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Lost and Found: Some History of Endogenous Money in the Twentieth Century

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Introduction

This chapter started in an airport waiting room. I happened on Tim Congdon, and we talked about Keynes’s monetary theory while we waited for our flight. The conversation brought into sharp focus an idea that had been festering in the back of my mind for some little time: that I had been brought up to take the endogenous generation of money (deposits) by banks for granted; why was it necessary for the modern theory of endogenous money to re-invent the concept? But Tim had been given a very different understanding. An informal survey of other economist friends of roughly his age (currently (2003) around the age of fifty), showed a pretty uniform experience of having been taught that ‘the central bank provides money and the banks multiply it’, as Roger Backhouse (in conversation) succinctly characterised the money-base theory of the money supply. Clearly something had happened somewhere between the time of my under- and post-graduate education in the late 1950s–early 60s to theirs some 15 years later.

Schumpeter (1954, pp. 1110–17) gives the impression that endogenous money was well understood in Germany (and even more so in England) by the 1930s at the latest and should have been understood by the end of the nineteenth century (perhaps he thought this because he understood it so well himself: Schumpeter, 1912). (See also Ellis, US treatise, 1934, pp. 395–7.) So why did that understanding disappear? This paper reconstructs some of the story of the struggle for, and loss of, the concept of endogenous money. To this end I have examined a number of monetary textbooks, these being the repository of accepted wisdom, as well as some treatises or ‘monographs’. I have explored only English-language texts. Since both banking institutions and ways of thinking differ between countries, especially in the early years covered here, I shall systematically indicate the origin of sources in the text, even for famous works. I have also been limited by time to a very quick examination of a somewhat unsystematic and incomplete selection from
the open shelves of the LSE library. This work then should be seen as asking what I hope is an interesting question and providing some preliminary evidence rather than giving a definitive answer.

No definite time-line emerged. This is to be expected, given that old doctrines are so persistent in economics. The work is further complicated by the fact that there are many strands to the endogenous-money story, and by the fact that very subtle differences of language and emphasis are involved. But a general drift can be discerned, from widespread acceptance of bank credit as the origin of the bulk of the money supply in the 1930s to the 1960s, to the emergence of the money-base story in the 1970s. Also, in the 1970s banks began to be portrayed as but one class of financial intermediary; later still they were analysed as multiproduct firms. In the first case, no amount of later questioning whether banks are ‘special’ is going to remove that first impression of banks ‘lending on’ deposits, which our forebears fought so hard to dispel. And in the second, the importance to the story of the monetary quality of deposits is fatally obscured, as is the distinction between the individual bank and the system as a whole.

That is where the story is going, but the story begins with metallic money, the question of a monetary standard and the role of money in the determination of prices and the exchange rate. There are texts on money from the nineteenth century – even, in one case, the twentieth – that do not even mention banks (e.g. F.A. Walker, 1891, US text; Nogaro, 1927, translated from a French text, 1924). The first step is recognising deposits as money. At the time of writing we take for granted that deposits are money, so it is surprising how late full recognition was in coming. Then came the distinction between primary and secondary or derivative deposits, which has now virtually disappeared. The main part of the story is the deposit multiplier, which begins as the hard-won core of the concept of endogenous money and ends up the villain of the piece. This transformation is connected to a progressive formalisation of the money multiplier, in which the emphasis in earlier literature on bank behaviour tends to be replaced with something mechanical, and to the role ascribed to reserves, which are seen first as a limit to expansion, then as the means of control, and finally as the cause of multiplicative expansion. The transition to an exogenous-money theory is then complete.

The rest of the chapter will explore the evolution of three key elements of endogenous-money theory: the mechanism of generating deposits by banks' acquisition of assets, the multiplicative expansion of bank lending, and the role of reserves. These are not easy to disentangle and the chronology is sometimes upset.

**Do banks ‘create credit’?**

This conventional formulation of our key question is, on the face of it, rather odd. I once wrote (1973) that of course the answer was yes: creating