Bank of England endorses Post-Keynesian Endogenous Money Theory

By Philip Pilkington
March 12, 2014 – *Fixing the Economists*

Well, the Bank of England has finally come out and said it: loans create deposits; banks create money and don't simply lend out savings; and the money multiplier in the economics textbooks is false. Actually, we've known this for a long, long time. While the BoE report references much Post-Keynesian work — including early work by Nicholas Kaldor and Basil Moore's path-breaking 1988 book *Horizontalists and Verticalists* — they would have done well to look up the findings of the Radcliffe Commission in the UK in 1957.

It is fantastic that the BoE has finally decided to lay its cards on the table and be honest with the public about how money is created. Unfortunately though, the report is not willing to make certain concessions. For example, it largely paints the Quantitative Easing programs as being effective — which they were not — and it also claims that the BoE still sets the variable that has the most influence on money creation; that is, the interest rate. This latter point ties into the whole debate surrounding the so-called 'natural rate of interest'.

With regards to the central bank's power to control lending the BoE authors insist that the "ultimate constraint on lending" is monetary policy. They explain how this functions as such,

> *The interest rate that commercial banks can obtain on money placed at the central bank influences the rate at which they are willing to lend on similar terms in sterling money markets — the markets in which the Bank and commercial banks lend to each other and other financial institutions… Changes in interbank interest rates then feed through to a wider range of interest rates in different markets and at different maturities, including the interest rates that banks charge borrowers for loans and offer savers for deposits. By influencing the price of credit in this way, monetary policy affects the creation of broad money. (p8)*

Now, the functionality of the mechanism that the BoE authors describe is perfectly in keeping with Post-Keynesian endogenous money theory — it is also perfectly in keeping with recent innovations (if we can call them that) in the New Keynesian literature by the likes of David Romer who replace the vertical-sloping LM curve in the ISLM model with a Taylor interest rate rule. But to a Post-Keynesian the characterisation of the setting of interest rates as being the "ultimate constraint on lending" is complete nonsense. Just to get a sense of the BoE authors' belief in the borderline omnipotence of the central bank let us once again quote them in the original,

> *The amount of money created in the economy ultimately depends on the monetary policy of the central bank. In normal times, this is carried out by setting interest rates. (p1)*

Actually no. The amount of money created in the economy is ultimately dependent on the demand for credit! Yes, the supply price of this credit — that is, the interest rate — will influence the demand for credit; but if we have learned anything from the economic stagnation of the past few years it is that the demand for credit is what truly drives credit creation and the supply price of credit is of secondary importance. Messing around with the supply price of this credit has very different affects, say, post-2008 as it did, say, at the beginning of the housing boom.

So, what decides the demand for credit? There are any number of different things that drive credit demand. Speculative excesses in the property or stock market might lead to substantially increased demand for credit as investors borrow money to speculate. Inflationary wage-price spirals may also drive the demand for credit as firms borrow money to meet increasing wage bills. But if we were to give one single determinate that is likely the most important in considering the demand for credit I would say: income growth. Yes, that's right: GDP growth.

At this point we encounter the classic Keynesian accelerator effect where increases in income cause increases in investment which in turn cause increases in income and so on in a circular fashion. What central banks do in such cyclical upswings or downswings of income and investment is of secondary importance.

Now, here's a controversial thought: what if the BoE authors actually understand this? We know that they have read the endogenous money literature which states all of this quite explicitly. Also, any time I encounter central bank economists they seem very pessimistic about their ability to spur lending. But what if in their official documents they simply cannot bring themselves to say it out loud?

Perhaps we should think of the central bank as a corporate institution that, like any corporate institution, seeks both funding/revenue and influence. And then perhaps we should understand their bald assertions that they are almost omnipotent in their creation of credit money not simply as self-aggrandisement — although there is surely an element of that — but as a sort of public relations exercise designed to keep the public interested and the politicians listening.

After all, it would be a strange emperor that would reveal his own nudity in front of his subjects. But still, the BoE — which is surely the most honest of the central banks — should certainly be given credit for at least giving its loyal subjects a little grin and a wink as it parades in front of us in its birthday suit.