HEA 717-25 The Theory of Credit

In the early nineteenth century the theory of credit was in process of development. The Napoleonic wars went on from Napoleon's rise to power until 1815. In 1797 the Bank of England suspended the convertibility of banknotes to gold. There was no such inflation as was experienced after the first world war and after the Vietnam war but the pound declined in value relatively to gold, the bank was blamed for its paper credit, and it could not explain the real source of the trouble, its extensive loans to the government during the war.

On p. 717 the author explains where the difficulty lay in developing the theory of credit. But let us first take a further step backward. Aristotle distinguished between what is first for us and what is first in itself. What is first for us is what is sensible; what is first in itself is what we get to know through insight, understanding, explanation. In the moon what is first for us/its various shapes, its phases. What is first in itself is its spherical shape. Were the moon a flat circular disc, the sun would illuminate all of it or none of it. But one/represent the phases of the moon by placing a basketball on a table in a dark room and have someone walk around it shining a flashlight upon it.

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Now what was first for us from Greco-Roman times were the copper, silver, or gold coins that passed from hand to hand. What second was a series of instruments of credit. In the eyes of the law such instruemnts were strictly secondary: they were not money; they were claims for money. As long as that view remains, one cannot arrive at a satisfactory account of credit. To explain credit in terms of money, is to leave money as the reality and present credit as just a substitute, and not a very creditable one.

In other words, one has to distinguish a monetary theory of of credit and substitute a credit theory of money. At the present time all money is credit. What we have is essentially a credit system: the bulk of payments occur at the clearing house, where debits and credits cancel and differences are carried forward to await cancellation or, failing that, to be met with cheque.. In brief money is what does the work of money.

Now in the first half of the nineteenth century there were economists hat understood credit and its workings; but they were not ready to take the bull by the horns and affirm that money is what does the work of money. In the second half up to Wicksell, even the understanding of credit seems to have vanished.

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HEA III (1790-1870) CH 7 # 4 THE THEORY OF CREDIT

717 Even today, textbooks on money, currency, and credit, are more likely than not to begin with an analysis of a state of things in which legal-tender money is the only means of paying and lending. The huge system of credits and debits, of claims and debts, by which capitalist society carries on its daily business of production and consumption is then built up step by step by introducing claims to money or credit instruments that act as substitutes for legal tender and are allowed indeed to affect its functioning in many ways but are not to oust it from the fundamental role in the theoretical picture of the financial structure. Even when there is very little left of this fundamental role in practice, everything that happens in the sphere of currency, credit, and banking is construed from it, just as the case of money itself is construed from barter.

Historically, this method of building up the analysis of money, currency, and banking is readily understandable: from the fourteenth and fifteenth centuries on (and even from the Greco-Roman world) the gold or silver or copper coin was the familiar thing. The credit structure -- which moreover was incessantly developing -- was the thing to be explored and to be analyzed. The legal constructions too -- remember that most economists who were not businessmen were jurists -- were geared to a sharp distinction between/as the only genuine and ultimate means of payment and the credit instrument that embodied a claim to money.. But logically it is by no means clear that the most useful method is to start from the coin -- even if, making a concession to realism, we add inconvertible government paper -- in order to proceed to the credit transactions of reality. It may be more useful to start from these in the first place, to look upon capitalist finance as a clearing system that cancels claims and debits and carries forward the differences -- so that 'money' payments come in only as a special case without any fundamental importance. In other words: practically and analytically, a credit theory of money is possibly preferable to a monetary theory of credit.

Note that beginning from barter and advancing to credit is the way of human discovery of credit, while inverting the order and beginning from a system of credit transactions is the way of explanation, the way that presupposes the insights gained by discovery and interprets the earlier stages by hindsight.

This is reverting to the original meaning of analysis (the way of discovery, the via inventionis) and synthesis (the way of teaching, the via doctrinae).

718 The situation of the period's theory of credit and banking may now be // characterized like this. The English bankers from Thornton to Mill did explore the credit structure, and in doing so made discoveries that constitute their chief contribution to monetary analysis but could not be adequately stated in terms of the monetary theory of credit. But they failed to go through with the theoretical implications of these discoveries, that is, to build up a systematic ~~theory~~ credit theory of money, and on principle clung to the monetary theory of credit. So they produced in the end something that was neither the one nor the other. An eminent critic of our day, Professor Rist, was therefore formally within his rights when he accused some of the authors of the period of having 'confused' money and credit. Their waverings in the use of terms certainly suggest this.

718 I Note 5: ... We come nearer to what these writers wished to express and what that difficulty was when we learn from Mill who (Bk III ch 12 # 1) averred that it was Credit which acts on prices and not 'banknotes, bills, and cheques.' He meant that an individual's power to purchase, which is an objective element behind demand in terms of numéraire, is not fully represented by the amount of the credit instruments that are actually used in 'payment' or even, so we should add, by the deposits, overdrafts, etc., against which checks are drawn, but by the total amount that an individual could command if he wanted to, i. e., the amount that is actually at his disposal in some measurable form plus something that might be called potential credit, which defies measurement yet is a factor in any given situation. And we may assume that it is this total that people meant when they used the term Credit. (Even today: his credit is good for it).

718 Text Keeping this in mind, we shall in this section discuss cursorily (a) the most interesting of the period's conquests in the theory of credit, and then (2) a few more points about banking and central banking that are most onvenientlyexpressed with reference to the quarrels between the currency and banking schools over the principles embodied or supposed to be embodied in Peel's act of 1844....

cf. p. 327 (a) Credit, Prices, Interest, and Forced Savings. As soon as we realize that there is no essential difference between these forms of 'paper credit' that are // used for paying and lending,
719 and that demand, supported by 'credit,' acts upon prices in essentially the same manner as does demand supported by legal tender, we are on our way toward a serviceable theory of the credit structure and, in particular, toward the discovery of the relations between prices and interest. Before turning to the period's theory of these relations we must, however, consider the obstacles that prevented many authors from accepting the two propositions just alluded to. We have already seen that the monetary theory of credit in its elf constitutes such an obstacle because, developingthe theory of the network of credit 'payments' from the case of payment in specie, it assigns to legal-tender money a logically privileged position. But we have still to consider some practical positions that seem to militate against an analysis that puts say 'money' and 'deposits' on essentially the same footing.

In the first place the law treats different types of means of payment differently. In the case of legal-tener money , it insists on acceptance; in the case of an acce pted bill of exchange, it does not. For the legal mind, the two are anything but essentially the same thing, since the credit instrument is on the face of it a claim to money. In the second place, and in connection with this, 'money' and 'paper credit,' and again the various forms of ' paper credit,' are not in practice equally well qualified for every purpose. They are not perfect substitutes for one another: legal-tender money is a universal means of payment; bank notes and deposits are less widely acceptable; the accepted and endorsed bill of exchange can circulate only in a relatively small circle of business concerns. And only legal-tender money is recognized in most historical cases as the ultimate reserve money of the banking system. These differences are of course quite i portant, and nobody would think of trying to expalin the way in which a given monetary system functions without trying to

719 take account of them. And this is why Thornton's perception of of the fact that different means of payment may, on a certain level of abstraction, be treated as essentially alike was a major analytic performance, for the mere practitioner will in general be impressed by the technical differences than by the fundamental sameness. But precisely for this reason, it is quite understandable that, though Thornton's view eventually prevailed with J. S. Mill, the opposit view found sponsors all along. And this was one of the reasons, though not the only one, why some writers
720 stoutly denied that 'credit' acts upon prices. Now we turn to the subject of price and interest or, as we may call it, of the Real and the Money Rate of Interest.

Within the scholastic system, interest being simply the price for the use of money, the phrase Real and Money Rate of interest is a label on an empty box -- there was no problem of any direct relation of this kind, any more than there is in the Keynesian system.[6]

[6 Of course if we dig more deeply, the problem does reappear in both systems.]

But when, under A. Smith's influence, Barbon's analysis began to prevail, according to which interest was that part of business gains which accrued to the purveyor of physical capital, the question was bound to arise how this interest was related to the interest in the market of loans, which after all is a distinct phenomenon. A. Smith answered in effect that the loan rate of the money market was simply the shadow on the rate of profit on real capital -- the latter being 'lent in the form of money' as the later slogan has it -- and that quantity of money, however defined, had nothing at all to do with it. I cannot emphasize sufficiently that this remained the dominant opinion throughout the nineteenth century, at any rate until Wicksell; that it was, as will presently be explained, also Ricardo's and that even Thornton's contribution to the problem of the relation between 'money' prices and the real rate of interest (important though they were), which point to a different conclusion, were largely forgotten.

Thornton related the volume and the velocity of money and other circulating media to interest in the four following ways.

(1) He was the first to point out that a high rate of interest will attract gold from abroad.

(2) He also pointed out the relevance of the prevailing rate of interest for the public's willingness to hold cash.

(3) Further, he pointed out the effect upon the loan rate of expectations about the future course of prices.

(4) Finally, soaring high above the commonplace controversy on the question whether or not banks have the power to inflate the currency, he presented (all the essentials of) of a complete analysis of the market for loanable funds that pivots on the fundamental equilibrium theorem, that the loan rate (money interest) tends to equal expected marginal profits of investment (marginal efficiency of capital). This requires some elaboration.

First, Thornton's theorem occurs in the course of an argument to the effect that there does not exist, within the logic of the credit mechanism itself and apart from convertibility, any restrict- that will prevent bank credit from exceeding the limit beyond which it will cause an inflatonary increase in prices and that,

721 in particular, 'sound banking practice,' that is, the practice of lending on good security only or even discounting bona fide
722 commercial // bills only, does not constitute such a restriction. The reasons for this are, of course, that an expansion of loans, unless accompanied by a compensating reduction of expenditure by people other than borrowers, will increase money incomes, hence the demand schedules for goods and services (not necessarily their prices), so that every additional wave of borrowing tends to justify itself ex post; and that such an expansion of loans can -- at least in favorable situations -- be induced by the offer to lend at a rate that is below expected marginal profits. In other words, the equilibrium of Thornton's theorem is unstable: an increase in loans beyond the equilibrium amount will eventually (though not necessarily at first) result in an increase in prices and if the rate of interest continues to be kept at its old level (the level that induced the first expansion), further borrowing will continue to be profitable at the new level of prices, further expansion of credit will follow, and so on, without any assignable limit, and we shall have the Wicksellian Cumulative Process (for restatement and criticism, see below, Part IV, ch. 8, # 8, p. 1118). To enforce stability, other conditions, such as convertibility -- direct or indirect -- of notes and deposits in gold are necessary. This practical conclusion, if not the whole of Thornton's analysis, was widely accepted, among others by King, Ricardo, Joplin, and Senior. J. S. Mill also accepted it though, presumably under the influence of Tooke, he toned it down.

[Long comment in fine print. We excerpt the following:
J. S. Mill argued "that the lending of banks qua lending does act on the interest rate and not on prices, but that, since the currency in common use, being a currency provided by bankers, is all issued in the way of loans (Principles Bk III ch 23 #4) the lending by banks qua creation of currency acts upon prices and not on the interest rate.

723 Second, Thornton knew of course perfectly well that the inflationary process he described presupposes an uncompensated expansion of lending. If the increase in loans is compensated, for example, by saving, it will not start that process. But preoccupied as he was by the operation of 'paper credit' in wartime, he did not bother about this and so he failed to state explicitly the condition for stable equilibrium in the market for loanable funds which reads in Wicksell's formulation of 1898, that loans should equal people's voluntary savings. To some extent at least the lacuna was filled by Joplin, though he got still less credit for it than he got for having anticipated the principles of banking policy that, so far as the notes of the Bank of England are concerned, were carried into effect by Peel's Act....

Third, Thornton realized not only that bank loans which add to the means of payment may stimulate output rather than prices if they impinge upon an unemployed economy, but also that, even
724 after full employment // has been reached, credit expansion may still have some effect upon output, though he immediately proceeded to show that this effect will be smaller than the inflationary one (Paper Credit pp 236 239ff). If some money incomes do not increase in step with prices, then recipients may

724 may be forced to curtail their purchases of goods and services, that is, to perform a kind of involuntary saving which may increase real capital as does saving in the ordinary sense. Thus, he anticipated Wicksell's doctrine of Forced Saving. But Bentham who coined the phrase Forced Frugality, went much more deeply into the matter than did Malthus. Ricardo turned a deaf ear to Thornton's suggestion and kept on repeating again and again -- almost unintelligently -- that 'fictitious' capital cannot stimulate industry, that capital can only be created by saving, and not by banking operations, and so, without facing the issue squarely. There was of course a reason for this. Here as elsewhere Ricardo was a prisoner for once-for-all conceived ideas. In this case, he had pinned his colors to the mast for rigid quantity theory. The theory implies that there is no relation between the quantity of 'money' and output. And he just would not admit that there might be one after all.

J. S. Mill was torn between the two opposing views (Bentham's and Ricardo's)....

725 .. After that leading economists forgot all about 'creation of additional deposits' and 'forced saving,' so much so that they looked askance at Wiksell's rediscovery of them: to borrow a phrase used by Lord Keynes in another connection, these notions, so obviously important and realistic, lived from about 1850 to about 1898 a dubious life in the economic underworld -- another lesson about the ways of the human mind.

(b) Gains from the Controversy about Peel's Act of 1844. For our purpose, it is not necessary to go much further. Most of the important things (none too numerous) that were said in that controversy had been said before. The two groups that opposed one another on the legislative issue involved became known as the Banking and Currency Schools. Only Tooke, Fullarton, and Gilbart of the former, and Torrens and Overstone of the latter, school are of importance for us.