

Business Cycle Basics, Part 8: Monetary Policy Dominates Fiscal Policy

John Greenwood

International Monetary Monitor

27 September 2026

“Monetary policy is not about interest rates. It is about the rate of growth of the quantity of money.” Milton Friedman, interviewed on NBC’s Meet the Press, October 24, 1976.

Monetary versus Fiscal Policy: Outline

- Monetary and fiscal theories of inflation
 - Monetary
 - Keynesian
 - Fiscal Theory of the Price Level (FTPL)
- A simple framework for case studies
- Some classical case studies

Monetary Theory of Inflation

- Monetary analysis is based on the Quantity Theory of Money:

(Traditional) $MV = PT$, or (Cambridge) $MV = yP = \text{NomGDP}$

- $V (= \text{NomGDP}/M)$ is relatively stable, normally with a steady downward trend.
- Research shows that all inflations have been preceded by sustained, rapid growth of Broad Money.
- To see how to control inflation, we transform $MV = yP$ to:

$$\Delta M = -\Delta V + \Delta y + \Delta P \quad (\% \text{ annual changes})$$

- In a typical advanced economy growing at 2% (real GDP), where the annual decline in V is 1.5% p.a., and targeting 2% inflation, the formula gives us the optimal medium-term broad money growth rate:

$$\Delta M = -(-1.5) + 2 + 2 = 5.5\%$$

Keynesian Theory of Inflation

- Real Aggregate Demand (AD) versus real Aggregate Supply (AS), especially when AD grows faster than AS.
- AD/AS adjustment is subject to short-run price stickiness so output and employment can adjust to demand shocks before prices fully adjust.
- The AD/AS framework is also subject to expectations and wage bargaining, leading to wage-price feedbacks.
- Factors driving AD:
 - If $AD > AS$, then with limited spare capacity, firms respond by raising prices.
 - External shocks (energy prices, wars, weather effects)
 - Cost-push elements prominent
 - Wage-price dynamics feature strongly
 - Capacity constraints and output gaps relied upon heavily
 - Monetary factors act as amplifiers, but not sole causes
- Heavy emphasis on targeting/managing inflation expectations

Fiscal Theory of the Price Level (1)

(FTPL, John Cochrane, Stanford Univ.)



- When government fiscal deficits are financed by printing the money it is easy to see that – if this creates excess money – the money-printing will cause inflation.
- In extreme cases of hyperinflation, it is almost always the inability of the government to raise revenue through taxes that leads the government to borrow directly from the central bank – i.e., printing the money to cover its expenditures.
- But there are many cases of moderate inflation NOT caused by the central bank (CB) financing of fiscal expenditures.
- Some MMT economists say that ALL money is ultimately produced by the government – by the CB or by the Treasury. This argument is wrong. In normal times, most money is created by commercial banks.

Fiscal Theory of the Price Level (2)

(FTPL, John Cochrane, Stanford Univ.)



- In 1980s and 1990s central bank and academic economists adopted New Keynesian theory. The result: *monetary policy was managed solely by adjusting interest rates.*
- After 2008, it was (wrongly) claimed that neither Keynesian, New Keynesian or Quantity theories did a good job of predicting low and mostly sub-target inflation; *hence the new FTPL theory.*
- “FTPL states that inflation adjusts so that the real value of government debt equals the present value of real primary surpluses...**Fiscal theory only predicts inflation when debt is larger than what people think the government will repay.**” (Cochrane)
- “Going forward, fiscal theory warns that inflation will have to be tamed by coordinated monetary and fiscal policy.”

The Interaction of Fiscal & Monetary Policy: A Framework for Analysis

FISCAL POLICY	MONETARY POLICY	
	Expansionary	Contractionary
Expansionary	Type A Monetary & fiscal policy In same direction → Inflation	Type B Monetary & fiscal policy In opposite directions → Outcome ?
Contractionary	Type C Monetary & fiscal policy In opposite directions → Outcome?	Type D Monetary & fiscal policy In same direction → Lower inflation → Or Deflation

The Interaction of Fiscal & Monetary Policy: Classic Cases from International Monetary History



International
Monetary
Monitor

MONETARY POLICY	
FISCAL POLICY	
Expansionary	Contractionary
Type A Kennedy Tax Cut 1963, Inflation up. China's CNY 4 trillion fiscal stimulus, 2008-10, Inflation up.	Type B US: President Ronald Reagan's Tax Cuts and Increased Defence Spending, 1981-86. Inflation down.
Type C Britain's 1931 Budget, Economy recovered, Deflation stopped. Britain's 1981 Budget: Infamous letter from 364 economists Economy revived despite tax increase.	Type D Japan's Matsukata Deflation, 1881-85. Deflation enabled restoration of silver std. Japan's Dodge Line, 1949. High inflation ended.

Why does monetary policy dominate over fiscal policy? Can fiscal policy ever be expansionary or contractionary?

Only three ways to finance government spending:

1. **Taxation** Crowds out private sector spending.
 2. **Borrowing** Crowds out private sector borrowing and investment.
 3. **Printing Money** Boosts ***total*** spending including government spending.
- **Implications** : Fiscal policy cannot be either expansionary or contractionary unless monetary policy is acting in the same direction (**= *the Friedman hypothesis***).

What does the data show?

Was Friedman's hypothesis validated?

- Every case documented here conforms to Friedman's hypothesis --
- i.e. fiscal policy -- on its own – is not effective in changing Nominal and Real GDP...
- ...unless supported by monetary policy acting in the same direction...as in Cases A & D.
- Significantly, wherever fiscal policy was in one direction, but monetary policy was in the opposite direction,...as in Cases B & C, it was ***always*** monetary policy that dominated.

Policy Implications

- Monetary policy (i.e. monetary growth) determines Nominal GDP or total spending.
- Fiscal policy only determines the division of total spending between private and public sectors.
- **It is therefore misguided to use fiscal policy to boost Nominal GDP or total spending while monetary policy (i.e. broad money growth) remains unchanged, or if broad money growth is moving in the opposite direction.**
- Friedman makes a sound case for fiscal austerity in recession provided that it is accompanied by monetary expansion. (*This was the case of the famous UK Budget of 1981.*)

Additional Case Histories

The Interaction of Fiscal and Monetary Policy: Classic Cases from Around the World (Detail)



		MONETARY POLICY					
FISCAL POLICY		Expansionary				Contractionary	
Expansionary	Case A	China's CNY 4 tn fiscal stimulus, 2008-10.				Case B	US: President Reagan's Tax Cuts & Defence Spending, 1981-86.
	Budget Balance (%)					Budget Balance (%)	
	<u>2008</u>	<u>09</u>	<u>10</u>	<u>2011</u>	<u>1981</u>	<u>1981</u>	<u>1986</u>
	-0.4	-2.8	-2.5	-1.1	-1.3	-2.8	-5.9
Contractionary	M2 Growth (% yoy)					CPI Inflation (% yoy)	
	<u>2008</u>	<u>09</u>	<u>10</u>	<u>2011</u>	<u>1981</u>	<u>1981</u>	<u>1986</u>
	14.7	29.6	19.5	16.2	-14.8	-11.8	-1.1
	Case C					Case D	
	Britain's 1931 Budget.					Japan's Matsukata Deflation, 1881-85.	
	Britain's 1981 Budget.					Japan's Dodge Line, 1949.	

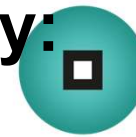
The Interaction of Fiscal and Monetary Policy: The United States during the 1960s



		MONETARY POLICY																					
FISCAL POLICY		Expansionary		Contractionary																			
Expansionary	Case A Kennedy Tax Cut Fiscal Policy: 1963 Tax Cut 1964 Great Society Programs & Vietnam War Monetary Growth: <table><tr><td></td><td>Feb 61</td><td>Nov 67</td><td>Apr 66</td></tr><tr><td>M1</td><td>1.2%</td><td>4.3%</td><td>6.0%</td></tr><tr><td>M2</td><td>6.0%</td><td>8.8%</td><td>7.8%</td></tr></table>		Feb 61	Nov 67	Apr 66	M1	1.2%	4.3%	6.0%	M2	6.0%	8.8%	7.8%	Case B 1967 Slowdown or Mini-Recession Fiscal Policy: Essentially no change from Case A Monetary Growth: <table><tr><td></td><td>Apr 66</td><td>Jan 67</td></tr><tr><td>M1</td><td>6.0%</td><td>1.7%</td></tr><tr><td>M2</td><td>7.8%</td><td>4.2%</td></tr></table>		Apr 66	Jan 67	M1	6.0%	1.7%	M2	7.8%	4.2%
		Feb 61	Nov 67	Apr 66																			
M1	1.2%	4.3%	6.0%																				
M2	6.0%	8.8%	7.8%																				
	Apr 66	Jan 67																					
M1	6.0%	1.7%																					
M2	7.8%	4.2%																					
Contractionary	Case C 1968 Tax Increase Fiscal Policy 10% tax surcharge on personal & corporate income Monetary Growth: <table><tr><td></td><td>Jun 67</td><td>Feb 69</td></tr><tr><td>M1</td><td>1.7%</td><td>7.9%</td></tr><tr><td>M2</td><td>4.2%</td><td>7.8%</td></tr></table>		Jun 67	Feb 69	M1	1.7%	7.9%	M2	4.2%	7.8%	Case D Recession: Nov 69 to Dec 70 Fiscal Policy Essentially no change from Case C Monetary Growth: <table><tr><td></td><td>Feb 69</td><td>Mar 70</td></tr><tr><td>M1</td><td>7.9%</td><td>2.8%</td></tr><tr><td>M2</td><td>7.8%</td><td>2.2%</td></tr></table>		Feb 69	Mar 70	M1	7.9%	2.8%	M2	7.8%	2.2%			
		Jun 67	Feb 69																				
M1	1.7%	7.9%																					
M2	4.2%	7.8%																					
	Feb 69	Mar 70																					
M1	7.9%	2.8%																					
M2	7.8%	2.2%																					

•Source: Invesco Research, 28 September 2018.

The Interaction of Fiscal and Monetary Policy: The United Kingdom, 1919-2009



International
Monetary
Monitor

FISCAL POLICY	MONETARY POLICY	
	Expansionary	Contractionary
Expansionary	Case A Anthony Barber's "Dash for Growth," 1971-73	Case B Alistair Darling and the Great Recession, 2008-09
Contractionary	Case C Britain's 1931 Budget (Philip Snowden) Britain's 1981 Budget (Geoffrey Howe)	Case D The Post-World War One Deflation, 1919-22

•Source: Invesco Research, 28 September 2018.

The Interaction of Fiscal and Monetary Policy: Episodes from British Monetary History (Detail-1)



International
Monetary
Monitor

	MONETARY POLICY																																					
FISCAL POLICY	Expansionary	Contractionary																																				
Expansionary	Case A Anthony Barber’s “Dash for Growth,” 1971-73. Fiscal Policy: Budget Balance (% GDP): <table><tr><td><u>1970</u></td><td><u>1971</u></td><td><u>1972</u></td><td><u>1973</u></td><td><u>1974</u></td></tr><tr><td>1.4%</td><td>-0.4%</td><td>-2.2%</td><td>-3.5%</td><td>-4.9%</td></tr></table> Monetary Growth (M3): <table><tr><td><u>1970</u></td><td><u>1971</u></td><td><u>1972</u></td><td><u>1973</u></td><td><u>1974</u></td></tr><tr><td>12.0%</td><td>16.3%</td><td>21.7%</td><td>22.3%</td><td>10.9%</td></tr></table>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	1.4%	-0.4%	-2.2%	-3.5%	-4.9%	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	12.0%	16.3%	21.7%	22.3%	10.9%	Case B Alistair Darling & the Great Recession, 2008-09 Fiscal Policy: Budget Balance (% GDP): <table><tr><td><u>2007</u></td><td><u>2008</u></td><td><u>2009</u></td><td><u>2010</u></td></tr><tr><td>-2.7%</td><td>-3.9%</td><td>-8.4%</td><td>-8.1%</td></tr></table> Monetary Growth: <table><tr><td><u>2007</u></td><td><u>2008</u></td><td><u>2009</u></td><td><u>2010</u></td></tr><tr><td>10.6%</td><td>3.7%</td><td>1.6%</td><td>2.5%</td></tr></table>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	-2.7%	-3.9%	-8.4%	-8.1%	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	10.6%	3.7%	1.6%	2.5%
	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>																																	
1.4%	-0.4%	-2.2%	-3.5%	-4.9%																																		
<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>																																		
12.0%	16.3%	21.7%	22.3%	10.9%																																		
<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>																																			
-2.7%	-3.9%	-8.4%	-8.1%																																			
<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>																																			
10.6%	3.7%	1.6%	2.5%																																			
Contractionary	Case C Philip Snowden’s 1931 Budget. Fiscal Policy: Opposed radical policies to counter the Great Depression, and refused to adopt protectionist tariffs. Budget Balance (% GDP): <table><tr><td><u>1930</u></td><td><u>1931</u></td><td><u>1932</u></td><td><u>1933</u></td></tr><tr><td>-1.5%</td><td>-2.4%</td><td>-0.6%</td><td>+0.5%</td></tr></table> Monetary Growth (M3): <table><tr><td><u>1930</u></td><td><u>1931</u></td><td><u>1932</u></td><td><u>1933</u></td></tr><tr><td>5.0%</td><td>-3.0%</td><td>10.7%</td><td>1.5%</td></tr></table>	<u>1930</u>	<u>1931</u>	<u>1932</u>	<u>1933</u>	-1.5%	-2.4%	-0.6%	+0.5%	<u>1930</u>	<u>1931</u>	<u>1932</u>	<u>1933</u>	5.0%	-3.0%	10.7%	1.5%	Case D Post-World War One Deflation, 1919-22 (Lloyd George Coalition) Fiscal Policy: Post-war social reforms, Health for Heroes 1922 The Geddes Axe (£52 mn cuts) Budget Balance (% GDP): <table><tr><td><u>1918</u></td><td><u>1919</u></td><td><u>1920</u></td><td><u>1921</u></td><td><u>1922</u></td></tr><tr><td>-26.5</td><td>-7.9</td><td>-0.4</td><td>-1.5</td><td>0.0</td></tr></table> Monetary Growth (M3 %yoy): <table><tr><td><u>1918</u></td><td><u>1919</u></td><td><u>1920</u></td><td><u>1921</u></td><td><u>1922</u></td></tr><tr><td>24.8</td><td>15.3</td><td>6.0</td><td>-3.4</td><td>-9.4</td></tr></table>	<u>1918</u>	<u>1919</u>	<u>1920</u>	<u>1921</u>	<u>1922</u>	-26.5	-7.9	-0.4	-1.5	0.0	<u>1918</u>	<u>1919</u>	<u>1920</u>	<u>1921</u>	<u>1922</u>	24.8	15.3	6.0	-3.4	-9.4
	<u>1930</u>	<u>1931</u>	<u>1932</u>	<u>1933</u>																																		
-1.5%	-2.4%	-0.6%	+0.5%																																			
<u>1930</u>	<u>1931</u>	<u>1932</u>	<u>1933</u>																																			
5.0%	-3.0%	10.7%	1.5%																																			
<u>1918</u>	<u>1919</u>	<u>1920</u>	<u>1921</u>	<u>1922</u>																																		
-26.5	-7.9	-0.4	-1.5	0.0																																		
<u>1918</u>	<u>1919</u>	<u>1920</u>	<u>1921</u>	<u>1922</u>																																		
24.8	15.3	6.0	-3.4	-9.4																																		

The Interaction of Fiscal and Monetary Policy: Episodes from British Monetary History (Detail-2)



International
Monetary
Monitor

	MONETARY POLICY																	
FISCAL POLICY	Expansionary	Contractionary																
Expansionary	Case A	Case B																
Contractionary	Case C Geoffrey Howe’s 1981 Budget. Fiscal Policy: Increases in indirect taxes, spending controls, and reduced PSBR Budget Balance (% GDP): <table><tr><td><u>1980</u></td><td><u>1981</u></td><td><u>1982</u></td><td><u>1983</u></td></tr><tr><td>-4.1</td><td>-3.3</td><td>-2.5</td><td>-3.3</td></tr></table> Monetary Growth (M3 %yoy): <table><tr><td><u>1980</u></td><td><u>1981</u></td><td><u>1982</u></td><td><u>1983</u></td></tr><tr><td>17.3</td><td>14.0</td><td>12.6</td><td>13.2</td></tr></table>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	-4.1	-3.3	-2.5	-3.3	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	17.3	14.0	12.6	13.2	Case D
<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>															
-4.1	-3.3	-2.5	-3.3															
<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>															
17.3	14.0	12.6	13.2															

•Source: Invesco Research, 28 September 2018.

The Interaction of Fiscal and Monetary Policy: Episodes from Japanese Monetary History



FISCAL POLICY	MONETARY POLICY	
	Expansionary	Contractionary
Expansionary	Case A Takahashi's Anti-Depression Measures, 1931-36. PM Tanaka's Plan to Remodel the Japanese Archipelago, 1972-74.	Case B The Deflation of the 1920s Japan's fiscal stimulus programs after 1990
	Case C The 1980s decade including the Bubble of 1985-90	Case D Matsukata Deflation, 1881-85. The Dodge Line, 1949.

The Interaction of Fiscal and Monetary Policy: Episodes from Japanese Monetary History (Post-WW2 -2)

		MONETARY POLICY																																							
FISCAL POLICY		Expansionary		Contractionary																																					
Expansionary		Case A		Case B																																					
Contractionary		Case C		Case D																																					
		The 1980s and Asset Bubble of 1985-90 Fiscal Policy: Budget Balance Shifted steadily from -6% (1979) to +2% (by 1991). Monetary Growth (M2): <table><tr><td>Dec 83</td><td>Dec 87</td><td>Apr 90</td></tr><tr><td>7.6%</td><td>11.5%</td><td>13.2%</td></tr></table>		Dec 83	Dec 87	Apr 90	7.6%	11.5%	13.2%	The Dodge Line, 1949. Fiscal Policy: Cessation of budget deficits. Change in Government Debt (Yen Bn) <table><tr><td>1946</td><td>1947</td><td>1948</td><td>1949</td><td>1950</td></tr><tr><td>+65.9</td><td>+95.3</td><td>+163.8</td><td>+112.8</td><td>-83.2</td></tr></table> Monetary Policy: End to Bank of Japan financing of government budget deficits Change in BOJ credit to govt (Yen Bn) <table><tr><td>1946</td><td>1947</td><td>1948</td><td>1949</td><td>1950</td></tr><tr><td>+35.3</td><td>+156.5</td><td>+124.9</td><td>-40.4</td><td>-124.8</td></tr></table> Results: Wholesale price Inflation (% yoy) <table><tr><td>1946</td><td>1947</td><td>1948</td><td>1949</td><td>1950</td></tr><tr><td>+365</td><td>+196</td><td>+166</td><td>+63</td><td>+18</td></tr></table>			1946	1947	1948	1949	1950	+65.9	+95.3	+163.8	+112.8	-83.2	1946	1947	1948	1949	1950	+35.3	+156.5	+124.9	-40.4	-124.8	1946	1947	1948	1949	1950	+365	+196	+166	+63
Dec 83	Dec 87	Apr 90																																							
7.6%	11.5%	13.2%																																							
1946	1947	1948	1949	1950																																					
+65.9	+95.3	+163.8	+112.8	-83.2																																					
1946	1947	1948	1949	1950																																					
+35.3	+156.5	+124.9	-40.4	-124.8																																					
1946	1947	1948	1949	1950																																					
+365	+196	+166	+63	+18																																					

Disclaimer

The information in this report has been prepared by International Monetary Monitor (IMM). Materials available herein have no regard to the specific business objectives, financial situation or particular needs of any specific recipient. The research is published for information purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. The opinions, estimates and projections in this report reflect the current judgment and express views of the author as at the date of the report. They do not necessarily reflect the opinions of IMM and are subject to change without notice. Unless specifically stated otherwise, all price information is indicative only. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the materials, nor are they a complete statement of the securities, markets or development referred to herein. The material should not be regarded by recipients as a substitute for the exercise of their own judgment. The financial instruments discussed in this report may not be suitable for all investors.

Copyright © 2026 International Monetary Monitor, not for distribution without express permission.