. It would be easy to show, if it were necessary, that no important power, delegated by the articles of Confederation, has been or can be executed by Congress, without recurring more or less to the doctrine of CONSTRUCTION or IMPLICATION. As the powers delegated under the new system are more extensive, the government which is to administer it would find itself still more distressed with the alternative of betraying the public interests by doing nothing, or of violating the Constitution by exercising powers indispensably necessary and proper, but, at the same time, not EXPRESSLY granted.

Had the convention attempted a positive enumeration of the powers necessary and proper for carrying their other powers into effect, the attempt would have involved a complete digest of laws on every subject to which the Constitution relates; accommodated too, not only to the existing state of things, but to all the possible changes which futurity may produce; for in every new application of a general power, the PARTICULAR POWERS, which are the means of attaining the OBJECT of the general power, must always necessarily vary with that object, and be often properly varied whilst the object remains the same.

Federalist 44, III (Madison)

Had they attempted to enumerate the particular powers or means not necessary or proper for carrying the general powers into execution, the task would have been no less chimerical; and would have been liable to this further objection, that every defect in the enumeration would have been equivalent to a positive grant of authority. If, to avoid this consequence, they had attempted a partial enumeration of the exceptions, and described the residue by the general terms, NOT NECESSARY OR PROPER, it must have happened that the enumeration would comprehend a few of the excepted powers only; that these would be such as would be least likely to be assumed or tolerated, because the enumeration would of course select such as would be least necessary or proper; and that the unnecessary and improper powers included in the residuum, would be less forcibly excepted, than if no partial enumeration had been made. Had the Constitution been silent on this head, there can be no doubt that all the particular powers requisite as means of executing the general powers would have resulted to the government, by unavoidable implication.

Federalist 44, IV (Madison)

No axiom is more clearly established in law, or in reason, than that wherever the end is required, the means are authorized; wherever a general power to do a thing is given, every particular power necessary for doing it is included. Had this last method, therefore, been pursued by the convention, every objection now urged against their plan would remain in all its plausibility; and the real inconveniency would be incurred of not removing a pretext which may be seized on critical occasions for drawing into question the essential powers of the Union. If it be asked what is to be the consequence, in case the Congress shall misconstrue this part of the Constitution, and exercise powers not warranted by its true meaning, I answer, the same as if they should misconstrue or enlarge any other power vested in them; as if the general power had been reduced to particulars, and any one of these were to be violated; the same, in short, as if the State legislatures should violate the irrespective constitutional authorities. In the first instance, the success of the usurpation will depend on the executive and judiciary departments, which are to expound and give effect to the legislative acts; and in the last resort a remedy must be obtained from the people who can, by the election of more faithful representatives, annul the acts of the usurpers.

Federalist 44, V (Madison)

The truth is, that this ultimate redress may be more confided in against unconstitutional acts of the federal than of the State legislatures, for this plain reason, that as every such act of the former will be an invasion of the rights of the latter, these will be ever ready to mark the innovation, to sound the alarm to the people, and to exert their local influence in effecting a change of federal representatives. There being no such intermediate body between the State legislatures and the people interested in watching the conduct of the former, violations of the State constitutions are more likely to remain unnoticed and unredressed

Hamilton's reply, I

- Hamilton writes a reply on the night of February 22, 1791 (at 79 3rd Street) based on necessary and proper clause: *Opinion as to the Constitutionality of the Bank of the United States*.
 - Washington asks Randolph and Jefferson first, thus giving Hamilton the last word.
 - This shows Washington's prior in favor of the desirability of the bank.
- Basis for a broad interpretation of government power under the Constitution by making the argument for implied powers of government.
- Thus, Washington and Hamilton lay the foundation for an expansive view of federal government and the interpretation of the constitution.
- Start of Washington's eventual break with all other prominent Virginians: Jefferson, Madison, Randolph, etc. (already separated from George Mason). Importance in balancing the Union during its first years.

Hamilton's reply, II

- Hamilton's opinion is in concert with the writings in Federalist 44.

“If the end be clearly comprehended within any of the specified powers, and if the measure have an obvious relation to that end and is not forbidden by any particular provision of the Constitution, it may safely be deemed to come within the compass of the national authority...

This general principle is inherent in the very definition of Government and essential to every step of the progress to be made by that of the United States; namely – that every power vested in a Government is in its nature sovereign, and include by force of the term, a right to employ all means requisite and fairly applicable to the attainment of the ends of such power;”

Hamilton's reply, III

- Hamilton bases his argument on the fiscal policy nature of the Bank; it will help with the collection of taxes through printing notes redeemable in specie and that can be used to pay taxes, it will help with the payment of the debt, and it will aid raising future debt when necessary.

“The power which can create the Supreme law of the land, in any case, is doubtless sovereign as to such case. This general & indisputable question puts at once an end to the abstract question – Whether the United States have power to erect a corporation.”

- Basically, Hamilton is arguing that any power is available if not prohibited by the Constitution. This is a very elastic interpretation.

“It has been questioned by some, whether the Act of Congress, for establishing the Bank of the United States, is Constitutional; but if it is a useful means for carrying into effect any of the powers specifically vested in the government of the United States, and does not infringe the rights of any individual state or persons, on what principle can it be unconstitutional.”

Who was right?

- The dispute has an economic and a legal component.
- Giving a monopoly as the government's fiscal agent would give the Bank an enormous advantage over competitors.
- The U.S., after Jackson and before the Federal Reserve Act, has no national bank, yet has remarkable economic success and carries out its fiscal policies without significant difficulty.
- Southerners' misgivings were, therefore, not totally unfounded. Patrick Henry had already warned during Virginia's Constitutional Convention that the "necessary and proper" clause opened the door to a gigantic expansion of federal power.
- However, at the time, there was not a sophisticated financial system in the U.S., so an institution like the First Bank would have been more helpful than at later dates, when there existed a well-developed private banking system.
- What about the constitutional issue?

The Supreme Court and the National Bank

- Washington signs the bill on February 25, only after being convinced it is constitutional.
- Washington initially viewed the veto power as one to be used only when a law passed by Congress was unconstitutional, not for reasons concerning his agreement with the legislation.
- Judicial review will not come to the fore until *Marbury v. Madison* (1803).
- However, we can uncover how the Marshall Court would have ruled by looking at his decision in *McCulloch v. Maryland* (1819).

The Second Bank of the United States

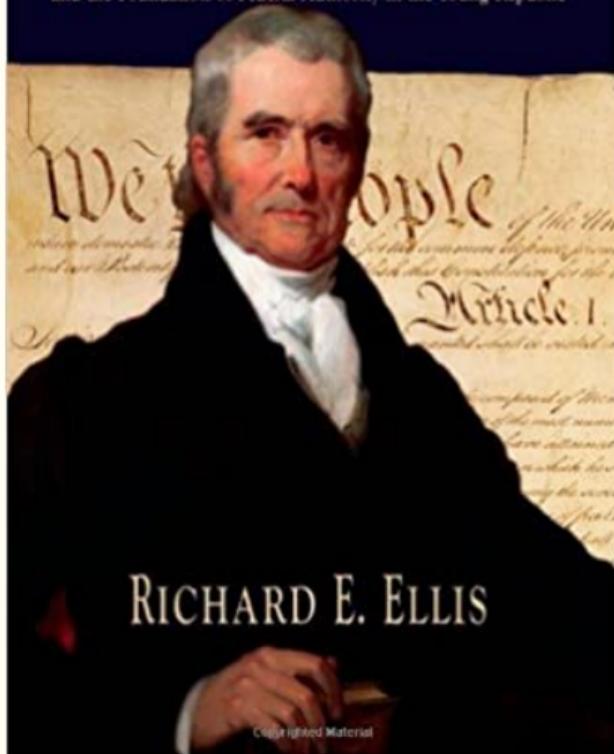
- After the First Bank charters expires in 1811, a Second Bank of the United States is organized in 1816 as a government-sponsored enterprise.
- Due to experience of the War of 1812. In fact, two leading proponents are southerners (Henry Clay and John C. Calhoun).
- Government gives it an exclusive charter and owns 20%. The President, with the consent of the Senate, appoints 5 of its 25 directors.
- Treasury keeps its deposits and specie at the Bank.
- Its notes are tender for payments to the U.S. government, which effectively makes them universally accepted.
- It also engages in commercial banking.

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Aggressive Nationalism

McCulloch v. Maryland

and the Foundation of Federal Authority in the Young Republic

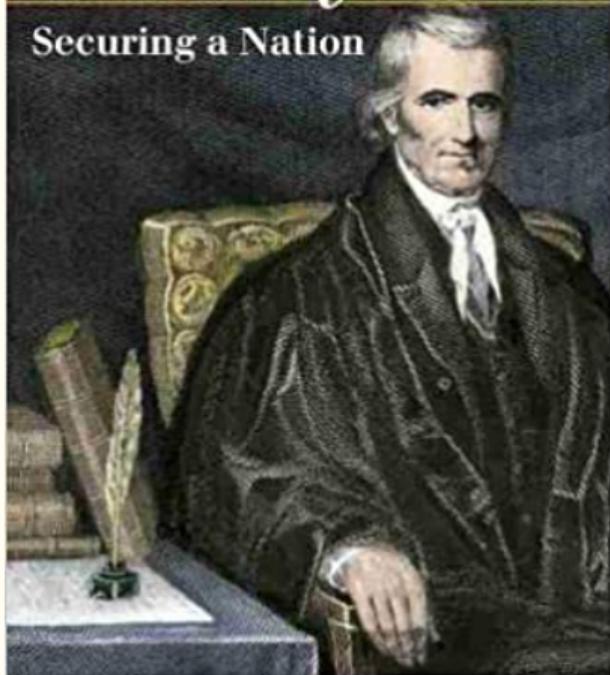


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M'Culloch
v. Maryland

Securing a Nation



McCulloch v. Maryland (1819), I

- Maryland decides to tax the Second Bank of the United States' notes.
- Recall that the Second Bank is a fiscal agent of the Treasury.
- Can a state tax an agency of the U.S. government?
- Maryland argues yes because the laws to be authorized are to be “necessary and proper” for the purpose, not “necessary or proper”.
- In Maryland's view, convenience is not a justification but must be “indispensably requisite.”
- Maryland's decision is ruled unconstitutional by the court 7-0 (only seven justices at the time), with John Marshall's writing the decision.

McCulloch v. Maryland (1819), II

- Marshall's opinion is, in some places, almost word for word what Hamilton wrote almost 30 years prior.
- Marshall rejects Maryland's argument and indicates that convenience is a justification. Necessary implies that any means that accomplish the end are allowable. Does not mean absolutely necessary, a phrase that appears in Article 1, Section 10.
- The legislature must be able to “avail itself of experience, to exercise its reason, and to accommodate its legislation to circumstances.”
- Marshall fears that the national government will fail without being able to exert discretion and that discretion will not undermine the enumerated powers, as Madison had argued earlier.

McCulloch v. Maryland (1819), III

- He casually dismisses the notion that the discretion granted will jeopardize what everyone knows. “This government is acknowledged by all to be one of enumerated powers.”
- In contrast to Madison, who gave examples of enumerated powers that were not left to implication, he gives three examples of unenumerated powers: to carry mail between post offices, to punish any violations of its laws, and to require congressional oaths of office.
- Of all these examples, Madison would have found them easy to justify. There is a definite connection between means and ends in all of them. The power to carry mail is “incident to the nature” of enumerated powers in Article 1, Section 8, and defending its laws is incident to the ability to make them.

McCulloch v. Maryland (1819), IV

- Marshall argues that the Bank is incidental to the furtherance of Congress's fiscal operations.

“Let the end be legitimate, let it be within the scope of the Constitution and all means which are appropriate, which are plainly adopted to that end, which are not prohibited, but consist with the letter and spirit of the Constitution, are Constitutional.”

- However, the constitution is a document of enumerated powers, not enumerated restrictions.
- Also, the country does without a national bank from 1811-16 and 1836-1914.

Current interpretations, I

- How would some current originalists approach the reasoning in this decision?
- At the time “necessary” was defined as 1. needful; indispensably requisite. 2. Not free; fatal; impelled by fate. 3. Conclusive; decisive by inevitable consequence”.
- Maryland’s argument applies this meaning. It does not imply convenient or useful.
- But the Constitution also contains the term “absolutely necessary” perhaps implying that “necessary” does not imply indispensable when used by itself. As well, in Article 11, Section 3 the words “necessary and expedient” are used, further indicating that necessary is not synonymous with indispensable.
- But if necessary is synonymous with expedient, why use it all in necessary and expedient?

Current interpretations, II

- George Mason introduces the article II language at the 11th hour with an amendment, so not much thought was given to the phrase. Mason's earlier statements at the Convention also made clear that he equated necessary with indispensable.
- It is interesting that Madison himself rejected that necessary meant indispensably necessary because “very few acts of the legislature could be proved essentially necessary to the absolute existence of government.”
- Madison urged that the words be “understood so as to permit the adoption of measures the best calculated to attain the ends of government, and produce the greatest quantum of public utility.”
- Thus, as was argued by Hamilton, necessity should not be so strict that no statute can pass, nor so lenient that any statute can pass. An appropriate level of scrutiny is required.

Current interpretations, III

- Many current constitutional scholars may interpret Marshall's opinion in an open-ended fashion. Certainly, his 1803 opinion in *United States v. Fisher* is open-ended, but in *McCulloch*, he is more circumspect.
 - “The means chosen must be “plainly” adapted to the end, not merely conducive to it; tenuous connections to granted powers will not pass muster. It must, in addition be “appropriate,” which implies some supervision of the reasonableness of the means...”
 - It must not be a “mere pretext ... for the accomplishment of objects not entrusted to the government.” It must be consistent with the spirit as well as the letter of the Constitution.
- However, in *McCulloch*, Marshall does make much effort to provide the scrutiny that would justify the Bank.