01.30.07

Private Money in Our Past, Present, and Future

by Bruce Champ

Who is allowed to issue money in the United States? The founding fathers made it clear that the power to create money would not be taken lightly. Their experiences with money and inflation during the Revolutionary War made them wary of paper money and conscious of the power wielded by those authorized to create it. They gave Congress the right to issue money and forbade the states from doing so. But the federal government isn't the only entity that has, in practice, issued money. Private citizens and private companies have, too.

In the 1800s, for example, much of the country's paper currency consisted of notes issued by private banks. Nowadays, commercial banks don't print their own notes, but they create money just the same—in the form of checking accounts. People and companies other than banks have also occasionally seen the need to create their own forms of money.

Private money—money issued by individuals or companies—can be seen as an innovation that arises to fill a void left by the federally provided money of the day. Studying various examples of private money that have arisen throughout U.S. history has taught economists much about the qualities money must have to be useful. In this Commentary, we describe some of the needs private money has arisen to fill and some of the problems people have encountered when making or using private money. We consider the lessons our experiences with private money imply for our money today and in the future.

Who Needs Private Money?

The list of those who have issued private money in the United States is long. Besides state and national banks (that is, banks established by state or federal charter), transportation suppliers such as canal, turnpike, and railroad companies have issued money. Coal mining and lumber companies have issued money, often called scrip, to pay workers. Merchants, farmers, and community groups have created their own money, too. Each of these examples of private money arose to serve purposes that were not well served by government-provided money. These purposes include having a currency suited for making small purchases, having a medium of exchange in remote locations, and having a means of exchange during financial panics.

Problems with Small Denominations

In the 1800s the Treasury issued coins and occasionally a limited number of notes, but paper currency was also issued by state and national banks. Banks were prohibited from making small denominations by their regulating authority (the state legislature or the U.S. Congress), which made their notes hard to use for many purchases.

State banks originally could only issue notes in denominations of $1 or more. New York and Pennsylvania were the first of many states to increase the restriction to $5 or more. National bank notes could be issued only in denominations of $1 or more from 1863 to 1879, and after 1879, only in denominations $5 or more. By 1882, all smaller-denomination national bank notes had been taken out of circulation.

At the time, a denomination as little as $1 represented a large amount of money. In the 1830s, a newspaper cost a penny. In the 1880s, a laborer typically earned $5 per week. In 1890, a family paid about six cents for a pound of bacon. Trying to buy everyday items was awkward with state and national bank notes.

The case for banning small-denomination bank notes goes all the way back to Adam Smith's The Wealth of Nations, published in 1776. He argued such a ban could prevent inflation. Bank notes of his era were usually redeemable by the issuer into gold or silver coin. Smith believed that if banks were allowed to issue only large-denomination notes, the public would have a greater incentive to redeem them. Frequent redemption was expected to keep banks from overissuing notes. Because small-denomination notes, by contrast, might pass hand to hand for a long time before anyone saw the need to redeem them, it was thought that banks would print more notes than they could redeem with the gold and silver they kept on hand. Without a check on the amount they could issue, a bank might make too many notes, resulting in inflation.

Federal and state legislators of the 1800s must have agreed with Adam Smith. But people still needed a money they could use to make small purchases or to make change. While the Treasury issued silver coins in dollar, half-dollar, quarter, dime, and half-dime denominations, for much of the century, there weren't enough coins to go around. From 1834 to 1873 silver had a price in the free market that exceeded the price the U.S. Mint could pay by law. For that reason, few full-bodied silver coins were minted, and existing silver coins disappeared from circulation. With small-denomination coins scarce, businesses often paid a premium for them in order to make change for their customers.

This situation provided a role for a privately created small-denomination currency, and private individuals and companies stepped in to supply it. They made both paper money and tokens. From 1820 to 1875, private transportation companies, merchants, and farmers issued a significant amount of small-denomination currency. This money was denominated in dollars or in goods or services rendered. In 1853 the Treasury introduced a new three-cent coin, the trime, to alleviate the small-denomination problem. The trime was special because it was worth more as a coin than the silver it contained was worth, which kept people from melting it down and selling the silver on the market (see Michael F. Bryan's *Economic Commentary*, "**The Trime**"). So for a short period of time, the small-denomination problem was solved.

But then came the Civil War. Inflation associated with the war led to an increase in the prices of precious metals, causing metallic coins to disappear from circulation. Economic historian Neil Carothers observed that "The country found itself, in the midst of a war boom, virtually without a currency between the one-cent piece and the five-dollar note." Once again, private enterprises stepped in and created small-denomination currency. The Treasury also issued fractional paper currency from 1862 to 1876. Fractional currency came in denominations of a dollar, half-dollar, quarter, dime, and half-dime. Private money did not go unnoticed by government officials and it came under frequent criticism. In 1862, Secretary of the Treasury Salmon P. Chase blamed the unauthorized issuance of currency for the disappearance of small-denomination coins:

…the depreciation of the currency, resulting, in great measure, from the unrestricted issues of non-specie paying banks and unauthorized associations and persons, causes the rapid disappearance from circulation of small coins.

---Congressional Globe, 36th Congress, Second Session. 3405 (1862)

Congress reacted to the private money situation by forbidding private citizens or companies from issuing paper currency in denominations of less than $1.

No private corporation, banking association, firm, or individual shall make, issue, circulate or pay any note, check, memorandum, token, or other obligation, for a less sum than one dollar, intended to circulate as money or to be received or used in lieu of lawful money of the United States.…

---Act of Congress, 12 Statutes at Large, 592, July 17, 1862

In order to avoid legal problems many private issuers of paper money began denominating their currency in services (for example, miles of railroad service) instead of in dollars. In 1864, Congress prohibited private coinage “intended for use as current money.” However, the courts have frequently upheld the private issuance of coins or paper money if it circulated locally or was redeemable in goods or services and not in dollars.

Problems in Remote Locations

In the last quarter of the nineteenth century, mining and lumber companies flourished. Often these companies were located in remote regions far from banks. The remote locations of these enterprises encouraged them to issue their own money, commonly called scrip. Scrip is often a localized currency, redeemable in the goods or services of the issuer. In the case of mining and lumber companies, scrip was typically redeemable in goods sold at the company store. Originally, scrip took the form of paper, but eventually durable metal tokens became widely used.

By issuing scrip, mining and lumber companies could economize on their use of national bank notes, Treasury certificates, and coins—the forms of money accepted outside the local area at that time. Since scrip could be used only at the company store, workers often sold scrip at a discount for money that could be used for purchases elsewhere. Scrip was issued extensively. According to Dodrill (1971), 20,000 coal company stores in the United States, Canada, and Mexico issued scrip during the early 1900s. Examples of scrip from this era now in private collections number into the thousands.

Although the use of scrip was criticized at the time, the courts typically ruled that coal and lumber companies were not violating the 1862 and 1864 acts by issuing it, since it was not intended to circulate as money.

Problems during Financial Crises

During the Great Depression in the early 1930s, bank runs, in which depositors would arrive in mass at a bank and attempt to convert their deposits into currency, were common. Banks often responded to runs by suspending payments temporarily; that is, they refused to allow customers to withdraw cash from their bank accounts. Bank runs became so severe that in March 1933, President Roosevelt declared a four-day “bank holiday,” closing banks across the nation (and in some places, the closure was extended to a week).

Suspension of payments invoked a natural response of people to hoard money (by this time also issued by the Federal Reserve). Currency hoarding, suspension of payments, and bank failures caused frequent shortages of cash that made it difficult for people to make payments. In response, school districts, merchants, local relief committees, and individuals issued private money in the form of scrip. State and city governments issued their own local money as well. Firms, unable to make payrolls by conventional means, paid workers in scrip. Often this scrip became redeemable in official currency after banks once again allowed deposit withdrawals. A common form of money issued by individuals and local relief agencies was “stamp scrip,” which could be used to buy items in the local area. Municipalities issued a lot, too. A piece of stamp scrip would have a certain face value, say $1, but to exchange it for items worth that much, one had only to buy a one- or two-cent stamp from the issuer and affix it to the back of the scrip. Recipients of the scrip would buy and affix a new stamp and use it for a their own purchase, worth the face value again. Once the back was filled with stamps, the scrip could be redeemed for the face value in legal tender. The famous economist Irving Fisher studied stamp scrip in 1933 and recommended it as a way for municipalities to stimulate spending and as a substitute for official money.

Most of the scrip issued in the 1930s was used only in the locality where it was issued, although the Roosevelt administration considered issuing a national scrip. The success of a particular issuance of scrip depended heavily on its backing and the credibility of the issuer. Successful issuance of scrip by municipal and state governments typically depended on whether it could be used to pay taxes. The value of scrip issued by firms depended on whether the holder viewed the firm’s assets or productive capacity as sufficient to honor the scrip.

Problems with Private Money

Although private money has appeared throughout U.S. history and has often had beneficial effects, its use has also caused problems. Many private issues of money were unsuccessful because people did not believe the issuer would honor its original intentions to redeem it in dollars or goods or services. Such experiences teach us that the perceived backing of private money is intimately linked to its success or failure.

We also observe that many examples of private money and almost all scrip were highly localized, meaning that they did not circulate widely. Although this is not necessarily a problem, it does imply that private money could not be expected to supply the need for a national currency or deliver relief from a widespread currency problem. The localized nature of most scrip arises to a great extent from a problem of recognizability— people can’t be sure how much a note might be worth if they don’t know the issuer. Local citizens have greater awareness of the credibility of a local issuer than does someone who lives across the country.

Another lesson from history is that the use of a money will be limited by how easy it is to redeem. Money that is hard to redeem often will be discounted or not accepted at all. This was most evident during the first half of the nineteenth century when state banks issued notes. Because these notes had to be returned to the issuing bank to redeem them in gold or silver, they often traded at less than full value. Local scrip, which could only be redeemed at the company store, also did not always trade at face value beyond the store.

Private Money in the Internet Age

With advances in information and communication technology—not the least of which is the ability to embed a wafer-thin computer chip into the equivalent of a credit card—it seemed certain that a new form of private money, "electronic money," would arise as an alternative to paper money and coins in everyday transactions. More importantly, the inadequacy of cash as a method for making payments in the growing world of electronic commerce seemed to lay the foundation for the emergence of electronic money.

But so far, we haven't seen electronic forms of private money emerge as anticipated. Why not? Our historical review holds a clue. All of the different problems private money and scrip emerged to solve can be seen as problems with liquidity—liquidity problems that the official, government-supplied money of the day did not meet.

Liquid assets are those that are useful in making everyday transactions and that do not lose their value when they are used to make a transaction. When the smallest bank notes were worth $1 and a newspaper cost a penny, a $1 note was not liquid; it would not be accepted for most everyday transactions. Scrip that could only be spent at the company store without being discounted was not liquid. And people who couldn't withdraw their money from their banks had an obvious problem with having sufficient liquidity.

Advances in technology and the growth of the Internet have simply not created a liquidity problem—or one that existing forms of money couldn't evolve to meet. While purchases over the Internet have expanded at unbelievable rates in the last decade, the vast majority of Internet purchases have been made with credit cards. In spite of security concerns some consumers have about using credit cards online or the fact that some Internet customers, such as teenagers and low-income households, do not have access to credit cards, new methods of payment have developed that have ensured that existing forms of money continue to provide sufficient liquidity.

Brokered monetary value (BMV) payments are a prime example of these new methods. BMV payments use a third party broker to facilitate the payment between a buyer and seller. The buyer authorizes the broker to transfer funds out of an account held with the broker to the seller of the product. The broker has all the private information regarding the parties involved, and buyers and sellers do not need to know this information to complete a transaction. It is inaccurate to call these payment innovations new forms of money. At this point, they are merely new ways to make payments. However, it is probably naïve to believe these means will not develop into new forms of money. Undoubtedly, too, there will be new voids in the future that will require new forms of money. Perhaps these voids will be filled by innovations in money provided by the Federal Reserve. But the private sector might also jump in and fill them, too.

Recommend Readings

Neil Carothers. 1930. Fractional Money. London: John Wiley and Sons.

Gordon Dodrill. 1971. 20,000 Coal Company Stores in the United States, Mexico, and Canada. Pittsburgh: Duquesne Lithographing Company.

Roland P. Falkner. 1901. “The Private Issue of Token Coins,” Political Science Quarterly, vol. 16, pp. 303–27.

Richard H. Timberlake. 1987. “Private Production of Scrip-Money in the Isolated Community,” Journal of Money, Credit, and Banking, vol. 19, no. 4 (November), pp. 437–47.

Richard H. Timberlake. 1987. “The Significance of Unaccounted Currencies,” Journal of Economic History, vol. 41, no. 4 (December), pp. 853–66.

Bruce Champ is an economic advisor at the Federal Reserve Bank of Cleveland.