Endogenous Money Supply Doctrine Versus Loanable Funds Theory: Reconciling Post-Keynesian Credit Creation Mechanics with Neoclassical Intermediation Paradigms Under Basel III Constraints

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Abstract. The longstanding dichotomy between endogenous money supply doctrine and loanable funds theory has persisted as a foundational fault line in macroeconomic thought, generating persistent misalignments in monetary policy transmission modeling. This study applies a dynamic stochastic general equilibrium (DSGE) framework augmented with balance-sheet heterogeneity to reexamine credit creation mechanics across seventeen OECD economies over the period 2010–2023. Employing panel vector autoregression (PVAR) and structural impulse-response analysis, the findings demonstrate that commercial bank lending operates predominantly through endogenous deposit creation rather than intermediated savings mobilization, critically undermining standard loanable funds assumptions embedded in canonical monetary models. Results further indicate that Basel III capital adequacy constraints modulate, but do not fundamentally reverse, endogenous credit dynamics. Policy implications for central bank forward guidance and macroprudential regulation are discussed.

Keywords: endogenous money supply, loanable funds theory, Post-Keynesian monetary economics, credit creation mechanics, dynamic stochastic general equilibrium, Basel III macroprudential regulation, monetary policy transmission, bank balance-sheet heterogeneity, panel vector autoregression

Introduction

The architecture of modern monetary economics rests, in large measure, upon assumptions regarding how credit is created, allocated, and absorbed within the macroeconomic system. Two competing theoretical traditions have long governed this discourse: the neoclassical loanable funds framework, which conceptualizes banks as passive financial intermediaries channeling pre-existing savings toward productive investment, and the Post-Keynesian endogenous money doctrine, which posits that commercial banks actively generate purchasing power through loan origination, with deposits constituting an ex post consequence rather than an ex ante prerequisite of lending activity. Despite decades of theoretical contestation, empirical resolution has remained elusive, partly because prevailing DSGE models embedded in central bank policy toolkits continue to operationalize the intermediation hypothesis, even as mounting microeconomic evidence from bank-level balance sheet data systematically contradicts it. The relevance of this debate has intensified considerably in the context of the post-pandemic macroeconomic landscape of 2024–2026. Central banks across advanced and emerging economies confront simultaneously elevated inflation, historically unprecedented sovereign debt levels, and structural fragilities in the commercial banking sector amplified by rapid interest rate normalization cycles. In this environment, the theoretical priors governing monetary policy transmission models carry direct operational consequences: if credit creation is endogenous, then contractionary monetary policy operates through mechanisms—primarily loan demand suppression and bank profitability compression—that are categorically distinct from those implied by loanable funds logic, where rate hikes are expected to curtail savings-to-investment conversion. Misidentification of these channels risks systematic policy calibration error with measurable welfare costs across income distribution strata. The imposition of Basel III regulatory architecture further complicates this theoretical landscape. Capital adequacy ratios, liquidity coverage requirements, and net stable funding ratios introduce binding constraints on bank balance sheets that interact non-trivially with endogenous money dynamics. Whether these prudential instruments effectively reconfigure credit creation toward an intermediation-consistent behavioral pattern, or merely impose frictional costs upon an inherently endogenous process, remains underexplored in the extant literature. This paper addresses these gaps through a rigorously specified empirical investigation. Section 2 provides a formal theoretical reconciliation of competing monetary doctrines within a unified balance-sheet accounting framework. Section 3 details the DSGE model augmented with bank heterogeneity and regulatory constraints. Section 4 presents the PVAR estimation strategy and dataset construction covering seventeen OECD economies. Section 5 reports structural impulse-response functions and variance decomposition results. Section 6 discusses macroprudential and forward-guidance policy implications, and Section 7 concludes with directions for future research.

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