

Endogenous Money Supply and the Redundancy of the Quantity Theory: Reassessing Monetary Transmission Mechanisms Under Post-Keynesian Credit Dynamics

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Abstract. This paper critically re-examines the theoretical foundations of the Quantity Theory of Money (QTM) in light of endogenous money creation frameworks, challenging its continued application in contemporary central bank policy design. Drawing on post-Keynesian monetary circuit theory, balance-sheet mechanics of commercial bank lending, and panel data from 38 OECD economies spanning 2005–2023, we demonstrate that the exogenous money multiplier model systematically misrepresents monetary transmission channels under modern credit-driven financial architectures. Employing structural vector autoregression (SVAR) and dynamic factor models, our results confirm that broad money aggregates are demand-determined endogenous outcomes rather than policy-controlled instruments. These findings carry significant implications for inflation targeting regimes, quantitative easing efficacy assessments, and macroprudential regulatory calibration across advanced and emerging market economies.

Keywords: endogenous money creation, quantity theory of money, post-Keynesian monetary theory, monetary transmission mechanism, credit dynamics, monetary circuit theory, structural vector autoregression, macroprudential policy, inflation targeting

Introduction

The foundational tenet of the Quantity Theory of Money (QTM)—that a stable and predictable causal relationship exists between the exogenously controlled money supply and the general price level—has underpinned orthodox monetary economics for over three

centuries, from Hume's proto-quantity theoretic essays through the Fisherian equation of exchange to Friedman's monetarist reformulation. Yet the persistence of this framework within central banking doctrine has grown increasingly untenable in an era defined by financialized capitalism, expansive shadow banking systems, and the demonstrated impotence of broad money targeting in the aftermath of the 2008 Global Financial Crisis and the COVID-19 macroeconomic dislocations of 2020–2022. As of 2024–2026, major central banks including the Federal Reserve, the European Central Bank, and the Bank of England operate entirely without explicit monetary aggregate targets, a *de facto* institutional acknowledgment of the QTM's empirical inadequacy that has yet to be fully reconciled within mainstream theoretical discourse. The endogenous money hypothesis, advanced systematically within post-Keynesian political economy, posits a categorically different monetary architecture: commercial banks create purchasing power *ex nihilo* through the act of lending, with the central bank's role reduced to one of accommodation and interest rate signaling rather than quantity control. This reconceptualization dissolves the mechanistic money-multiplier model that continues to populate undergraduate textbooks and inform significant strands of dynamic stochastic general equilibrium (DSGE) modeling, raising profound questions about the internal consistency of policy frameworks that rely upon it. Despite a growing empirical literature supporting money endogeneity—including landmark contributions from Kaldor, Moore, Lavoie, and more recently Jakab and Kumhof at the Bank of England—a systematic cross-country econometric validation integrating balance-sheet-level bank data with macroeconomic transmission evidence remains absent from the literature. This paper addresses that gap directly. Specifically, we interrogate whether monetary aggregates across 38 OECD member states exhibit properties consistent with endogenous determination over an eighteen-year window encompassing multiple monetary policy regimes, including unconventional asset purchase programs. The remainder of this article is structured as follows. Section 2 provides a formal theoretical exposition contrasting the exogenous and endogenous money paradigms, with explicit attention to circuit theory and horizontalism. Section 3 details the empirical strategy, including the structural VAR specification and dynamic factor model construction. Section 4 presents and interprets the cross-country estimation results. Section 5 discusses policy implications for inflation targeting credibility, macroprudential leverage constraints, and the design of post-QE normalization pathways. Section 6 concludes with recommendations for theoretical revision in mainstream monetary modeling frameworks.

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