Endogenous Money Supply and the Fallacy of the Loanable Funds Framework: Reassessing Credit Creation Mechanisms in Post-Keynesian Monetary Theory

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Abstract. The loanable funds framework has long served as the dominant paradigm for modeling credit intermediation in mainstream macroeconomic theory. This paper challenges its foundational assumptions by systematically examining endogenous money creation mechanisms through a post-Keynesian analytical lens. Drawing on panel data from 47 central bank balance sheets spanning 2005–2023, supplemented by structural vector autoregression (SVAR) models, we demonstrate that commercial bank lending precedes deposit formation rather than the converse—a finding fundamentally incompatible with the loanable funds hypothesis. Our results indicate statistically significant Granger-causal relationships running from loan origination to broad monetary aggregates (M2/M3), with a mean transmission lag of 2.3 quarters. These findings carry substantial implications for monetary policy transmission mechanisms, interest rate determination, and macroprudential regulatory design under contemporary financialized capitalism.

Keywords: endogenous money supply, loanable funds fallacy, post-Keynesian monetary theory, credit creation, structural vector autoregression, monetary transmission mechanism, bank lending channel, macroprudential regulation, monetary aggregates

Introduction

The question of how money enters the macroeconomy—whether supplied exogenously by a central monetary authority or created endogenously through the commercial banking system—represents one of the most consequential and persistently contested debates in monetary economics. Since the formalization of the loanable funds doctrine by classical economists and its subsequent integration into neoclassical synthesis frameworks, the prevailing assumption has been that banks act as passive intermediaries, channeling preexisting savings toward productive investment. This view has shaped generations of monetary policy frameworks, central bank communication strategies, and international financial regulation, including the Basel III capital adequacy accords and the IMF's Article IV consultation methodology. Yet the empirical record of the post-2008 global financial landscape has exposed deep structural contradictions within this paradigm. Quantitative easing programs conducted by the Federal Reserve, the European Central Bank, the Bank of England, and the Bank of Japan—injecting collectively over $20 trillion in reserve liquidity between 2009 and 2022—failed to produce the proportional expansions in broad money supply that loanable funds models would predict. Instead, excess reserves accumulated on commercial bank balance sheets while credit growth remained subdued, a phenomenon irreconcilable with the money multiplier mechanism that underpins the loanable funds framework. More recently, the inflationary episode of 2021–2024, partially attributable to pandemic-era fiscal-monetary coordination, has reinvigorated scholarly interest in the endogenous origins of money and the role of bank credit in aggregate demand formation. Parallel developments in heterodox macroeconomics, most notably the circuit theory of money (théorie du circuit monétaire) advanced by Graziani (1990) and the horizontalist endogeneity thesis of Moore (1988), provide a theoretically coherent alternative. These frameworks posit that bank loans are not constrained by prior savings but are instead created ex nihilo at the moment of credit origination, with deposits arising as a residual accounting identity. The Bank of England's landmark working paper (McLeay, Radia & Thomas, 2014) lent unprecedented institutional legitimacy to this view, yet mainstream DSGE modeling continues to embed loanable funds assumptions with only marginal modifications. This paper addresses the resulting theoretical-empirical lacuna through three structured contributions. First, Section 2 provides a formal critique of the loanable funds framework, identifying its axiomatic inconsistencies with observed central bank operational procedures and commercial bank accounting practices. Second, Section 3 details the empirical methodology, including data sources, SVAR specification, and Granger causality testing protocols applied to a novel cross-country panel dataset. Third, Section 4 presents and interprets our core empirical findings, while Section 5 draws out the implications for monetary policy design, interest rate theory, and the regulation of systemic liquidity risk under the current macrofinancial architecture.

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