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State Banking in Early America: A New Economic History | Book Reviews

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Howard Bodenhorn, *State Banking in Early America: A New Economic History*. New York: Oxford University Press, 2003. ix + 355 pp. \$45 (cloth), ISBN: 0-19-514776-6.

Reviewed for EH.NET by Peter L. Rousseau, Department of Economics, Vanderbilt University.

The antebellum period in U.S. history is fertile ground for economists and economic historians seeking to understand the linkages between financial factors and macroeconomic performance. This is especially so because the topic has not, until recently, attracted much attention among scholars of the period. I suspect that this is for two reasons. First, developments in agriculture, commercial trade, and internal improvements in the first sixty years of the nation's history appear, to many, to have had a more direct link with the nation's early growth, diverting attention from the capital markets that made these advances possible. Second, the preoccupation of financial history with banks rather than with financial systems more generally leads inevitably to an over-emphasis on the rather checkered record of antebellum banking. Nowhere is this more apparent than in the traditional view that problems in the nation's early banks usually began with deviations from the real bills doctrine, in which self-liquidating commercial paper was to be a bank's primary asset, and backed by as much specie and as little real estate as possible. More recent scholarship recognizes the potential for missed investment opportunities and for a perverse elasticity of money that can follow from conservative practices such as these, and has contributed to the view that state banks -- even those managed under real-bills principles -- could not have added much punch to early U.S. growth.

Howard Bodenhorn's second book, titled *State Banking in Early America: A New Economic History*, takes on the challenge of explaining how banks did contribute to the growth of the antebellum economy. The task is formidable because an enormous body of research on early U.S. banking has, if anything, shown that successful banks did not conform to simple principles that worked universally. This means that idiosyncratic practices in various states and at various times must be placed in the context of regional growth, piece by piece. The case might have been more convincing had federal banks, state

banks, and markets been considered together, as Robert Wright does in *The Wealth of Nations Rediscovered* (Cambridge University Press, 2002), but Bodenhorn still does a respectable job of synthesizing the literature on early U.S. banking and placing it in a broader context.

The early chapters (2 and 3) consider difficulties faced by banks in navigating the often-politicized process of obtaining charters, compensating states for them, and serving the varied lending needs of the communities in which they operated. Emphasis is on just how well banks were able to develop governance structures under difficult circumstances that reduced informational asymmetries along the corporate chain of command. Bodenhorn then asserts that it was deviations from the real-bills doctrine that, when not leading to non-performing loans and bank failure, were most effective in promoting entrepreneurship and growth. In terms of impact, however, this may be an instance of seeing the glass as 1/4 full rather than 3/4 empty. This is not to say that banks never made loans to entrepreneurs, and that these loans did not improve economic conditions, but it is likely that the effects of state banks on economic growth in the early United States were more a result of growth in their numbers and in the resources that became available to them, than the quality of their allocation decisions.

Bodenhorn then considers banking systems region-by-region, starting with New England (chapters 4 and 5). In revisiting how kinship ties affected the allocation of credit (i.e., the so-called "insider-lending" hypothesis), he raises the important question of why uninformed outsiders would choose to hold minority shares or lodge deposits with banks that might divert returns from them while advancing the interests of a core group of insiders. Bodenhorn contributes the insight that minority insiders, related by kinship to the majority shareholders, held similar interests to outsiders, and could thus monitor the bank's practices for them. This augments the simpler view that capital scarcity was at the heart of insider lending with a plausible story of its advantages in reducing the severity of problems in firm governance.

Attention then turns to the Suffolk System, which allowed for the clearance of New England bank notes at par. The system should have been an improvement over gross clearings, but had one serious flaw, namely that costs fell primarily on country banks that saw their notes redeemed more rapidly under the Suffolk system than would have otherwise occurred. By inverting the logical cost structure to favor those Boston bankers who had the most to gain from the system, the Suffolk Bank created a structure which, though working for years, collapsed when the Bank of Mutual Redemption emerged as a viable alternative to its coercive practices. Bodenhorn submits the Suffolk Bank as an example of how an innovation, however flawed, worked in a particular place and time to improve the flow of credit and make a rapidly monetizing economy more efficient.

The next three chapters (6, 7, and 8) focus on the Mid-Atlantic States. After describing how the state interfered with the free allocation of bank credit in New York, Pennsylvania, and Maryland early on, Bodenhorn considers the relative success of New York's Safety Fund in establishing confidence among holders of bank notes, and the

system's fatal inability to maintain this confidence by winding up troubled banks in a timely manner when faced with the depression of the 1840s. The experience showed that liability insurance could be used effectively, but that some form of central banking would be needed to administer the system and to serve as a lender of last resort. This was not to be, of course, for nearly another century. Instead, New York turned to free banking. The ability to issue notes based on holdings of government bonds was an attractive feature of the free banking legislation, and allowed the number of banks to expand rapidly. And while it is easy to focus on the problems associated with free banking, Bodenhorn takes a more balanced stance, reiterating Richard Sylla's point that the real contribution of free banking was to introduce the notion of free *incorporation*, which encouraged entrepreneurship.

When considering the South and West in chapter 9, Bodenhorn describes a set of banking systems that drew eclectically upon the experiences of other regions to serve the credit needs of agriculture. As the South and West have received relatively less scholarly attention than banking in other regions, the account here is particularly useful.

Overall, I would recommend the book to scholars interested in a fresh discussion of antebellum banking. It is, however, largely a synthesis of older research in the area, and Bodenhorn's ready adoption of the "accepted views" of various historical events gives the impression that little has been done recently to sharpen our views of them.

Nonetheless, the book does provide answers to several questions about finance and growth in early America that had interested this reader for some time. How much did state-level banking practices contribute to growth? Perhaps not all that much in general, but the interaction of these practices with other institutional characteristics of the regions in which they were implemented had important local effects. Were particular institutional structures clearly superior to others? Probably not, since states both succeeded and failed with a myriad of approaches that cannot be reduced to a simple set of rules.

These questions and answers relate closely to the modern debate on banks vs. markets, or Anglo-American vs. German-style financial systems. The conclusion of this literature seems to be that financial development matters for the agglomeration of capital, and that the methods by which this finance is administered are of secondary importance. The early United States saw rapid expansion of banks and bond, stock, and insurance markets, starting almost immediately from the adoption of the Federal Constitution. By 1825 it had a financial *system* that was world-class. It is difficult to make the case that state banks, or any one component of the system, was the prime mover -- all were crucial. Bodenhorn's book aptly fills in the details of the emergence and meteoric growth of one of these components, and describes how lessons learned in the period of early state banking have gone on to shape the institutional forms that remain with us today.

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Theory and U.S. Historical Evidence from Unobservable Components Models," *Journal of Monetary Economics* (October 1998), "Jacksonian Monetary Policy, Specie Flows, and the Panic of 1837," *Journal of Economic History* (June 2002), and "Historical Perspectives on Financial Development and Economic Growth," *Review*, Federal Reserve Bank of St. Louis (July/August 2003).

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