

# The Fiscal dominance taboo

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# Fiscal vs Monetary dominance

- **Monetary dominance:** Fiscal policy must adjust to the actions of the independent monetary authority targeting low inflation
  - CB should not support fiscal policy objectives
  - Limits on borrowing via fiscal rules
  - Govt must reduce spending or increase taxation if budget deficits increase due to tighter monetary policy
- **Fiscal dominance:** central bank must adjust monetary policy to enable the government to achieve its spending objectives
  - keeping interest rates on government debt low
  - buying up government bonds
  - directly lending to government

# Fed-Treasury tensions and the risk of fiscal dominance

By Edoardo Reviglio / 16 September 2025



## Central bank personnel changes in US and euro area could unhinge global markets

Financial markets face a growing threat of 'fiscal dominance' – when finance ministries force central banks to underwrite government debt or reduce interest rates to cope with burgeoning government debt. As has [long been recognised](#), hampering central banks' independence weakens safeguards against inflation, upsets markets and ends up not supporting but reducing growth.

## 'Fiscal populism' is coming for central banks

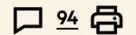
When monetary policy is set to meet government budgetary needs, these institutions become piggy banks

ANDY HALDANE Added



Andy Haldane

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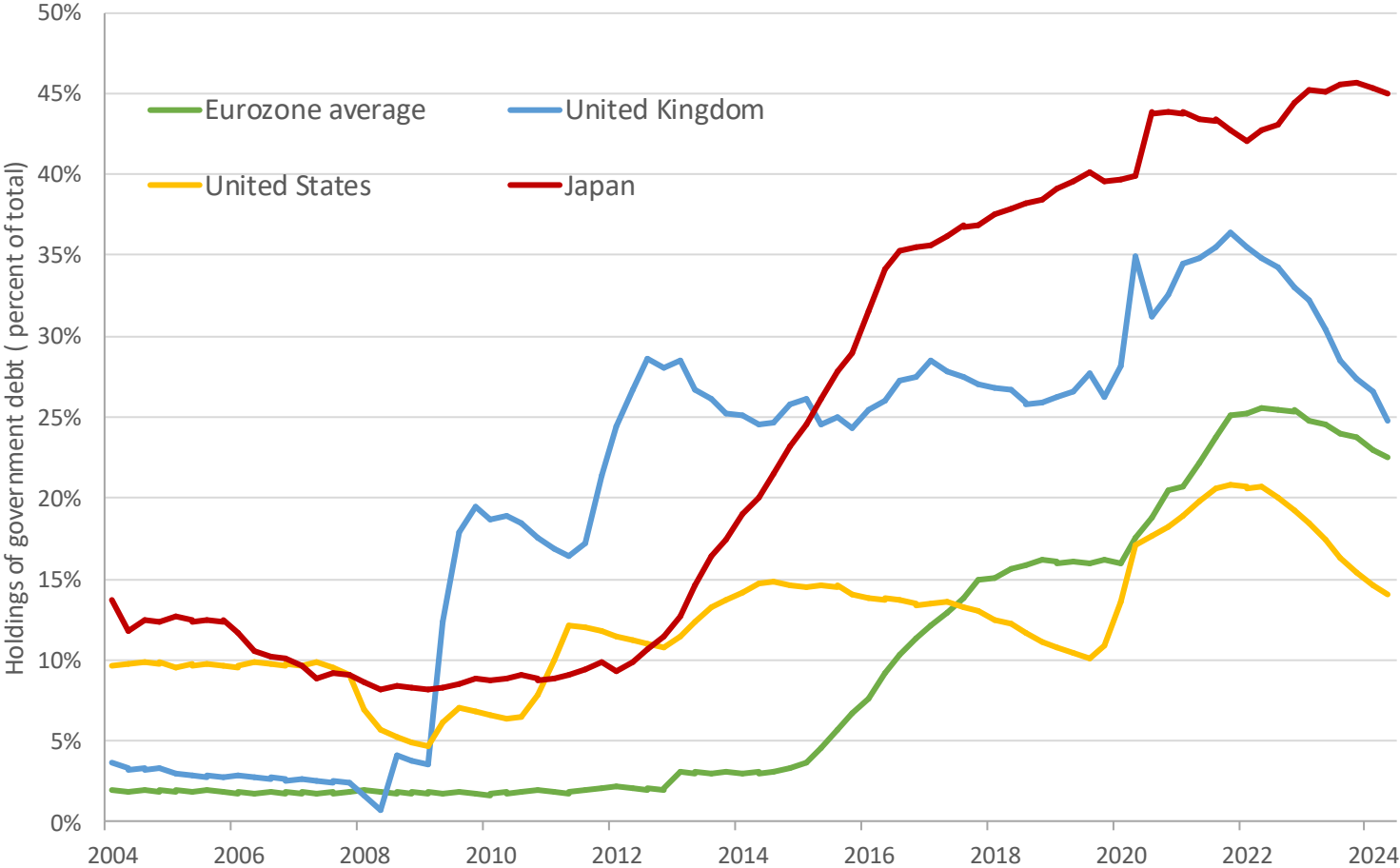


*The writer, an FT contributing editor, is former chief economist at the Bank of England*

The only thing central banks fear more than a bout of inflation is an era of fiscal dominance. This is one in which governments' budgetary needs begin to dictate monetary policy outcomes, either through direct financing of fiscal deficits or artificially low interest rates. Either way, the books are balanced courtesy of an inflation tax.

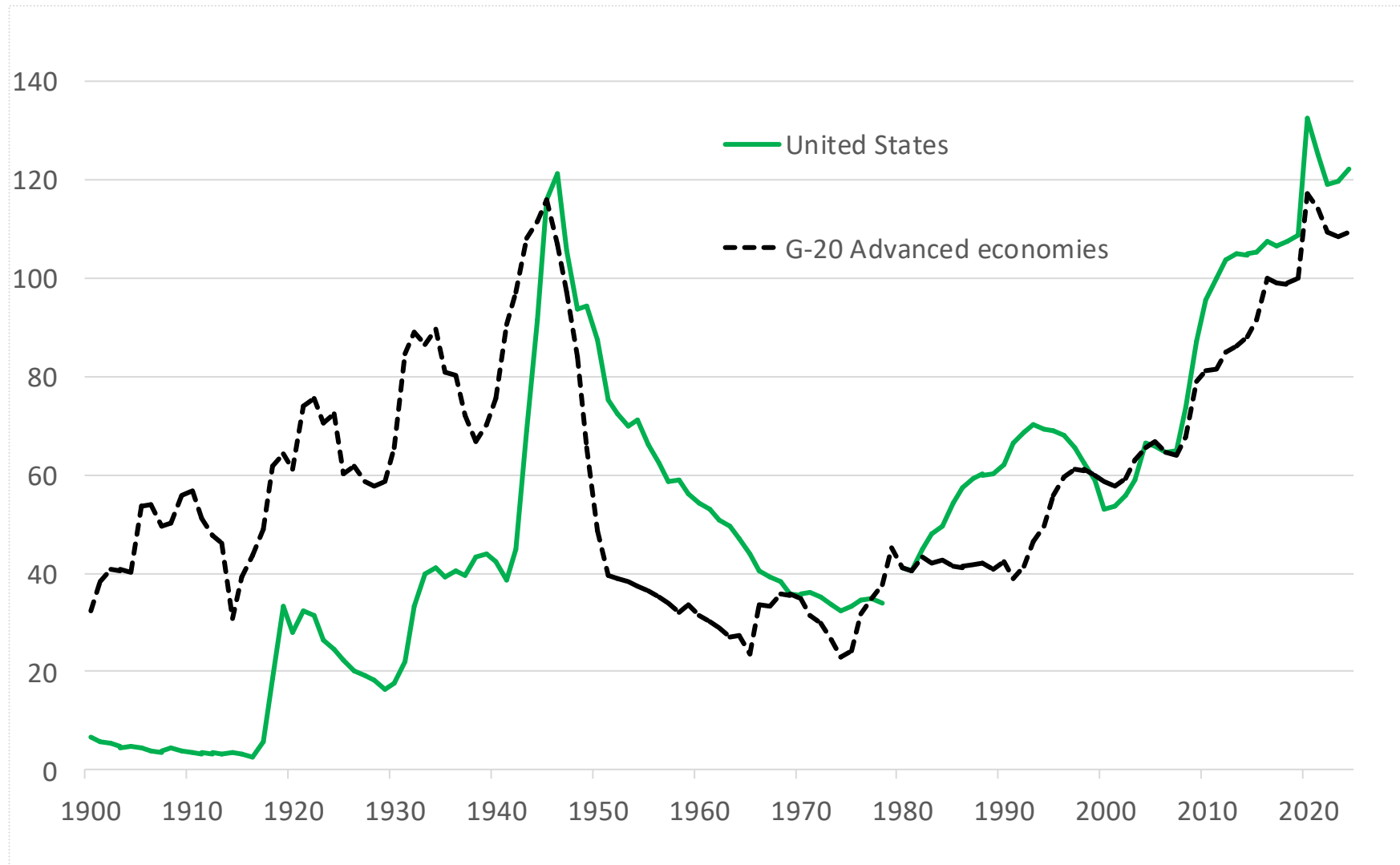
# Post-GFC: return of fiscal dominance?

Proportion of total govt. debt held by domestic central banks, 2004-2024



Source: IMF Sovereign Debt Investor Base for Advanced Economies (April 2020 update), available at [https://www.imf.org/~media/Websites/IMF/imported-datasets/external/pubs/ft/wp/2012/Data/\\_wp12284.ashx](https://www.imf.org/~media/Websites/IMF/imported-datasets/external/pubs/ft/wp/2012/Data/_wp12284.ashx);

# Debt-to-GDP ratios 1900-2025



Source: IMF datamapper [https://www.imf.org/external/datamapper/DEBT1@DEBT/FAD\\_G20Adv/GBR/USA/JPN](https://www.imf.org/external/datamapper/DEBT1@DEBT/FAD_G20Adv/GBR/USA/JPN)

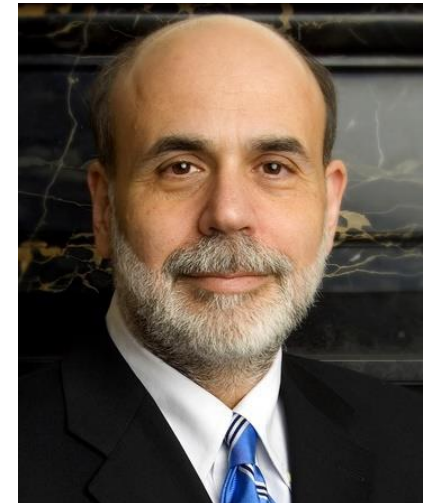
# Mainstream macro view on fiscal/monetary roles

- Long-run GDP growth determined on *supply side* (technology & human capital)
- 1970s ‘stagflation’ – rising inflation and rising unemployment - blamed on inflationary deficit financing of governments (Friedman)
- Time inconsistency problem (Kydland and Prescott 1977)
- Targeting demand through deficit financing doesn’t work:
  - “Crowding out” – deficit financing raises interest rates by pushing up demand for limited ‘loanable funds’ → fall in investment offsets stimulus (Buiter 1977)
  - Rational expectations & Ricardian equivalence: rational agents ‘see through’ fiscal stimulus (Lucas 1973; Barro 1974)) & reduce their spending accordingly
- Monetary financing will generate inflation & inflationary expectations (South America in 1980s - Alessina 1988; Cukierman 1992)



# New Keynesian synthesis (1990-2020?)

- Distinction between 'short-run' and 'long-run' (Woodford 2003)
- Keynes' insights apply to short-run dynamics created by imperfect markets: sticky prices, wage rigidities, financial frictions can lead to short-run deviations from equilibrium (a.k.a. the 'business cycle')
- Key job of macroeconomic policy: remove short-run frictions and stabilize the economy
- Monetary policy (interest rate adjustment) better placed to achieve this as fiscal policy takes time and can distort natural rate of interest
- Fiscal used only for short-term adjustments to shocks (automatic stabilizers) and discretionary interventions when interest rate policy exhausted (Zero Lower Bound) or other emergencies



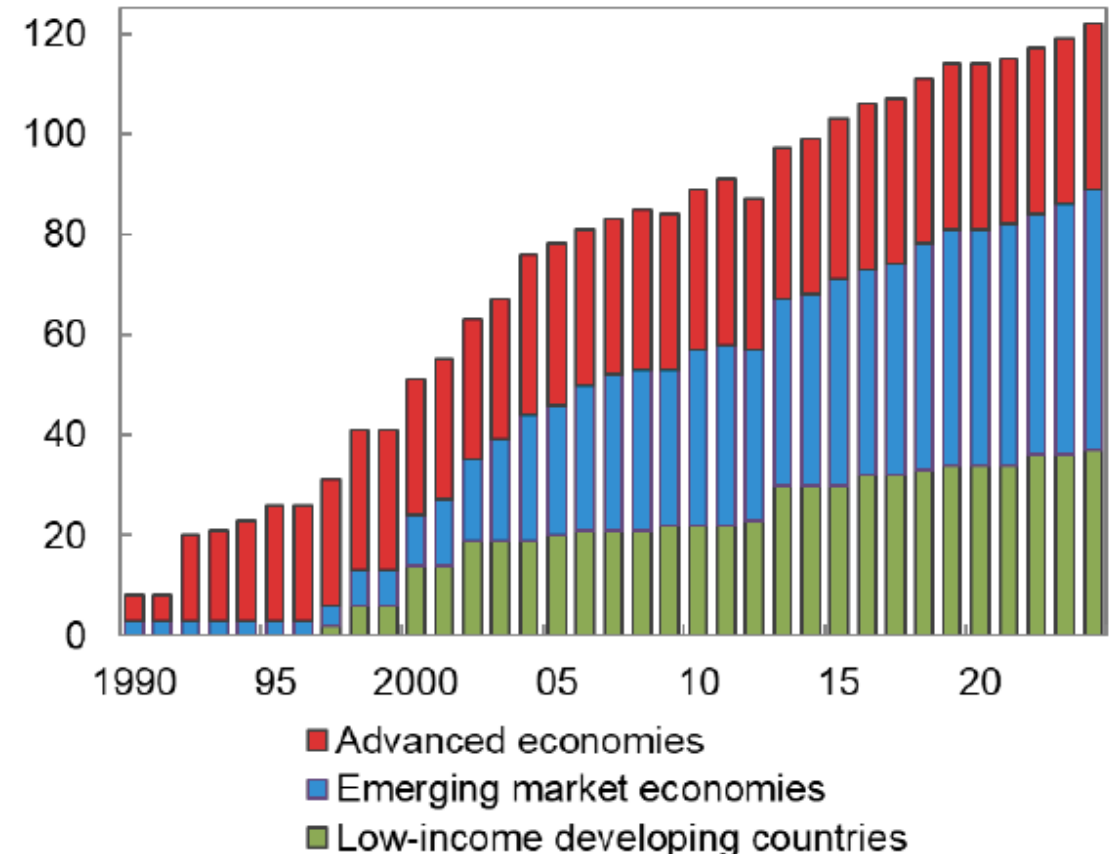
# Mainstream fiscal policy

- State ultimately faces a hard budget constraint determined by ratio spending to taxation
- Avoid 'political inflation' by outsourcing money creation to **independent central bank** focused on inflation & prohibited from financing government
- Avoid crowding out and maintain debt sustainability via '**fiscal rules**' / '**fiscal anchor**' that limits annual deficit or debt-to-GDP ratios.
- Strict separation of fiscal and monetary policy functions

# The establishment of monetary dominance

- 1990s onwards: inflation targeting as primary central bank objective & CBI
- 1980s/1990s: prohibition of monetary financing made a condition of IMF/World Bank loans ('structural adjustment')
- EU: 1992 Maastricht Treaty forming the European Union:
  - prohibits CB purchase of govt debt on primary markets
  - Growth & Stability Pact – limits member states' annual budget deficits to 3% GDP & 60% govt dept-to-GDP ratio.
- Creation independent agencies charged forecasting & monitoring impacts of fiscal policy on govt. debt (Congressional Budget Office (US); Office of Budget Responsibility (UK)).

Number of countries with at least one fiscal rule



Source: IMF Fiscal rules database, 1985-2024

# Fiscal dominance myths no. 1: Relationship between central bank independence and low inflation

- Empirical observation of correlation between CBI and low inflation/high deficits suffers from selection bias (South American/Eastern Europe 1970s-1990s) (Crowe and Meade 2007; Klomp and De Haan 2010)
- These countries had weak tax raising powers, limited financial markets, limiting government options. Also, persuasive supply-side explanations for these crises, e.g. oil shocks, balance of payments crises, excessive capital inflows (Vernengo 2007)
- Relationship does not apply to advanced economies with mature institutions.
- Virtually no instance of hyperinflation outside war time or major economic dislocation (Hanke and Krus 2013)
- Correlation versus causation: low inflation regimes reflect financial sector (creditor) dominance and *lead* to CBI (Epstein, 1994, Posen, 1995, Ingham, 2004)
- Modern day inflation coming from supply-side, not demand side shocks driven by geopolitical fragmentation, ageing population, environmental breakdown, oligopolistic firm power, resource scarcity not wage-price spirals
- No empirical evidence of 'anchored' inflation expectations

# History suggests fiscal dominance/monetary financing can support long-run growth and debt-to-GDP reduction

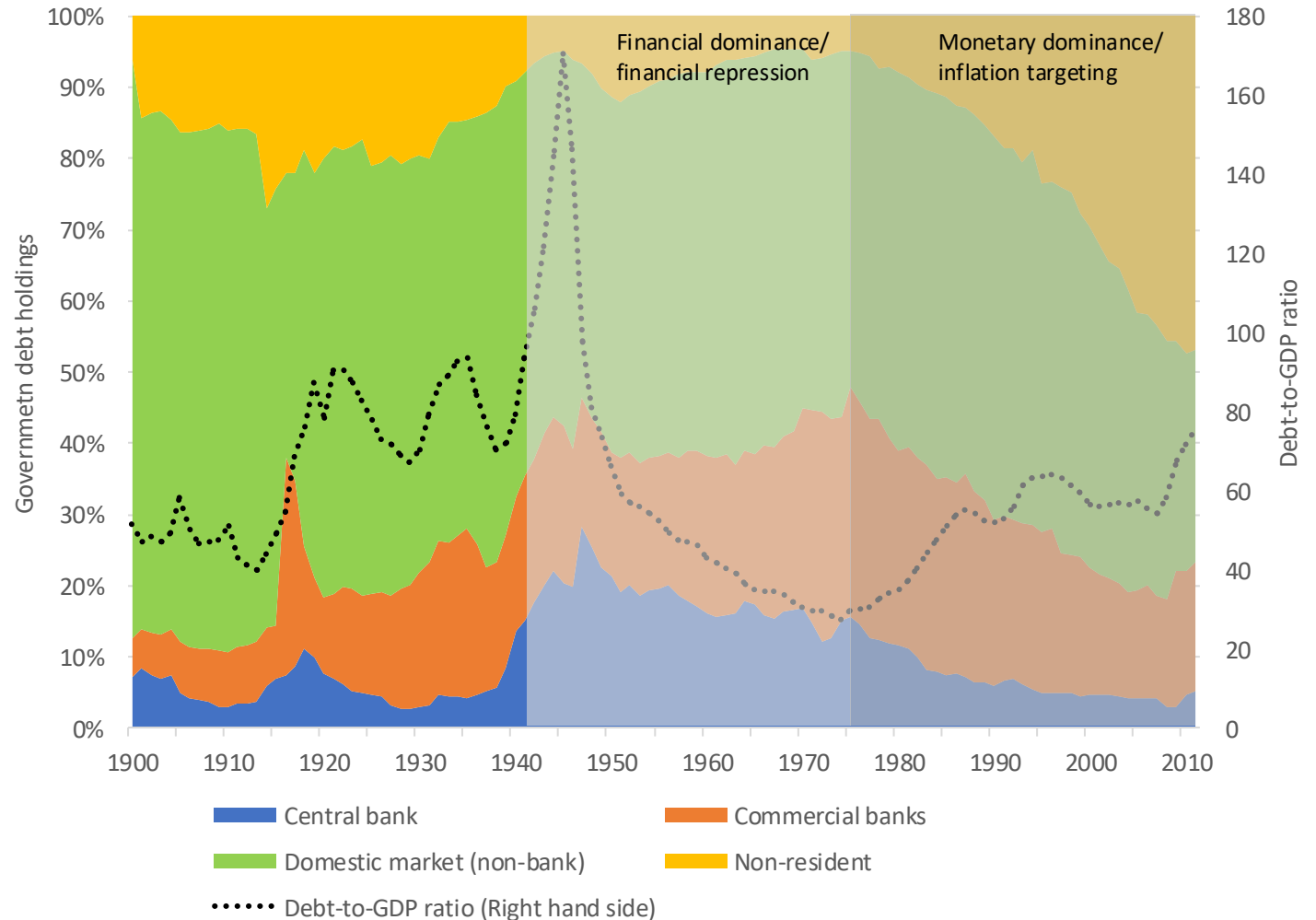
- 1940-1970s fiscal dominance

- Central banks held down yield on govt. debt below growth rate of economy & inflation, reducing war debts (held c.15% of debt on balance sheet)
- 'Financial repression': commercial banks & NBFIs also forced to hold govt. debt at low yields (Reinhard & Sbrancia 2015)
- Capital controls, most debt held domestically
- High public & private capital investment, full employment, high growth

- 1980s-2000s monetary dominance

- Inflation targeting
- Higher interest rates, rising debt-to-GDP ratio
- Financial globalisation & liberalization

Composition of ownership of government debt and debt-to-GDP ratio averaged across 13 high-income economies, 1900-2011



# Example: Canada 1935-1970

- Great Depression & War: nationalisation of debt, substantial direct and indirect monetary financing, via the CB and chartered banks, credit creation to fund government war spending
- post-war recovery and industrialization in the 1950s and 1960s, ¼ of govt. debt monetized, enforced low interest rates, T-bills held by private banks
- The Canadian small business sector, through the Industrial Development Bank (IDB), a wholly-owned subsidiary of the Bank

*The British Journal of Sociology* 2017



## **Breaking the taboo: a history of monetary financing in Canada, 1930–1975**

Josh Ryan-Collins

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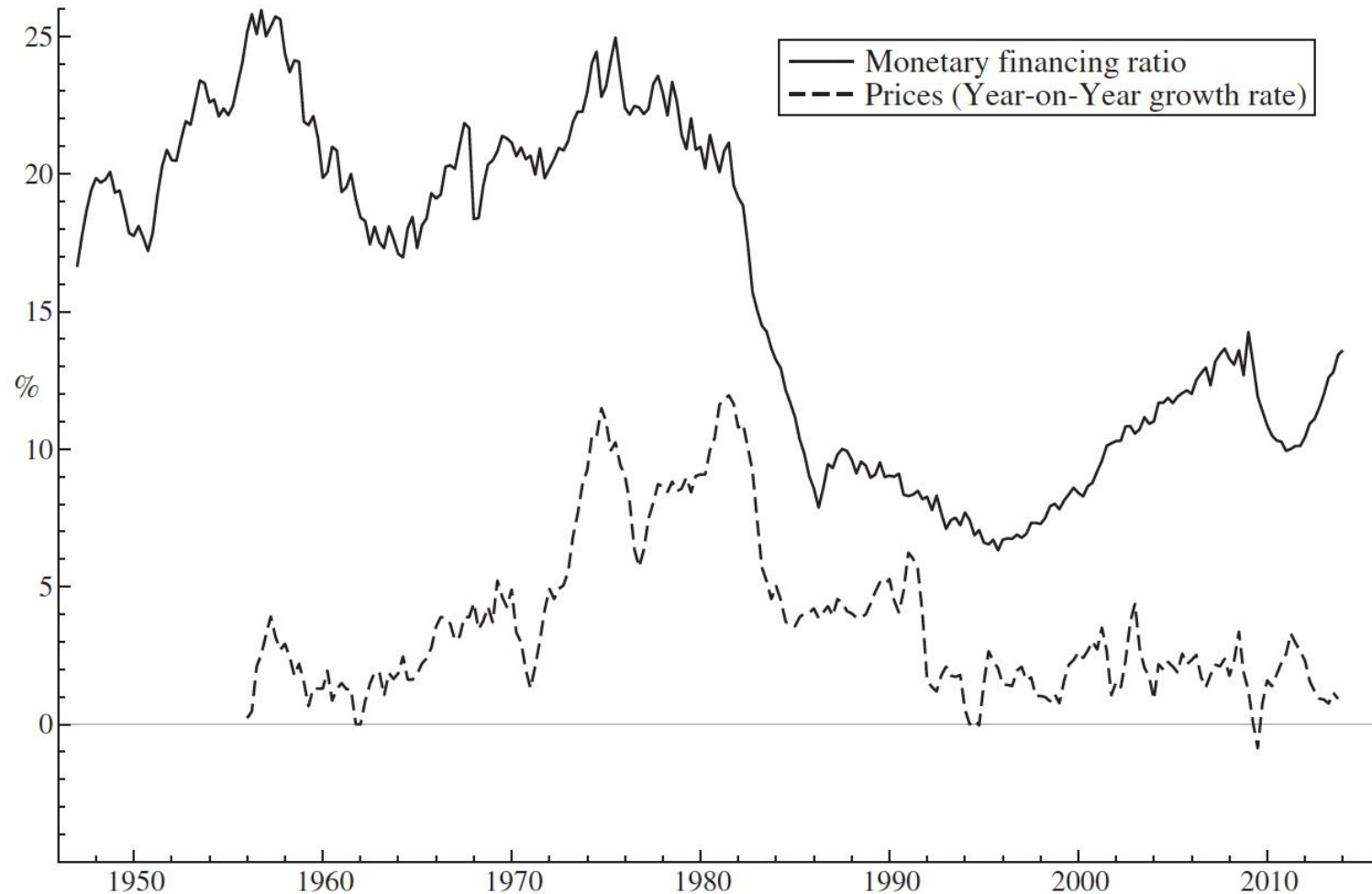
### **Abstract**

Monetary financing – the funding of state expenditure via the creation of new money rather than through taxation or borrowing – has become a taboo policy instrument in advanced economies. It is generally associated with dangerously high inflation and/or war. Relatedly, a key institutional feature of modern independent central banks is that they are not obligated to support government expenditure via money creation. Since the financial crisis of 2007–2008, however, unorthodox monetary policies, in particular quantitative easing, coupled with stagnant growth and high levels of public and private debt have led to questions over the monetary financing taboo. Debates on the topic have so far been mainly theoretical with little attention to the social and political dynamics of historical instances of monetary financing. This paper analyses one of the most significant twentieth-century cases: Canada from the period after the Great Depression up until the monetarist revolution of the 1970s. The period was a successful one for the Canadian economy, with high growth and employment and manageable inflation. It offers some interesting insights into the relationship between states and central banks and present-day discussions around the governance of money creation.

**Keywords:** money; central banks; credit; sociology of money; inflation; canada

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# Central bank holdings of government debt & inflation in Canada



Sources: Ryan-Collins, 2017, Breaking the taboo; CANSIM Table 1876-0022; CPI, 2010=100 from OECD Main Economic Indicators.

# Myth no 2: “Crowding out”

- “Loanable funds” theory of money and natural rate of interest, with banks intermediating pre-existing savings (deposits)
- In monetary production economy, banks create >90% of money supply based on confidence in borrower’s ability to repay (or ability to generate fees from securitization) – loans create deposits and savings are a residual of credit creation, i.e. no ‘natural rate’
- Government ‘spending’ is also money creation in a balance sheet sense, with CB crediting government account, not recycling of tax money or savings (Berkeley et al 2025)
- Bond issuance (‘deficit-financing’ or ‘borrowing’) involves selling government debt securities to investors who purchase them with funds that are not actively supporting investment or production.
- One financial asset (deposits) has been replaced with another (government bonds), rather than scarce loanable funds being taken from investors and given to the government. Deficit-financing thus *creates new assets in the private sector*: opposite of ‘crowding out’ the private sector.
- Deficit financed government spending creates new *net* private sector assets (in contrast to bank lending). Yield on sovereign debt always lower than on bank debt.

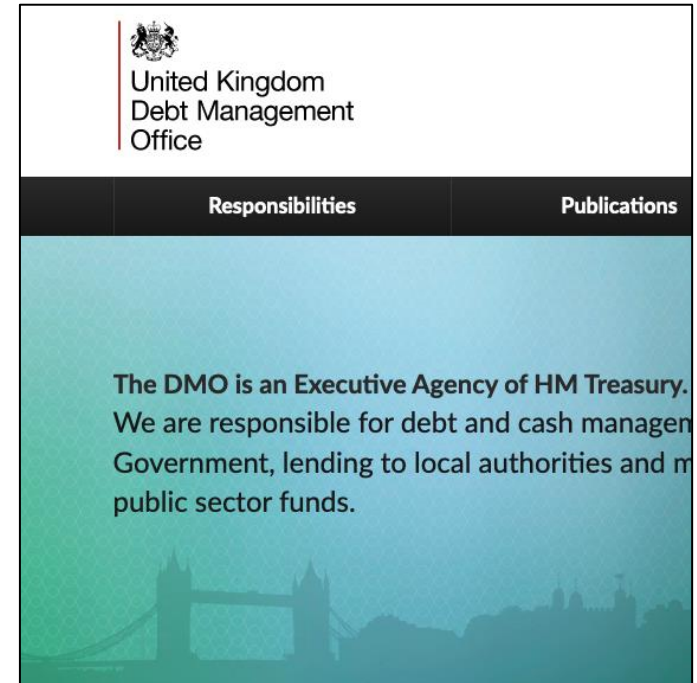
# Myth no. 3: Ricardian equivalence

- Assumptions:
  - people care about future generations
  - no borrowing constraints (i.e. agents can always access credit for any purchase they want)
  - taxes have no distortionary impacts
- Empirical and behavioural studies including by mainstream show the theorem does not apply in the real world (Summers et al., 1987; Galí et al., 2007).
- Multiple studies show fiscal multiplier can be higher than 1 & fiscal policy can have long term impacts (IMF 2012; Blanchard and Leigh, 2013; Erickson et al., 2015)

# Technical justification for ‘full funding’ rule: support interest rate targeting

- ‘...the government believes that the principles of transparency and predictability are best met by the **full funding** of its financing requirement’... [and]
- ‘...to avoid the perception that financial transactions of the public sector could affect *monetary conditions*, consistent with the institutional separation between monetary policy and debt management policy.’
- The overall debt management objective is ‘to minimise, over the long term, the costs of meeting the government’s financing needs, taking into account risk, while ensuring that debt management policy is consistent with the aims of monetary policy’

(Debt Management Office, Debt management report 2021 to 2022,p3).



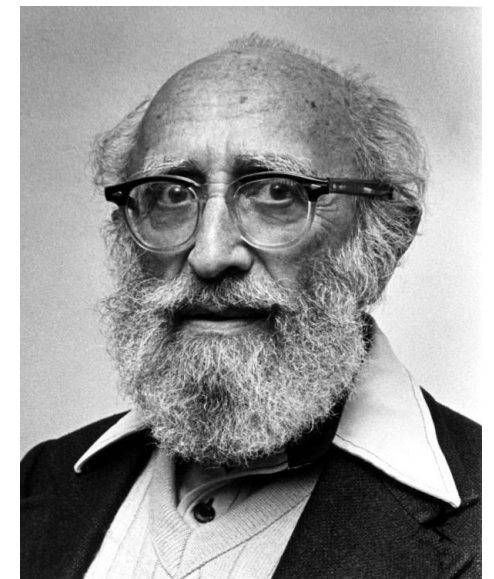
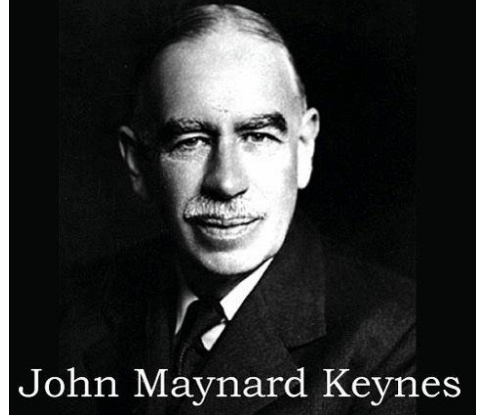
# Changing reserve management regimes

- Pre-GFC, CBs aimed at specific *quantity* of reserves in interbank market to hit short-term interest rate. Open-market operations by CB (buying & selling govt. bonds) removed or increased reserves or 'corridor' reserve remuneration schemes (UK & EU).
- Post-GFC, QE meant excess of reserves in interbank market. CBs began to remunerate all reserves at policy rate to ensure transmission of policy rate ('floor system').
- Price floor renders quantity of reserves in the interbank market *largely irrelevant* to achievement of interest rate target (Berkeley et al 2025)

# Post-Keynesian macro theory

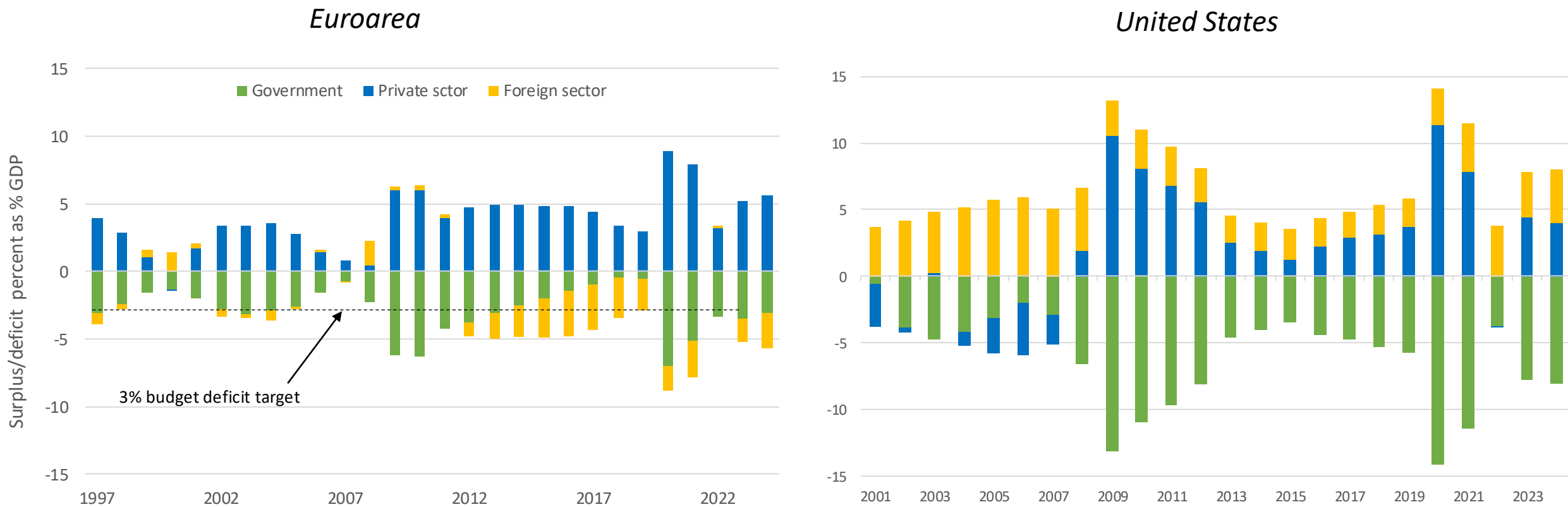
- In a monetary production economy with credit creating banking system, no 'natural rate' of interest where savings and investment equilibrate
- Lending, investment and private spending determined by *expectations* about an uncertain future – '*animal spirits*' and liquidity preferences (which determine market interest rates)
- Capitalist markets prone to instability and persistent unemployment due to uncertainty
- If rate of interest  $>$  rate of return on capital investment, investment will fall
- Objective of public finance should be to achieve public purpose: (e.g. full employment/green transition), not target arbitrary debt ratio. (Lerner 1943)
- Monetary policy ineffective during crisis because of collapse in confidence: "*monetary policy is like a string, you can pull, but not push*"
- Real constraint on fiscal space is *productive capacity* of economy and, relatedly, inflation
- **Taxation** is a tool to manage inflation/redistribute resources
- Purpose of **borrowing** is to:
  - provide safe store of value for private sector
  - Manage liquidity (reserve management)

## The General Theory of Employment, Interest and Money



# Sectoral balances: government deficit is private sector surplus

$$(Private\ sector\ Savings - Investment) + (Taxes - Government\ spending) + (Imports - Exports) = 0$$



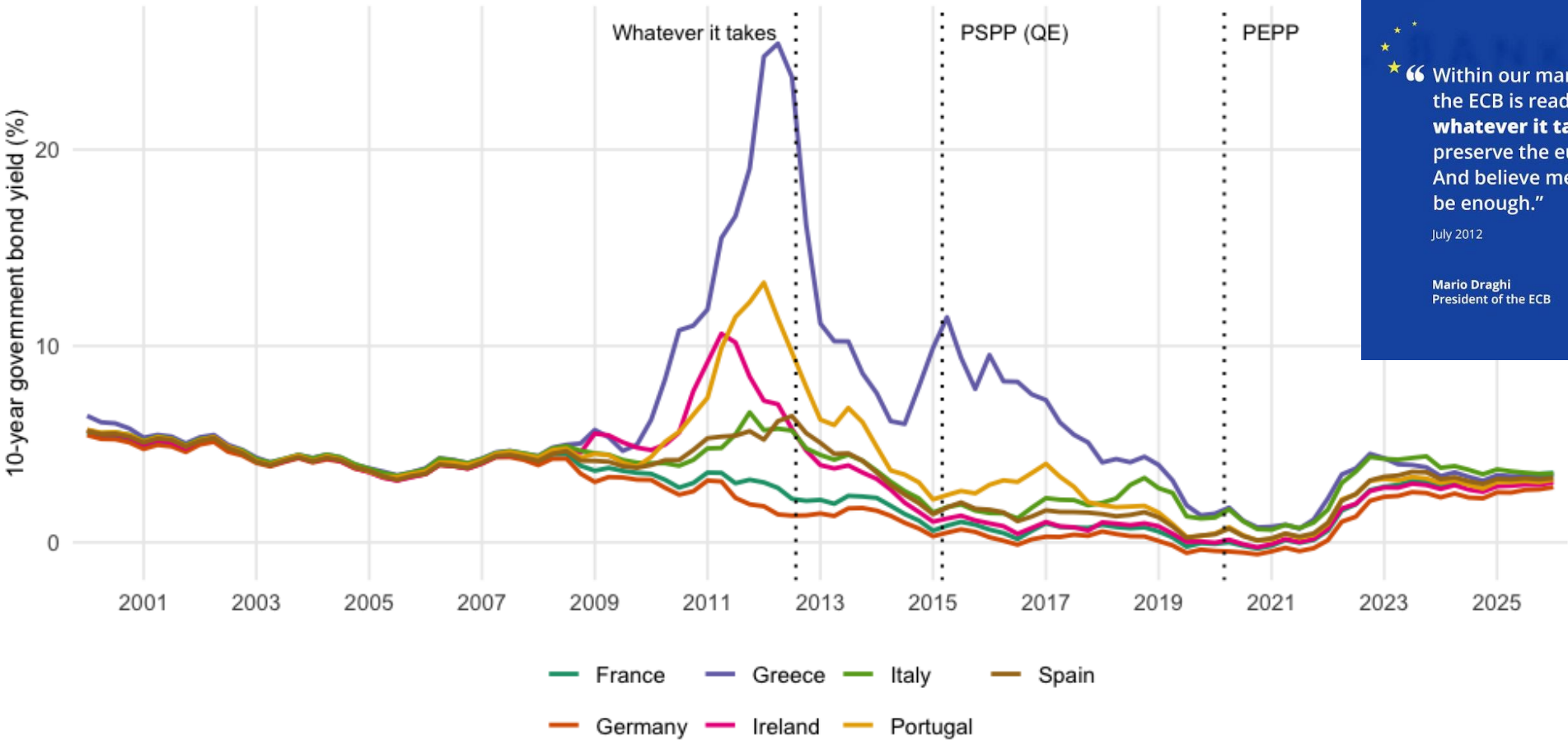
Source: Assa et al (2025) Macroeconomics in 3D: Three Sectoral Balances for 195 Countries, 1980-2024 (Assa et al., 2025)

# Covid-19 interventions: Monetary policy support for fiscal expansion

- Sharp falls in policy rates and huge asset purchase programs (far in excess of GFC) ensured public borrowing costs declined across most economies
- Explicit yield curve targeting on govt debt:
  - March 2020: RB Australia committed to holding 3-year yields at 0.25%, later 0.1% (RBA 2020).
  - March 2020: ECB Pandemic Emergency Purchase program
- Supported on average 9% increase in fiscal deficits

# Eurozone crisis

10-year sovereign bond yields on selected Eurozone economies, 2000-2025



“ Within our mandate, the ECB is ready to do **whatever it takes** to preserve the euro. And believe me, it will be enough.”

July 2012

Mario Draghi  
President of the ECB

Source: OECD Main Economic Indicators – Long-term interest rates (10-year government bonds)

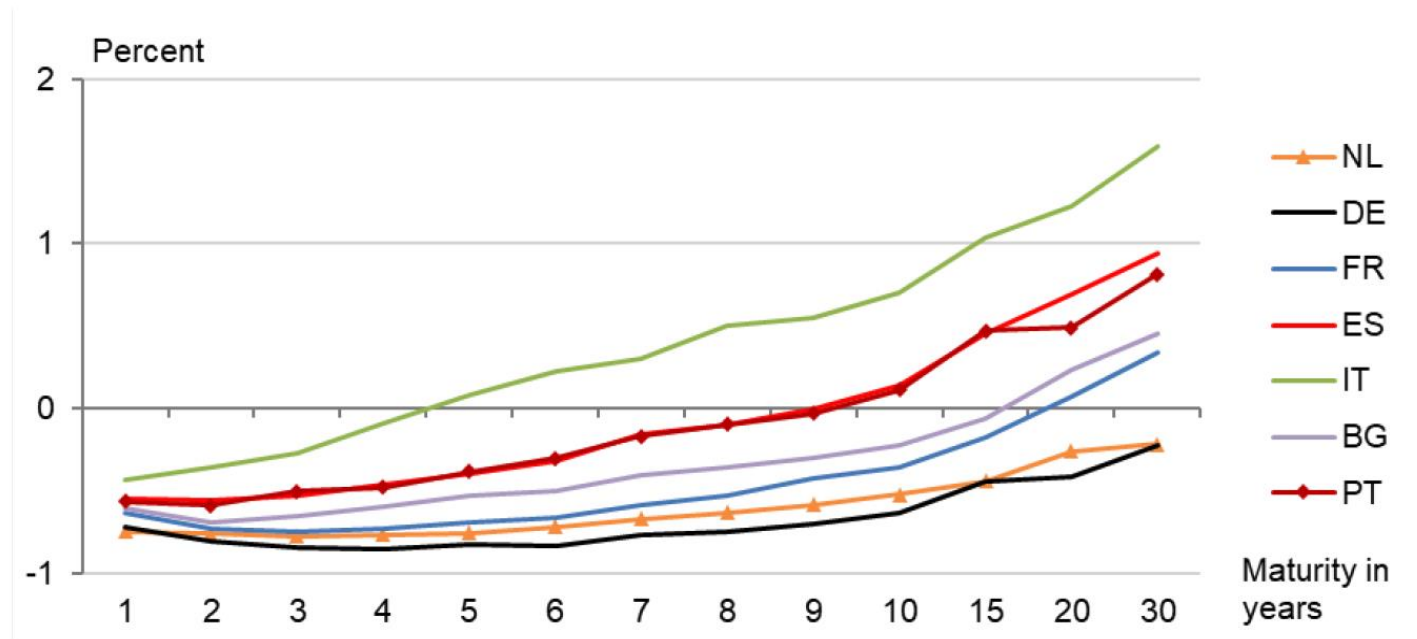
# ECB forced in to yield curve control



12<sup>th</sup> March 2020:  
*“The ECB is not here to close spreads”*

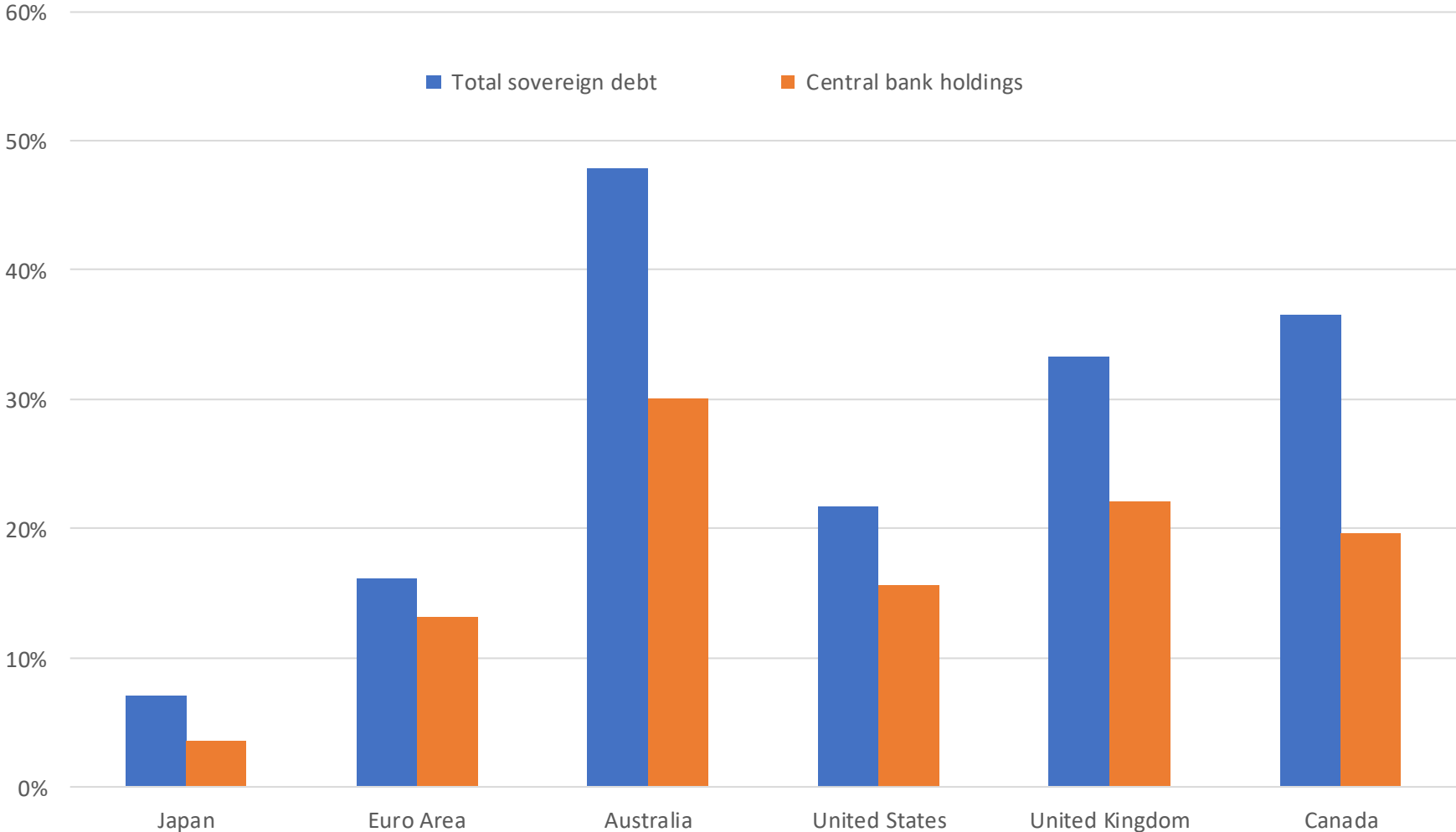
18<sup>th</sup> March 2020 (after launching PEPP):  
*“there are no limits to our commitment to the Euro”.*

Eurozone negative real yields on EZ member state sovereign bonds, Oct 2020



Source: European Commission (2020) ‘Monetary-fiscal nexus after the crisis’, November 2020, p15

# Pandemic: increase in sovereign debt and central bank holdings of sovereign debt between 2019Q4 and 2021Q4 as % of 2019Q4 total, selected high-income economies



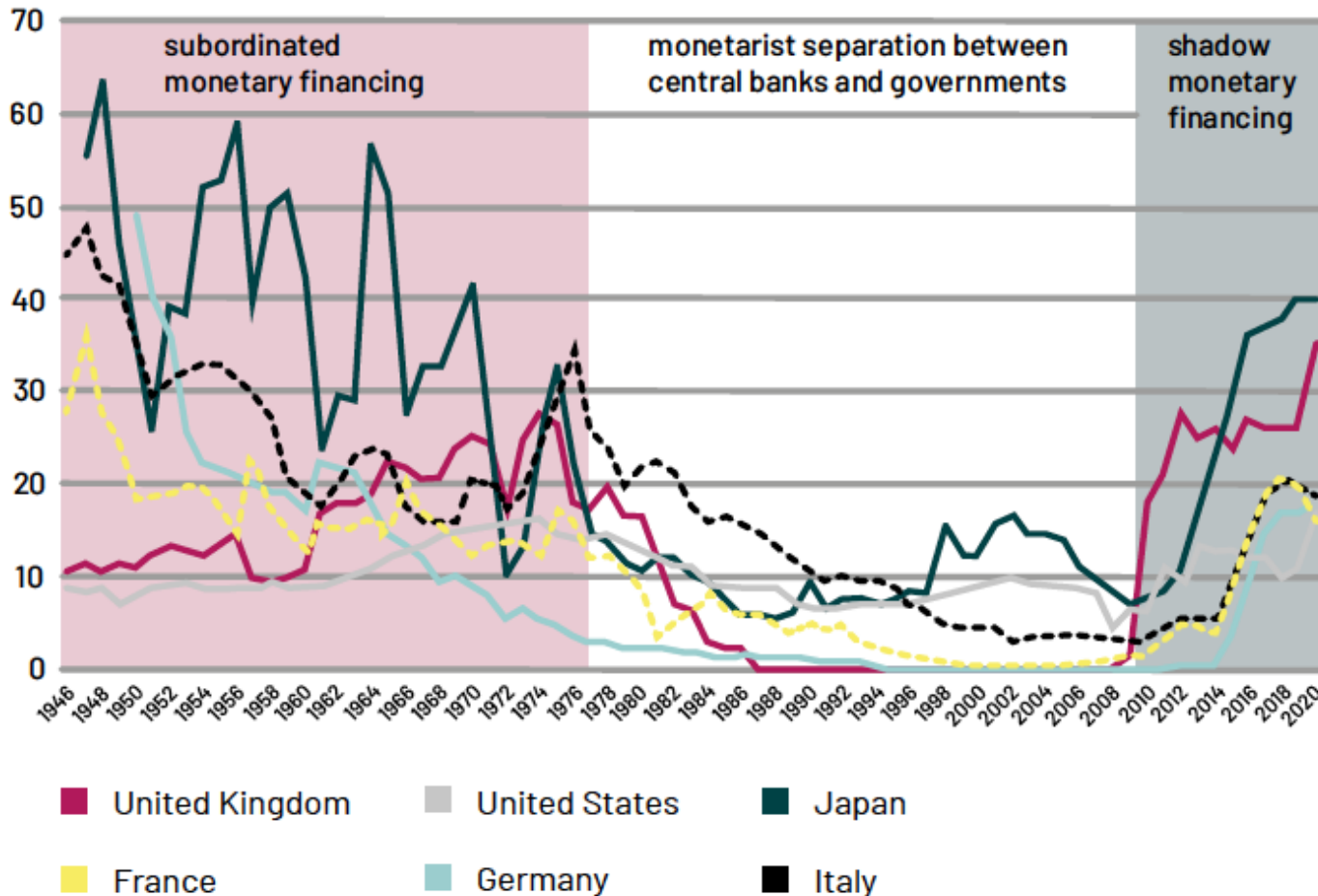
Sources: IMF Sovereign debt database (Arslanalp and Tsuda, 2014)

# Fiscal or financial dominance?

- Market-based financial system:
  - FIs access means of settlement by selling securities, or using those securities as collateral to borrow (repo), in **money markets**.
  - Maintaining liquidity of the credit system requires stabilisation of instruments to be sold or used as collateral to obtain deposits or reserves.
  - Danger of liquidity spirals
- Central bank may need to act as a “Market Maker” as well as Lender of last resort to stabilize market-based financial systems (Merhling 2012; Sissoko 2026)
  - 2007-08 GFC: value of RMBS & derivatives linked to US sub-prime mortgage market fell, causing withdrawal of short-term repo financing for banks
  - Spring 2020: Covid pandemic: ‘dash for cash’, massive sell off of Treasury Bills in Spring 2020 until Fed engaged in **US\$3 trillion** liquidity intervention, 70% increase in balance sheet in 4 months.
  - Sept 2022: UK Liability Driven Investment (LDI) crisis – fall in bond yields led to margin calls on pension funds, leading to sell of gilts. BoE forced to buy **£19.3bn** worth of gilts.

# Shadow money financing

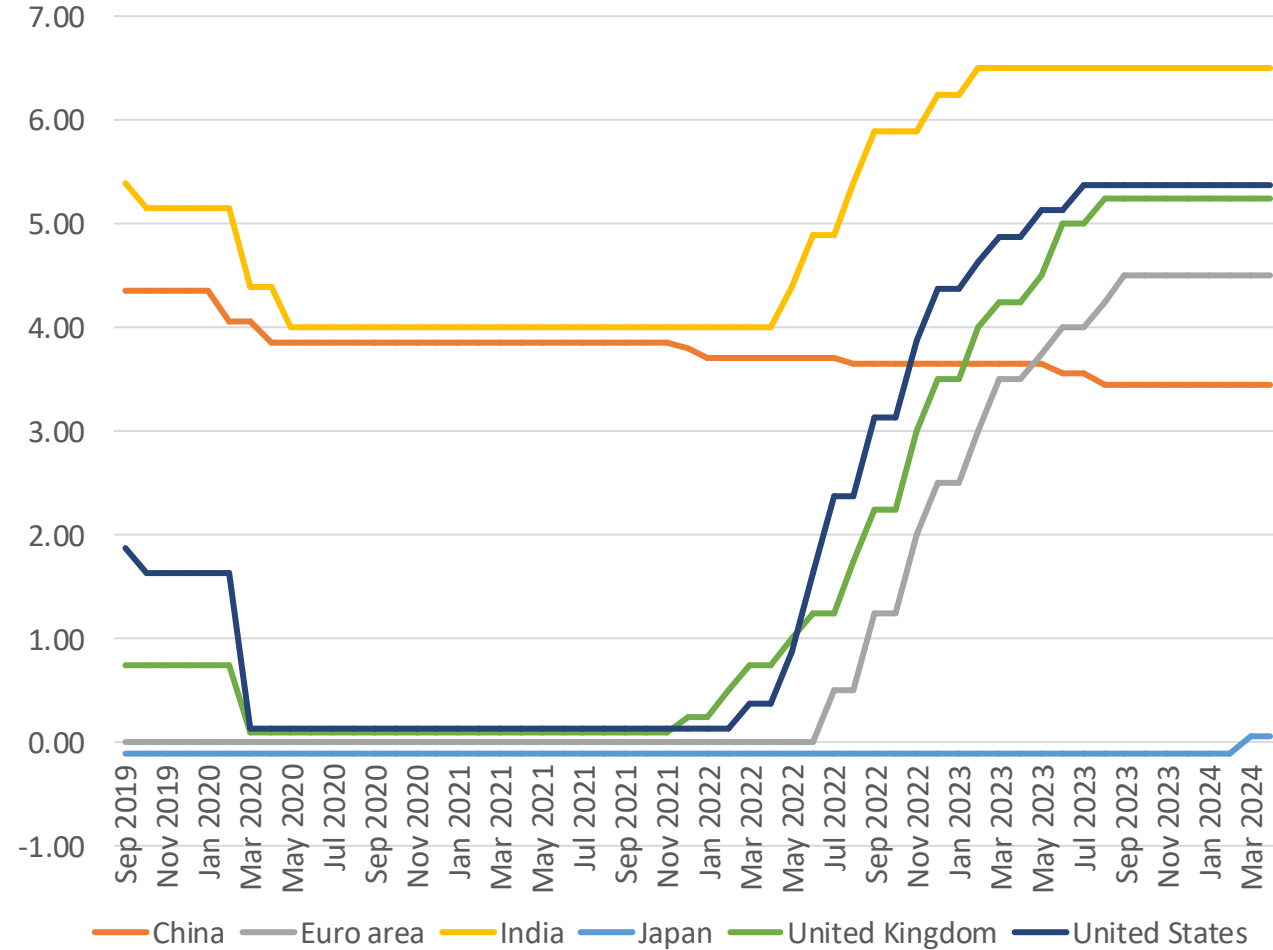
## CB holdings of government debt



- ‘Shadow monetary financing’ aims to:
  - preserve market liquidity and backstop balance sheets of financial actors
  - Anchor inflationary expectations (of markets) by reinforcing signalling role of central bank monetary policy
- Coordination between monetary and fiscal policies is an optical illusion that mask the macro-financial rather than fiscal reasons behind the intervention (Gabor 2021)

# Post-covid – return to monetary dominance?

Central bank policy rates 2019-March 2024



# Policy implications

- Case against fiscal dominance is based on flawed theory and lacks empirical evidence
- Given polycrisis facing world, strong case for monetary-fiscal coordination to support government objectives, including keeping rates below growth rate
- Low rates would require credit policies to manage private bank credit creation
- Supply-side inflation shocks also favour fiscal interventions rather than raising rates to control prices
- Publicly owned off-balance sheet financial corporations/state investment banks (KfW, China)

