JOURNAL ARTICLE

The loanable funds fallacy: saving, finance and equilibrium

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Cambridge Journal of Economics, Volume 34, Issue 4, July 2010, Pages 807–820, https://doi.org/10.1093/cje/bep073

Published: 17 November 2009 **Article history** ▾

Abstract

The loanable funds controversy cannot be settled without prior agreement on the meanings of income and equilibrium. The essential claim of loanable funds theory is that disequilibrium in the goods market affects the rate of interest. This paper introduces financial accounting concepts and a new understanding of the principle of effective demand to clarify that loanable funds theory relies on a concept of income other than current income, namely yesterday's income in the case of Robertson, or full-employment equilibrium income in the case of Hicks. In Robertson's case, this is a matter of bad accounting, a confusion between an income statement and a balance sheet. In Hicks's more subtle case, it is about the inapplicability of Walras' Law to a monetary economy. Keynes's principle embodies a Marshallian concept of system equilibrium under which the goods market is treated as never in disequilibrium in the sense required by loanable funds theory.

JEL: B22 - Macroeconomics, E20 - General, E43 - Interest Rates: Determination, Term Structure, and Effects

Issue Section: Articles