# A HISTORY OF BANKING THEORY

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## IN GREAT BRITAIN AND THE UNITED STATES

*By* LLOYD W. MINTS

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# *PREFACE*

BESIDES presenting a general history of banking theory in Great Britain and the United States, it has been my hope to contribute something toward the resolution of a number of long-standing controversies.

Monetary theory is a matter of paramount importance in a free-market economy; but, to the present time, banking legislation has been too much controlled, in the United States at any rate, by the belief that a restriction of the banks to the making of loans for bona fide commercial purposes will automatically provide for all needed variations in the means of payment. This belief, which I have called the "real-bills doctrine," is utterly subversive of any rational attack on the problem of monetary policy. If there is a central theme in what I have written, it is that this doctrine is unsound in all its aspects.

Mr. Aaron Director, Professors Henry C. Simons, Jacob Viner, and C. R. Whittlesey have read the manuscript in its entirety; while Professor Garfield V. Cox, Mr. Elgin Hunt, and Professor Simeon E. Leland have read large portions of it. They have saved me from a number of errors and have offered many useful suggestions for improvement. I am prepared to discover that I have not heeded their advice as often as I should have.

Somewhere there should be recorded the indebtedness of all economists at the University of Chicago to Professor Chester W. Wright for his painstaking efforts in building up the University library in the field of economics; and, inasmuch as I am one of the beneficiaries, it is appropriate that it be done here. I am also indebted to the Social Science Research Committee at the University for assistance in various directions.

LLOYD W. MINTS

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# CHAPTER I

## INTRODUCTION

ATTEMPTS in English-speaking countries to explain the operations of commercial banks began with the inception of these institutions, that is to say, in the second half of the seventeenth century in Great Britain and in the 1780's in the United States. The early explanations were, of course, inadequate; and yet some writers understood from the first that by their lending operations the banks increase the quantity of the circulating medium. By the early eighteenth century in England and from the beginning in the United States, the significance of reserves in limiting the volume of loans was recognized.

It was not until the 1770's in Great Britain or until after 1820 in America that we find a clear-cut statement to the effect that the banks should restrict their advances to short-term commercial purposes. Briefly, those who have defended this position have held that, if only "real" bills are discounted, the expansion of bank money will be in proportion to any extension in trade that may take place, or to the "needs of trade," and that, when trade contracts, bank loans will be correspondingly paid off. Closely associated with this point of view is the doctrine that, if only commercial loans are made, the currency will have a desirable elasticity and the banks will at all times be in a liquid condition. I shall designate these ideas as the "real-bills doctrine."[1] Prior to 1860 the supposed limiting effect on the quantity of loans was emphasized. Since approximately that date more attention has been paid to the problems of elasticity and liquidity, with the former receiving the major emphasis during some thirty or forty years before 1913 in the United States and the latter coming into equal prominence only during approximately the last twenty years.

The real-bills doctrine has been a most persistent one. Given its most elegant statement in all its history by Adam Smith in the *Wealth of Nations*, it has since served as the defense for the directors of the Bank of England during the period of the Restriction; with some changes it reappeared as the banking principle; it was the main reliance of the agitators for banking reform in the United States before 1913; it was as comforting

[1] I have chosen this term rather than that frequently used in recent years, namely, the "commercial loan theory of credit," largely because it is much shorter. However, it also better reflects the terminology of the period of origin of the doctrine.

to the Federal Reserve Board following the depression of 1921 as it had been a century earlier to the directors of the Bank of England; more recently it has re-emerged as the doctrine of "qualitative" control of bank credit; and, quite aside from these special uses to which it has been put, it has been consistently defended throughout all these years by a large proportion of bankers and economists.

Nevertheless, the doctrine has been attacked, in one or more of its three aspects, from the time of its first adequate enunciation by Smith. Adam Dickson, a Scottish contemporary of Smith, pointed out what he believed to be the fallacy in the contention that operation in accordance with it would appropriately limit the quantity of the circulating medium; and from his day to the present it has been criticized by only a minority of writers. Likewise, the claims that it would furnish an elastic currency and provide for banking liquidity have been criticized, although even less frequently and also, for the most part, more recently.

In so far as the "limitational" aspect of the doctrine has had a definite and significant competitor, it has been to the effect that the rate of interest charged by the banks, in relation to the rate of return to be earned on funds borrowed, is the controlling factor. This point of view was presented by Henry Thornton shortly after the publication of the *Wealth of Nations*, first in 1797 and then more adequately in 1802. Since then it has frequently been reiterated, and it acquired its largest number of adherents during the 1920's. However, since about 1930, the efficacy of the bank rate has been somewhat more under suspicion.

For nearly two centuries in Great Britain and over a century in the United States we therefore have had frequent restatements of the real-bills doctrine, with occasional critisicms of it; while somewhat less frequently there has been advanced the alternative claim that the bank rate will control the volume of bank credit. Yet the difference of opinion is by no means resolved at the present time. This is a scandal, and, so long as it continues, economists are in no position to complain when their ideas in regard to banking legislation are ignored. My own belief in the essential fallaciousness of the doctrine forces me to think that responsibility for this state of affairs rests primarily with the proponents of the real-bills point of view. It would appear that the superficial and common-sense appeal of the notion that, of course, the volume of loans will vary directly with the volume of trade must have disarmed many writers and have led them to approve the doctrine without critical examination of it. Nevertheless, the blame for the failure to arrive at some degree of unanimity of opinion is by no means wholly to be placed upon the friends of the real-bills doctrine.

Its opponents have not often been convincing in their criticisms, and frequently they have simply ignored it. If this were a case in which theories had been in process of development, one might condone the present state of opinion; but this is not so. There has been no improvement to this day on Smith's statement and little advance in the criticism of it.

On the subjects of monetary and banking policy there has been something more nearly resembling an evolution of ideas. To be sure, this could not come from the adherents of the real-bills doctrine, for they in effect excused themselves from all responsibility in this matter by prescribing merely that banks should maintain convertibility of their obligations and discount only bona fide, self-liquidating commercial bills. Others, however, have not been so limited. If we assume an international gold standard and a central bank to which discretionary powers are to be given, Thornton's early statement of policy would be hard to improve upon. But these assumptions have not always been made, and in any case there has been a variety of alternative opinions, whether or not they may be considered to be superior to those of Thornton.

While it has long been held that stability in the value of money is desirable, the dominant opinion, from the beginnings of banking to the present time, has been that the best we can do about achieving stability is to retain the gold standard. This being the case, it was perhaps inevitable that discussions of banking policy would revolve, in the main, around the question either of eliminating banking and returning to a "hard" money or of so controlling the banking system that the convertible currency would function substantially as would a purely metallic money. Within this framework of ideas there developed in England in the early part of the nineteenth century the belief either that the foreign exchanges should, and necessarily would, be the guide to action by a central bank clothed with discretionary monetary authority or that the banking system should be so controlled by legislation that it would automatically expand with an inflow of gold and contract with an outflow. In the United States the tendency to look upon a metallic standard as the ideal was exhibited in a demand that the banks be eliminated and that we return to a system of so-called "hard" money.

It was not until the 1920's that any support developed for the opinion that the price level might be stabilized by means of central bank action, although there formerly had been, of course, much discussion of nonbanking proposals for this purpose.[2] However, faith in a central bank has also

[2] This statement ignores Wicksell; but he can hardly be considered in a history of banking theory in the English language, despite the fact that he published a short article in English

rapidly waned since this period of time, with the consequence that in very recent years a number of writers have attempted to find what they believed might be more efficacious devices for the achievement of any desired monetary goal. Thus we come to the present-day insistence, on the part of what is probably a minority of economists, that control of the price level can be achieved only through an integration of fiscal and monetary authorities and the subordination of fiscal to monetary policy.

It is with the development of the foregoing ideas and of others ancillary to them that we shall be concerned in the following pages.

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in 1907, in which he contended that the central bank might control the price level by means of rate manipulation.

# CHAPTER II

## THE BEGINNINGS OF BANKING THEORY IN GREAT BRITAIN

THE goldsmiths began the business of banking in Great Britain at the time of the Commonwealth.[1] As might be expected, from about this time we have meager statements—meager in both the extent of the analysis and the number of such statements, which deal with one or more of the problems in which we are interested.

William Potter, in 1650, urged the necessity of increasing the quantity of circulating medium and suggested what was essentially a co-operative credit company for the purpose. His writing is excessively tedious and lacking in clarity; but it is evident that the company he proposed was to lend to its members and issue bills, payable in six months, which were to circulate as money.[2] He makes no suggestion that there would be any automatically limiting factor on the amount of such bills to be issued or that there would be any need of arbitrary limitation. He denied that an increase in the quantity of money would necessarily raise prices but rather insisted that its (more likely?) effect would be to increase the volume of trade.[3] His work would be of little interest except for the fact that his is the first suggestion I have found in English to the effect that the liabilities of a banking company might circulate as money.

In 1655, Sir Ralphe Maddison made a much clearer and more explicit statement in describing the work of bankers. Men of wealth bring their money to the bank and receive double and treble credit—presumably double and treble the amount the borrower may have on deposit, although this point is not made entirely clear. At any rate, it is stated that loans are made "by assignation, without laying out of the bank any money," the

[1] A. E. Feavearyear, *The Pound Sterling* (1931), pp. 91–95.

[2] William Potter, *The Key of Wealth* (1650), pp. 38–45.

[3] *Ibid.*, pp. 13, 80–81. In 1641, Henry Robinson advocated the establishment of a bank which would receive deposits, upon which interest would be paid, and which would lend money; but he did not suggest that the obligations of the bank might circulate as money (see Henry Robinson, *England's Safety, in Trades Encrease* [1641], reprinted in part in W. A. Shaw, *Select Tracts and Documents Illustrative of English Monetary History, 1626–1730* [1896], pp. 55–58). Eleven years later, Robinson made vague statements by which he may have intended to suggest that a bank might by its operations increase the volume of circulating medium in the form of its own obligations (see Henry Robinson, *Certain Proposalls in Order to the Peoples Freedome and Accommodation in Some Particulars* [1652], also reprinted in part in Shaw, *op. cit.*, pp. 80–82).

money itself remaining with the banker.[4] Here is a definite implication to the effect that the liabilities of the bankers serve the purposes of money and an equally clear statement as to how such liabilities are created.[5]

Samuel Lamb in 1659 made statements which are markedly similar to those of Maddison. "Imaginary money" is loaned by the banks to depositors to the extent of two or three times the amount of the deposits, and payment of the proceeds is made again by "assignation."[6] The notion of "imaginary money" is all that is added to Maddison's statement. Sir William Petty thought the banks could increase a given sum of money to "near double" its amount.[7]

Sir Josiah Child showed less insight. He objected to the "trade of bankering" on the ground that it obstructed circulation and advanced usury, for the reason that men deposited their money with the goldsmiths and thus withdrew it from circulation.[8] Locke said little on the subject of banking, but he did suggest that credit can, for a limited time, supply the place of money, although he was not explicitly referring to banking.[9]

Michael Godfrey and John Pollexfen recognized a fact which has been explicitly stated by a strikingly small number of writers but which, if more frequently seen, might have prevented many men from coming to erroneous conclusions. They pointed out that when money is deposited with a bank the depositor has as full use of it as before it was deposited and that any notes issued upon the basis of the cash so received by the banker will constitute so much addition to the currency.[10]

An anonymous writer of 1705 saw the possibility that the banks might issue too many notes; in fact, he seemed to feel that there was nothing in

[4] Sir Ralphe Maddison, *Great Britains Remembrancer, Looking In and Out* (1655), pp. 19–20. This work is an expansion of an earlier pamphlet by Maddison, *Englands Looking In and Out* (1640). This latter work I have not seen. It is quite likely that Maddison should be given precedence over Potter.

[5] Maddison also stated a crude and simple quantity theory (see *Great Britains Remembrancer*, p. 15).

[6] Samuel Lamb, *Seasonable Observations* (1659), in *Somers' Tracts: A Collection of Scarce and Valuable Tracts*, arranged by Walter Scott (2d ed., 1809–15), VI, 457, 459.

[7] Sir William Petty, *A Treatise of Taxes and Contributions* (1662), p. 18; *Political Arithmetick* (1690), pp. 29–30, 113; *Quantulumcunque Concerning Money* (1695), p. 7. All of these are reprinted in *The Economic Writings of Sir William Petty* (1899), ed. Charles Henry Hull; the first two in Vol. I and the third in Vol. II. The original paging is included in these reprints and is used in the above citations.

[8] Sir Josiah Child, *A Discourse about Trade* (1690), Introd., pp. 41–42.

[9] John Locke, *Some Considerations of the Consequence of Lowering the Interest, and Raising the Value of Money* (1691), in *The Works of John Locke* (12th ed., 1824), IV, 148.

[10] Michael Godfrey, *A Short Account of the Bank of England* (1698), in *Somers' Tracts*, XI, 5; John Pollexfen, *A Discourse of Trade, Coyn and Paper Credit* (1697), p. 69.

the nature of banking to prevent bankers from indefinitely expanding their issues. He feared that the Bank of England through this expansion of its credit would ultimately attain such a degree of power as to render it dangerous to others engaged in trade.[11] John Briscoe likewise objected that the bank might "issue out bills for as many millions as they please," which he felt would be inadequately secured. He proposed, therefore, a national land bank, and he answered the possible objection that it also would issue too many bills by the assertion that "these bills being a new species of money, and to all intents and purposes answering the end of money; we may as well fear that we shall have too much money in the nation, which no wise man will complain of."[12]

Richard Harley denied that "banks and paper-credit" have any influence on either the volume of trade or the quantity of money employed in trade. First, a banker who has no "proper stock" of his own is a knave to lend the money of others, that is, of his depositors; second, the banker is a "fool" if he fails to take valuable and sufficient security; third, he never denied that it is helpful to trade to borrow money, but borrowing could be done without bankers; and, finally, in answer to the statement that they issue more bills than they have in cash, he stated that the bankers "must either have it in specie, or the money is in being, and they know where to command it (which is the same thing in our argument) or else they run into a precarious credit, which is a cheat in the bottom, and ought to be avoided as much as the passing of clipped money."[13] His argument, in so far as it pertains to the influence of the banks on the quantity of money, is good support of the position of those against whom it is directed. He insisted that in lending the money of other men the banks should do so only "upon the most valid securities, and with a certain prospect that they can command it at a short warning." Otherwise the public would become suspicious and demand its money from the banks. He asserted that a sound paper credit is never lessened in amount, but traders are afraid of a "precarious" credit. Although Harley did not so phrase it, his objection to the doctrine that the banks increase the quantity of money amounted to a denial that bank notes are money; but substantially he admitted that they do the work of money, although he doubtless would have denied this statement.

John Law was one of the better-informed men of his day on the subject

[11] Anonymous, *Remarks upon the Bank of England* (1705), pp. 18–21, 36–37.

[12] John Briscoe, *A Discourse on the Late Funds* (3d ed., 1696), pp. 60, 63–64.

[13] [Richard Harley], *A Vindication of the Faults on Both Sides* (1710), in *Somers' Tracts*, XIII, 7–8; *Faults on Both Sides* (1710), p. 42.

of banking. He saw clearly that the amount of bank credit is related to the cash held by the bank, stating that the Bank of Scotland loaned its notes to the extent of four or five times the amount of specie it had in vault and that it was by just this amount that the money of the nation was increased.[14] Law recognized that as an unfavorable balance of payments caused money to leave the country, the volume of bank credit would have to be contracted. His scheme for a land bank is of only incidental interest here; but, without defending his proposal, it may nevertheless be noted that his ideas, if judged on a comparative basis, hardly deserve the excessive degree of opprobrium with which reference is frequently made to them. Those of his critics who adhere to the notion that loans based upon commercial transactions cannot lead to an overissue of notes are committing essentially the same mistake as that made by Law. Both they and he unwarrantedly are assuming that, if loans are based upon a given money's worth of some commodity, overissue cannot take place.[15] Law made the same claim for his proposed notes secured by land that many writers have made for notes based on "real mercantile" transactions, namely, that the amount would vary precisely with variations in the demand for them and that consequently they would not fluctuate in value.[16]

Richard Cantillon's discussion of banking is much the best to be found during the period under consideration, that is, before 1750. He held that, if a banker found it necessary to maintain a ratio of 10 per cent of cash to deposits, he could lend 90 per cent of any deposit he might receive; and, while he believed that so low a ratio was possible, he thought it was not usual.[17] In this analysis he thought of the bankers as putting money back into circulation after it had been deposited, and thus accelerating the rapidity of the circulation of coins;[18] but elsewhere he remarked that "an acceleration or greater rapidity in circulation of money in exchange, is equivalent to an increase of actual money up to a point."[19] Nevertheless, at other times he recognized that the banks increase the quantity of money. He suspected that the ratio of cash to notes in the Bank of England was perhaps 25 per cent and, if so, then the money of the country

[14] John Law, *Money and Trade Considered* (1705), reprinted in Paul Harsin, *John Law: Œuvres complètes* (1934), I, 38–39, 60 (the original paging).

[15] This statement will be defended in chap. iii.

[16] Harsin, *op. cit.*, pp. 89–90, 96.

[17] Richard Cantillon, *Essai sur la nature du commerce en général* (written *ca.* 1730), ed. Henry Higgs (1931), pp. 299–303.

[18] *Ibid.*, pp. 139–43, 301. For a discussion of this point of view, see below, pp. 38, 96.

[19] Cantillon, *op. cit.* (Higgs ed.), p. 161.

would be increased to the extent of three times the amount of coin held by the bank as a reserve against notes. He believed that this increase would be of great "utility" when there was need for a speeding-up of the circulation of the currency, but he also thought that there were times when retardation rather than acceleration was desirable.[20]

Cantillon's conclusions in regard to the amount of lending made possible for the individual bank by the acquisition of a new primary deposit and of the extent of the increase in the total of the stock of currency brought about by the banking system were not substantially inaccurate; and yet I doubt that he understood how it is that a sharp limitation of expansion by the individual bank fails to prevent a less limited expansion on the part of the system as a whole. When he was discussing the problem of lending by the individual bank, he was looking at the *deposit* reserve ratio; and when he was considering the question of the increase in the aggregate of the currency, he meant the *note* reserve ratio.

The relationship of the banks to general economic conditions was also briefly considered by Cantillon. He believed that, with an inflow of specie, prices would rise, luxury creep in, more goods would be bought abroad, and eventually, therefore, the specie would again be sent out, thus bringing on poverty. This seemed to him to be a more or less inevitable round of events if the government did not intervene. Nevertheless, he believed that an increase in the quantity of money is desirable; but, once it has been acquired, the government should withdraw the excess (?) from circulation and retain it for emergencies.[21] His analysis of the unequal effects of the increased spending on the prices of commodities and on the various income groups is excellent.[22] He pointed out that the "fictitious" or "imaginary" money issued by the banks has the same influence on prices as "real" money but that the "furtive abundance" of the former "vanishes at the first gust of discredit and precipitates disorder." He contended, therefore, that when money circulates in a great state (as contrasted with a small state) "in greater abundance than among its neighbours a national Bank does more harm than good"; but whether this statement is to be interpreted as a general condemnation of banking is uncertain.[23]

[20] *Ibid.*, p. 307.

[21] *Ibid.*, p. 185.

[22] *Ibid.*, pp. 161–65, 177–81.

[23] *Ibid.*, p. 311. Brief assertions or implications to the effect that the banks increase the quantity of circulating medium can also be found in the following works: Anonymous, *A Letter to a Member of the Honourable House of Commons* (1697), pp. 14–15, 24; Anonymous, *The Circumstances of Scotland Considered* (1705), p. 27; Anonymous, *Considerations upon a Proposal for Lowering the Interest of All the Redeemable National Debts to Three Per Cent. per Ann.* (1737), p. 26; Robert Murray, *A Proposal for a National Bank* (1695? Another pamphlet with