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Bank Credit and the “Creation” of Deposits

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Abstract: It is much more realistic to say that the banks “create credit,” that is, that they create deposits in their act of lending, than to say that they lend the deposits that have been entrusted to them. And the reason for insisting on this is that depositors should not be invested with the insignia of a role which they do not play. The theory to which economists clung so tenaciously makes them out to be savers when they neither save nor intend to do so; it attributes to them an influence on the “supply of credit” which they do not have. The theory of “credit creation” not only recognizes patent facts without obscuring them by artificial constructions; it also brings out the peculiar mechanism of saving and investment that is characteristic of full-fledged capitalist society and the true role of banks in capitalist evolution. With less qualification than has to be added in most cases, this theory therefore constitutes definite advance in analysis.

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The important developments that occurred during that period in the banking systems of all commercialized countries and in the functions and policies of central banks were, of course, noticed, described, discussed. We cannot survey the vast literature which performed this task and of which reports of official commissions and the articles of the best financial journals, the London *Economist* in particular, formed perhaps the most valuable part. It was written by businessmen, financial writers, business economists of all types who knew all about the facts, the techniques, and the current practical problems of banking but who cared little about “principles” – except that they never failed to refer to established slogans – and cannot be said to have had any very clear ideas about the meaning of the institutional trends they beheld. Considered from the standpoint of scientific analysis, these works were, therefore, raw material rather than finished products. And since the “scientific analysts” of money and credit largely failed to do their part, namely, to work up this material and to fashion their analytic structures to its image, we might almost – though not quite – characterize the situation by saying that that literature on banking and finance was as much of a separate compartment within the literature on money and credit as the latter was a separate compartment within the literature on general economics.

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There are a number of books for England, in particular, such as W.T.C. King's *History of the London Discount Market* (1936) and the various histories of the Bank of England (e.g., the recent one by Sir John Clapham, *The Bank of England*, 1944), which will supply part of the information that cannot be given here. For other references, see the little bibliography attached to the article on "Banking, Commercial" in the Encyclopaedia of the Social Sciences (especially the books of the following authors: C.A. Conant, A.W. Kerr, A. Courtois, E. Kaufmann, A. Huart, J. Riesser, O. Jeidels, C. Supino, C. Eisfeld, H.P. Willis). This bibliography contains two items which, owing to their high quality, should be particularly mentioned: C.F. Dunbar's *Theory and History of Banking* (5th ed., 1929, but essentially a work of the nineteenth century) and F. Somary's *Bankpolitik* (1st ed. 1915; 2nd ed. 1930). Perusal of *A History of Banking Theory* by L.W. Mints (1945) will show the reader how far the descriptive literature "spilled over" into the books on monetary and banking theory, though the author's presentation of his huge material is somewhat impaired by undue emphasis on the shortcomings of a particularly narrowly defined commercial theory of banking (the "real-bills doctrine").

The situation described above by the separate-compartment simile accounts for the emergence of a special type of book which was written not only for the general reading public but also for economists in order to enlighten them on the facts and problems of banking or finance. The success of these books proves, better than anything else could, how far the separation of those departments, between which they sought to establish connection, had actually gone. Two famous instances call for notice. The one is W. Bagehot's *Lombard Street: A Description of the Money Market* (1873), one of the most frequently and most admiringly quoted books in the whole economic literature of the period. No doubt it is brilliantly written. But whoever now turns to that book with its fame in mind will nevertheless experience some disappointment. Barring a plea for the reorganization of the management of the Bank of England and for a reform of English practice concerning gold reserves, it does not contain anything that should have been new to any student of economics. Obviously, however, it did teach many economists things they did not know and were glad to learn. Our other instance is the not less brilliant book by Hartley Withers, *The Meaning of Money* (2nd ed., 1909), whose chief merit consists, as we shall presently see, in having boldly spoken of the "manufacture" of money by banks. But this should not have surprised anyone. Yet it was considered as a novel and somewhat heretical doctrine.

Thus, academic analysis of credit and banking – including the contribution of writers who, without being academic economists themselves, conformed to the academic pattern, as did some bankers – went along on the stock of ideas inherited from the preceding period, refining, clarifying, developing no doubt

but not adding much that was new. Substantially, this meant the prevalence of the commercial theory of banking which made the commercial bill or, somewhat more generally, the financing of current commodity trade the theoretical cornerstone of bank credit. We shall, of course, trace this position to Tooke and Fullarton. But the currency school influence was stronger than appears on the surface. Toward the end of the period, it asserted itself particularly in the precincts of the theory of cycles (see below, sec. 8).

As regards central banking, economists enlarged indeed their conception of the functions of central banks, especially the controlling and regulating function of the “lender of last resort”. But most of them were surprisingly slow in recognizing to the full the implications of Monetary Management, which as we have seen was developing under their eyes. Adherence to the commercial theory was, of course, partly responsible for this. Because of it, control continued to mean – not wholly but primarily – control by “discount policy”. The economics profession was not even sure whether it was in the power of central banks to regulate market rates or whether bank rate was merely “declaratory”.¹ Votaries of both opinions then discussed the effects of bank rate in terms of the two classic *modi operandi*: on the one hand, pressure on prices by restriction of credit (*almost* equivalent to amount of commercial bills presented for discount); on the other hand, attraction from abroad of foreign funds or recall from abroad of domestic funds.

As regards banking in general, it is quite true that strict adherence to the commercial theory caused economists to overlook or misconceive some of the most important banking developments of that time. Nevertheless, the derogatory criticism leveled at it in our own day is not entirely justified. To begin with, it was not so unrealistic for England, and English prestige in matters of banking tended to make English practice the standard case. But, quite apart from this, it should be emphasized that acceptance of the commercial theory does not necessarily involve uncritical optimism about the working of the discounting mechanism. Economists stressed the “elasticity” of the system that turns on financing commodity trade. But they had grown out, or were growing out, of the opinion that if banks simply finance the “needs of trade,” then money and production will necessarily move in step and no disturbance will arise – which is the really objectionable thesis. On the one hand, most of them realized, as Ricardo and Tooke had done before them, that there is no

¹ The futility of this discussion, which could have been settled by a glance at the facts, should be obvious. We shall, however, think more kindly of it if we observe that the technique of “making bank rate effective” was only slowly developing during that period and that economists were still slower in discovering what was actually being done. Without this technique it is indeed a fair question to ask whether central banks can do much more than follow the market – which is what is meant by the phrase that their rates are “declaratory.”

such thing as a quantitatively definite need for loans or discounts and that the actual amount of borrowers' demand is as much a question of the banks' propensity to lend and of the rates they charge as it is a question of borrowers' demand for credit. On the other hand, they realized more and more that the practice of financing nothing but current trade – discounting good commercial paper – does not guarantee stability of prices or of business situations in general or, in depression, the liquidity of banks.² And it was Wicksell's achievement to introduce both facts into the general theory of money by means of his famous model of the Cumulative Process (see below, sec. 8).

Finally, there is another point, quite independent of all this, that must be noticed: the curious narrowness and lack of realism in that period's conception of the nature of bank credit. In order to make this point stand out clearly, let us restate how a typical economist, writing around 1900, would have explained the subject of credit, keeping in mind, however, all the limitations and dangers inherent in speaking of typical views. He would have said something like this. In the (logical) beginning is money – every textbook on money, credit, and banking begins with that. For brevity's sake, let us think of gold coin only. Now the holders of this money, so far as they neither hoard it nor spend it on consumption, “invest” it or, as we may also say, they “lend” their “savings” or they “supply capital” either to themselves or to somebody else. And this is the fundamental fact about credit.³ Essentially, therefore, credit is quite independent of the existence or non-existence of banks and can be understood without any reference to them. If, as a further step in analysis, we do introduce them into the picture, the nature of the phenomenon remains unchanged. The public is still the true lender. Bankers are nothing but its agents, middlemen who do the actual lending on behalf of the public and whose existence is a mere matter of division of labor. This theory is satisfactory enough in cases of actual “lending on account of others”⁴ and of savings deposits. But it was also applied to

² In other words – putting the matter from the standpoint of the policy of credit control – it was being increasingly realized that attention to the purpose to be financed (current commodity transaction) and to the quality of the credit instruments involved (good commercial paper) did not enable central banks to dispense with attention to the quantity of credit outstanding: this is implied, though perhaps not adequately, in the theory of the bank rate.

³ We know that leading theorists described the process in terms of the commodities that credit operations were in the last analysis intended to transfer. But for our present purpose it is not necessary to go into this again.

⁴ By this is meant a contractual arrangement by which an owner of large funds which he does not immediately need, e.g. an industrial corporation that has just received the proceeds of a bond issue, employs the services of a bank to lend out these temporarily idle funds in the money market, to stock brokers or bill brokers.

checking deposits (demand deposits, the English current accounts). These, too, were made to arise from people's depositing with banks funds that they owned (our gold coins). The depositors become and remain lenders both in the sense that they lend (“entrust”) their money to the banks and in the sense that they are the ultimate lenders in case the banks lend out part of this money. In spite of certain technical differences, the credit supplied by deposit banking – the bulk of commercial credit in capitalist society – can therefore be construed on the pattern of a credit operation between two private individuals. As the depositors remain lenders, so bankers remain middlemen who collect “liquid capital” from innumerable small pools in order to make it available to trade. They add nothing to the existing mass of liquid means, though they make it do more work. As Professor Cannan put it in an article in *Economica* (“The Meaning of Bank Deposits”) which appeared as late as January 1921: “If cloak-room attendants managed to lend out exactly three-quarters of the bags entrusted to them... we should certainly not accuse the cloak-room attendants of having “created” the number of bags indicated by the excess of bags on deposit over bags in the cloak rooms.” Such were the views of 99 out of 100 economists.

But if the owners of those bags wish to use them, they have to recover them from the borrowers who must then go without them. This is not so with our depositors and their gold coins. They lend nothing in the sense of giving up the use of their money. They continue to spend, paying by check instead of by coin. And while they go on spending just as if they had kept their coins, the borrowers likewise spend “the same money at the same time.” Evidently this phenomenon is peculiar to money and has no analogue in the world of commodities. No claim to sheep increases the number of sheep. But a deposit, though legally only a claim to legal-tender money, serves within very wide limits the same purposes that this money itself would serve. Banks do not, of course, “create” legal-tender money and still less do they “create” machines. They do, however, something – it is perhaps easier to see this in the case of the issue of banknotes – which, in its economic effects, comes pretty near to creating legal-tender money and which may *lead* to the creation of “real capital” that could not have been created without this practice. But this alters the analytic situation profoundly and makes it highly inadvisable to construe bank credit on the model of existing funds' being withdrawn from previous uses by an entirely imaginary act of saving and then lent out by their owners. It is much more realistic to say that the banks “create credit,” that is, that they create deposits in their act of lending, than to say that they lend the deposits that have been entrusted to them. And the reason for insisting on this is that depositors should not be invested with the insignia of a role which they do not play. The theory to which economists clung so tenaciously makes them out to be savers when they neither save nor intend to do so; it attributes to them an influence on the “supply of credit” which they do not have. The theory of “credit creation” not only

recognizes patent facts without obscuring them by artificial constructions; it also brings out the peculiar mechanism of saving and investment that is characteristic of full-fledged capitalist society and the true role of banks in capitalist evolution. With less qualification than has to be added in most cases, this theory therefore constitutes definite advance in analysis.

Nevertheless, it proved extraordinarily difficult for economists to recognize that bank loans and bank investments do create deposits. In fact, throughout the period under survey they refused with practical unanimity to do so. And even in 1930, when the large majority had been converted and accepted that doctrine as a matter of course, Keynes rightly felt it to be necessary to re-expound and to defend the doctrine at length,⁵ and some of its most important aspects cannot be said to be fully understood even now. This is a most interesting illustration of the inhibitions with which analytic advance has to contend and in particular of the fact that people may be perfectly familiar with a phenomenon for ages and even discuss it frequently without realizing its true significance and without admitting it into their general scheme of thought.⁶

For the facts of credit creation – at least of credit creation in the form of banknotes – must all along have been familiar to every economist. Moreover, especially in America, people were freely using the term Check Currency and talking about banks' "coining money" and thereby trespassing upon the rights of Congress. Newcomb in 1885 gave an elementary description of the process by which deposits are created through lending. Toward the end of the period (1911) Fisher did likewise. He also emphasized the obvious truth that deposits and banknotes are

⁵ *Treatise on Money*, ch. 2. It is, moreover, highly significant that, as late as June 1927, there was room for the article of F.W. Crick, "The Genesis of Bank Deposits" (*Economica*), which explains how bank loans create deposits and repayment to banks annihilates them – in a manner that should have been indeed, but evidently was not even then, "time-honored theory." There is, however, a sequel to Lord Keynes's treatment of the subject of credit creation in the *Treatise* of 1930 of which it is necessary to take notice in passing. The deposit-creating bank loan and its role in the financing of investment *without any previous saving up of the sums thus lent* have practically disappeared in the analytic schema of the *General Theory*, where it is again the saving public that holds the scene. Orthodox Keynesianism has in fact reverted to the old view according to which the central facts about the money market are analytically rendered by means of the public's propensity to save coupled with its liquidity preference. I cannot do more than advert to this fact. Whether this spells progress or retrogression, every economist must decide for himself.

⁶ In consequence, there may be merit and even novelty in a piece of work which can be proved to say nothing that has not been said before in some form or other – which in fact we have had occasion to observe many times. It seems to me that Professor Marget's account of the development of the doctrine of credit creation Marget, (*Theory of Prices*, 1938–42, vol. 1, ch. 7) does not attach sufficient weight to this consideration.

fundamentally the same thing. And Hartley Withers espoused the notion that bankers were not middlemen but “manufacturers” of money. Moreover, many economists of the seventeenth and eighteenth centuries had had clear, if sometimes exaggerated, ideas about credit creation and its importance for industrial development. And these ideas had not entirely vanished. Nevertheless, the first – though not wholly successful – attempt at working out a systematic theory that fits the facts of bank credit adequately, which was made by Macleod,⁷ attracted little attention, still less favorable attention. Next came Wicksell, whose analysis of the effects upon prices of the rates charged by banks naturally led him to recognize certain aspects of “credit creation”, in particular the phenomenon of Forced Saving.⁸ Later on, there were other contributions toward a complete theory, especially, as we should expect, in the United States. Davenport, Taylor, and Phillips may serve as examples.⁹ But it was not until 1924 that the theoretical job was done completely in

7 Henry Dunning Macleod (1821–1902) was an economist of many merits who somehow failed to achieve recognition, or even to be taken quite seriously, owing to his inability to put his many good ideas in a professionally acceptable form. Nothing can be done in this book to make amends to him, beyond mentioning the three publications by which he laid the foundations of the modern theory of the subject under discussion, though what he really succeeded in doing was to discredit this theory for quite a time: *Theory and Practice of Banking* (1st ed., 1855–6; Italian trans. 1879); *Lectures on Credit and Banking* (1882); *The Theory of Credit* (1889–91).

8 In itself the idea was not new, see F.A. von Hayek, “Note on the Development of the Doctrine of ‘Forced Saving’”, *Quarterly Journal of Economics*, November 1932, republ. in *Profits, Interest and Investment* (1939). But it now appeared in a larger context and with a new emphasis. During the last decade, the concept has fallen into unmerited disfavor. But it has its merits. In particular, it clears up a point that has caused difficulties to many. Banking operations, so Ricardo had said, cannot create “capital” (i.e. physical means of production). Only saving can do this. Now, whenever the expenditure from deposits that are created by banks increases prices, i.e. under conditions of full employment (and also in other cases), a sacrifice of consumption is imposed upon people whose incomes have not risen in proportion, which achieves what otherwise would have to be achieved by saving, and there is point in calling this, metaphorically, Involuntary or Forced Saving and in contrasting it with what is usually called Saving (Voluntary Saving). That under conditions of unemployment and excess capacity no such sacrifice need necessarily be imposed upon anyone is no reason for discarding the concept.

9 Davenport’s contribution merely consisted in hints which he threw out in his *Value and Distribution* (1908) without making much of them: he emphasized, e.g., that it is not correct to say that banks “lend their deposits.” W.G.L. Taylor, in a book which (like Davenport’s) never received the recognition it deserved, went much further (*The Credit System*, 1913). A great stride was made by C.A. Phillips (*Bank Credit*, 1920), who not only did much to clear up the theoretical questions involved but in addition pointed out the difference between the expansion of loans and investments that is possible for an individual bank which competes with others and the expansion that can be performed by a system of competing banks, considered as a whole.

a book by Hahn, and even then success was not immediate.¹⁰ Among English leaders credit is due primarily to Professors Robertson and Pigou not only for having made the theory palatable to the profession but also for having added several novel developments.¹¹ Elsewhere, especially in France, resistance has remained strong to this day.

The reasons why progress should have been so slow are not far to seek. First, the doctrine was unpopular and, in the eyes of some, almost tinged with immorality – a fact that is not difficult to understand when we remember that among the ancestors of the doctrine is John Law.¹² Second, the doctrine ran up against set habits of thought, fostered as these were by the legal construction of “deposits”: the distinction between money and credit seemed to be so obvious and at the same time, for a number of issues, so important that a theory which tended to obscure it was bound to be voted not only useless but wrong in point of fact – indeed guilty of the elementary error of confusing legal-tender money with the bookkeeping items that reflect contractual relations concerning this legal-tender money. And it is quite true that those issues must not be obscured.¹³ That the theory of credit creation does not necessarily do this seemed small comfort to those who feared its misuse.

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10 Albert Hahn, *Volkswirtschaftliche Theorie des Bankkredits* (3rd ed., 1930). One reason why this book left so many economists unconvinced was, however, the fact that the theory of bank credit there presented was wedded to certain highly optimistic views about the possibility of achieving permanent prosperity, which prejudiced some economists against its essential achievement.

11 D.H. Robertson, *Banking Policy and the Price Level* (1926). Forced saving figures there under the name of Imposed Lacking. A.C. Pigou, *Industrial Fluctuations* (1927), Part I, chs. 13 and 14.

12 Thus Walras saw the phenomenon of credit creation quite clearly (though he confined himself to banknotes). But he considered it as an abuse that ought to be suppressed and refused for this reason, to make it a normal element of his general schema (*Études d'économie politique appliquée*, ed. of 1936, p. 47 and pp. 339 et seq.).

13 One of them is the old issue: control of “money” vs. control of “credit.” Considerations of the kind alluded to explain the aversion of many French authorities to the credit-creation idea. For instance, one of the leading purposes of Professor Rist’s *History of Monetary and Credit Theories* is to combat the “confusion” of money and credit.

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