Crypto currency crashes recall 'wildcat' banking

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Chenzi Xu feels like she's watching history repeat itself. The cryptocurrency exchange FTX recently went belly up, vaporizing billions in customers' deposits. A few months earlier, the Luna coin lost 99% of its value in one week, the latest in a series of shocks to the crypto market that started when Bitcoin's value plunged in early 2022. These crashes, Xu says, recall the wild days of the mid-19th-century American banking system, when thousands of banks printed their own currencies, often backed by unreliable investments.

"There's a time historically when we didn't have fully backed banknotes," says Xu, an assistant professor of finance at Stanford Graduate School of Business. "So we had lots of runs on those notes and, subsequently, bank failures." Xu sees many of the mistakes and vulnerabilities of that era being played out today in the largely unregulated market for digital money.

In a new working paper for the National Bureau of Economic Research, Xu and He Yang, a former graduate student in economics at Harvard, look at what banking in the U.S. was like on the eve of America's first modern banking regulations. "It's absolutely wild," Xu says. "The U.S. was very anti-centralization, especially in the financial sector."

In 1836, President Andrew Jackson let the charter of the Second Bank of the United States expire, kicking off what is now known as the Free Banking Era. The country had no unified banking system. Instead, towns had their own independent banks, all of which were only allowed to have one branch. On the eve of the Civil War, there were 1,600 private banks across the country and, confusingly, each one used a different kind of money, known by names like shinplasters, shingles, stump tails, and red dogs. "Every bank would fund itself in part by printing paper money, and therefore every single individual bank around the U.S. would have its own currency," Xu says.

Because there was such a confusing array of currencies of uncertain underlying value, they often couldn't be used in neighboring areas or states. Unless it could be verified that a banknote was actually worth something (i.e., it wasn't counterfeit or issued by a bank that had failed or was on the verge of failing), people would not be willing to take it in payment for a debt. All this made it exceedingly difficult for Americans to trade or travel domestically because they couldn't be sure that their money would be accepted—or that the money they received was genuine.

The value of customers' dollars could change dramatically from one day to the next. And it could crash entirely if they'd trusted an undercapitalized or unscrupulous banker. Ideally, currencies would be backed by gold, the standard at the time; but often, they were backed by stocks or land investments. If those investments crashed, that could trigger a run on the bank. If it didn't have enough gold to cover all the notes it had issued (which it usually didn't), it would go bust.

Free from regulation, "wildcat" banks could print more money than they had assets to back up. "The unscrupulous model was to print stuff and hope that somebody uses your notes," Xu says. "Then when they come and find you, you've gone bankrupt." The same scenario, she says, can play out with cryptocurrencies. "You issue them and you hope somebody buys them and pays real U.S. dollars for them. But then when they want to get out, when they want to convert back into dollars, that cryptocurrency might not be worth anything."

The buck stops with Uncle Sam

While crypto losses can be massive, investors can still go back to using dollars. In the mid-19th century, in towns where the private currency was devalued or a bank failed, residents could be left without a ready supply of money, essentially freezing payments in the local economy. And the country as a whole didn't have enough banknotes in circulation. The only alternative was to use gold, which was heavy, hard to transport, and a target for robbery.

The country needed a new form of money that was safe and liquid, meaning it wouldn't suddenly lose all its value and could be used to buy and sell things everywhere. The solution didn't come out of common sense; it came out of necessity. "You can almost think of it as a historical accident," Xu says.

The U.S. government needed lots of money to fight the Civil War and had invented a new national paper currency known as "greenbacks." But they were unbacked, and people didn't trust them. Greenbacks that were nominally worth $1 could only buy 50¢ worth of goods.

So in 1863 and 1864, Congress passed the National Bank Acts, which established a national banking system and a national currency fully backed by Treasury bonds. The new national banks were strictly regulated to be more stable and the value of the dollar was no longer tied to the fortunes of the local bank. The National Bank Acts' effect on trade was significant. A reliable, safe, and liquid currency helped towns and cities become more integrated into a national market.

However, national banks were still private institutions that were founded locally, and not all towns had one. Xu and Yang use census data from 1870 to 1890 to measure the impact of locally established national banks on local economies. They find that a 10% increase in access to safe money over one decade translated to a 3% increase in manufacturing and agricultural output from more trade integration.

That increase in monetary access also led to a 6% increase in Americans working in manufacturing jobs and a 4% increase in urban populations. The regulation many Americans had long feared actually solved one of the major problems that had constrained commerce. Even so, it took another five decades for Congress to formalize this system by creating the Federal Reserve in 1913.

Some of the lessons of the wildcat era may apply to cryptocurrency, which is a form of privately created money that's only as good as the (sometimes questionable) assets underlying it. Access to safe and liquid forms of money is still crucial for communities to grow and thrive economically. Xu says that cryptocurrencies could help countries or communities without a stable currency integrate into international markets. Yet, she warns, just like paper money, "a stablecoin is only stable if it's fully backed."

More information: Real Effects of Supplying Safe Private Money (May 2022). NBER Working Paper No. w30060, Available at SSRN: ssrn.com/abstract=4117087

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