

A Fiscal Theory of Monetary Policy with Financial Frictions and Long-Term Debt

Elliot Spears
University of Washington
October 2025

Abstract

This paper introduces financial frictions into a fiscal theory of monetary policy model with long-term government debt. Incorporating a Gertler-Kiyotaki intermediary links bank leverage, credit spreads, and net worth to government bond prices, making discount rates endogenous to financial conditions. Monetary policy tightenings generate larger and more persistent inflation responses as contractions in bank credit raise firms' marginal costs. Fiscal shocks, by contrast, produce less cumulative inflation despite larger declines in expected surpluses, as intermediary balance-sheet dynamics absorb fiscal disturbances through discount-rate variation. These results show that bank balance sheets are a central transmission channel for fiscal and monetary policy under fiscal dominance, materially altering inflation and debt dynamics.

Chapter 2: A Fiscal Theory of Monetary Policy with Financial Frictions and Long-Term Debt

Elliot Spears

1 Introduction

Adam Smith once wrote: “A prince, who should enact that a certain proportion of his taxes be paid in a paper money of a certain kind, might thereby give a certain value to this paper money.”¹ In other words, a sufficient condition for a currency to hold value is its acceptance for tax payments. This simple notion lays at the heart of what is known as the fiscal theory of the price level (FTPL), which says that the price level adjusts so that the real value of government debt equals the present value of future primary surpluses.

Under the gold standard, paper currency was valuable due to its ability to be redeemed for gold. In so far as a government with a currency on a gold standard would restrict convertability (or fail to convert paper bills to gold), the currency depreciated. Without enough gold to “soak up” the currency, this would lead to inflationary pressures. In the same vein, under FTPL, inflation arises when there is an imbalance between outstanding debt and future surpluses, which ultimately entails an imbalance between the money supply and tax receipts.

The motivation for introducing an alternative theory of price level determination to what is implied by the Taylor principle is simple. The Taylor principle tells us that inflation is

¹Smith, Adam (1776). *Wealth of Nations*, Vol. I, Book II, Chapter II.

brought under control when interest rates respond more than one-to-one to it. Our experience during the zero lower bound period casts doubt on this notion.² If nominal interest rates must respond more than one-for-one to inflation to avoid a situation where real interest rates drop below zero and inflation explodes, then the experience of the early to mid 2010s undermines our belief in the Taylor principle’s ability to determine the price level. Therefore, it is desirable to begin exploring alternative theories of inflation — this is the purpose of FTPL.

Traces of fiscal theory can be found as far back as [Sargent and Wallace \(1981\)](#) and [McCallum \(1984\)](#), where the interactions between fiscal and monetary policy are examined to assess their effects on inflation. Sargent & Wallace argued that in an environment where fiscal policy “dominates” monetary policy (meaning the government declares its budget to the world, leaving the central bank to determine how to bridge any gaps between the government’s spending and its revenue by providing seigniorage and revenue from bond sales), the central bank may not be able to control inflation.

[Leeper \(1991\)](#) introduces the terminology that distinguishes between an “active” versus “passive” fiscal policy regime. An active fiscal regime simply requires that government budget surpluses do not respond one-for-one to changes in the price level — fiscal theory requires active fiscal policy. The work on fiscal theory has gradually expanded, with seminal developments made by [Sims \(1994, 2011\)](#), [Woodford \(1995, 2001\)](#), and [Cochrane \(2005, 2022a\)](#).

The purpose of this paper is to build upon the foundation of [Cochrane \(2022b\)](#), where fiscal policy is active, monetary policy is passive (interest rates respond less than one-for-one to inflation), and long-term debt is incorporated in order drive realistic inflation dynamics. The contribution to the literature is the incorporation of financial frictions into the model à la [Gertler and Kiyotaki \(2010\)](#), which alter the dynamics of all variables in the model, especially government debt and surpluses.

²End of 2008 to the end of 2015.

Following the literature, I implement four experiments, which involve analyzing fiscal and monetary shocks, each of which is performed with and without monetary policy rules. Both the fiscal shock, which constitutes a shock to surpluses, and the monetary policy shock result in fundamental shifts in the dynamics of the endogenous variables brought about by the presence of financial frictions. With the exception of the case of a monetary policy shock without rules, we see credit contract in wake of the shocks.

Firms face marginal costs that are increasing in the borrowing costs incurred to pay their expenses. When a deficit shock hits, borrowing costs rise — increasing marginal costs, which leads to a stronger inflationary response than what is observed in the absence of financial frictions. In wake of this, discount rates rise over the medium term in a manner that is smaller in magnitude than the benchmark case without financial frictions, however discount rates remain above trend for longer, which has the effect of prolonging the reevaluation of debt.

Importantly, the financial frictions feed into the debt valuation equation itself through bond prices. The bank's shadow value of net worth, along with the stochastic discount factor (SDF), are among the elements that price the government debt portfolio. Bond prices pin down the discount rate, which itself is an explicit ingredient of the debt valuation equation. Therefore, we have a linkage between financial intermediaries and bond prices, which is a key gap needed filling in the FTPL literature.

In terms of the financial frictions themselves, there is a bank who provides credit to firms issued out deposits made by households, which the bank compensates households for. A key element of the bank's budget constraint is that it owns long-term government-issued debt. Hence, there are interactions between government debt and bank balance sheets. It turns out that interest rate spreads and bank net worth are major drivers of bond prices, which in turn determines discount rates and, therefore, government debt dynamics.

By introducing a Gertler–Kiyotaki intermediary into the long-term debt FTPL environment, this paper shows that the discount rates governing the valuation of government debt

inherit the dynamics of intermediary net worth. Because discount rate variation is a key determinant of inflation in FTPL, fiscal and monetary disturbances now propagate through bank balance sheets. This linkage causes shocks to alter the valuation equation through movements in bond prices, leverage, and the intermediary pricing kernel, thereby altering the dynamics of inflation and debt.

2 Related Literature

The fiscal theory of the price level is not new. As mentioned in the introduction, the notion of a distinction between fiscal and monetary dominant regimes, along with differing consequences that flow from having one regime in place over another, goes back to at least the early 80s with [Sargent and Wallace \(1981\)](#). Fiscal theory has come a long way with the work discussed in the introduction, but not without resistance.

One of the principal objections raised against fiscal theory is that the government is capable of violating its budget constraint for certain price levels. [Buiter \(2002\)](#) states that fiscal theory mistakes what is ultimately a budget constraint for an equilibrium condition. The early 2000s saw an explosion of critiques along these lines leveled against fiscal theory — see [Bassetto \(2002\)](#); [Marimon \(2001\)](#); [Kocherlakota et al. \(1999\)](#), for a sample. Then Cochrane came out with “Money as Stock”,³ which answered these objections by drawing an analogy between stock price determination via the dividend discount model and the debt valuation equation that is at the heart of fiscal theory, making it a valuation equation, or a market-clearing condition and not some crude budget constraint.⁴ He also showed that the theory works even when the government is forced to respect its budget constraint.

The model in this paper draws its ingredients primarily from two sources: [Cochrane \(2022b\)](#) and [Gertler and Kiyotaki \(2010\)](#), the financial frictions obviously come from the latter. A few modifications are made to the bank optimization problem, but those familiar

³[Cochrane \(2005\)](#)

⁴ibid. See page 504

with the GK⁵ mechanism will easily recognize it. Overall, this paper attempts to answer a call from [Cochrane \(2023\)](#) to incorporate financial frictions into the FTPL framework. The motivation for doing this is that [Cochrane \(2022a\)](#) shows the significant effects discount rates have on inflation. Furthermore, the financial sector plays an important role in determining discount rate variation. Therefore, it's of considerable interest to add ingredients into the model that tie the financial sector to discount rates, bond prices, and, ultimately, the debt valuation equation.

The road map for this paper is: section three will introduce the core elements of the benchmark fiscal theory model. Then, I will introduce the financial frictions, showing how they alter the model. In section four we'll take a look at the IRFs produced by simulations with the model. We will compare the benchmark model from [Cochrane \(2022b\)](#) with the results generated by financial frictions. Section five will conduct additional policy-relevant analysis. Section six concludes.

3 FTPL and the Data

Before proceeding with the model, it seems appropriate to remind the reader why continuing to develop the FTPL framework is a worthwhile enterprise. After all, if the theory is junk, who cares how adding financial frictions to the model changes its predictions?

The 21st century has confirmed the predictions of FTPL on more than one occasion and in a manner that neither conventional monetary policy wisdom nor monetarism can account for. The first case of interest is the dynamics of inflation in wake of the COVID-19 pandemic.

The fiscal response to the pandemic included the introduction and passage of the CARES Act, signed off on by the Trump administration, which injected \$2.2 trillion of spending into the economy. Then, in December of 2020, another spending package was introduced by Congress, which provided \$900 billion in COVID relief. On top of these two spending packages, in March of 2021, the Biden administration signed off on the American Rescue

⁵[Gertler and Kiyotaki \(2010\)](#)

Plan, which introduced an additional \$1.9 trillion in spending.⁶

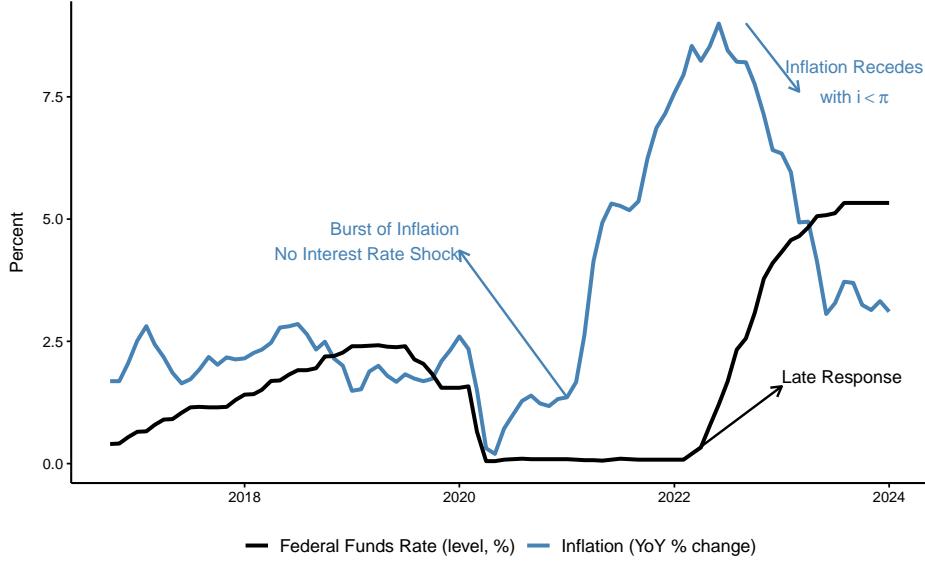


Figure 1: FFR vs CPI

Figure 1 plots the evolution of the consumer price index against the federal funds rate since 2016.⁷ At the beginning of 2021, the economy experienced a massive burst of inflation (up nearly 3.5% in one quarter). In spite of this spike, the federal funds rate remained at the zero bound for several quarters before finally lifting off at the beginning of 2022.

Nonetheless, inflation already begins to recede as the federal funds rate begins to lift off the zero lower bound, and continues to recede despite the fact that interest rates remain below inflation until the beginning of 2023.

So what happened here? According to conventional wisdom, inflation only should have begun its return to trend once interest rates exceeded the inflation rate. Here we have inflation returning to trend long before interest rates exceed the inflation rate. FTPL says that the price level adjusts so that the real value of nominal debt equals the present value of future surpluses. Once the government engaged in the massive fiscal outlays at the beginning of the pandemic, market participants adjusted their expectations of future government surpluses in

⁶Bernanke and Blanchard (2025) point out that: “as a share of GDP, the headline costs of these three covid-era fiscal packages were about 4-1/2 times the size of the American Recovery and Reinvestment Act (ARRA), enacted in response to the 2008 financial crisis and the ensuing recession.” (p. 1)

⁷Figure 1 and Figure 2 are borrowed from Cochrane (2025).

a manner that displayed incredulity towards their ability to generate the revenue necessary to repay the newly-issued debts. These changes in expectations had largely been priced in by the time the federal funds rate overtook the inflation rate.

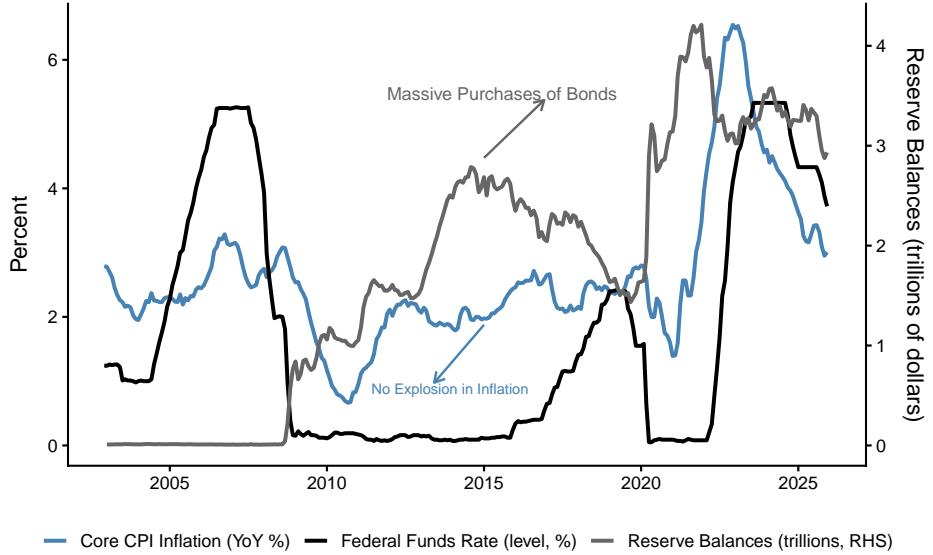


Figure 2: Fed Liabilities vs CPI

Both monetarism and FTPL predict that if the government prints off a large amount of money and injects it into the economy that this will create inflationary pressure. But what happens if the government engages in the kind of quantitative easing (QE) that we observed during the '08 financial crisis, where they swap out money for government debt? The monetarist will say that this should cause inflation since we're taking cash and swapping it out for a less-than-completely-liquid instrument. Fiscal theory says that this alone should not create inflation — all you have done is change the composition of the public's holdings of government liabilities. [Figure 2](#) illustrates the cogency of FTPL's predictions in this regard.

Over the course of the Fed's QE program in response to the financial crisis, the Fed exchanged cash for bonds by crediting member banks of the Federal Reserve System's accounts. As a result, you see Fed liabilities rise by trillions of dollars over a short period of time. Interestingly, CPI displays only moderate responses in wake of this. If the monetarists' predictions were correct, this should have led to explosive inflation dynamics. But

they weren't, because it didn't. Therefore, FTPL manages to explain two curious cases of monetary phenomena in the 21st century, which conventional theories of inflation are unable to fully account for.

4 Model

Figure 3 provides a bird's-eye view of how the model works. Households and banks acquire debt issued by the government. In an ideal world, the government repays previous debts accumulated when running deficits by running future surpluses — soaking up its currency in the form of tax revenue in the process. This fiscal backing of the currency ultimately determines the prices level. If future surpluses are expected to fall short of the amount necessary to cover the value of existing debt, then price level will rise, and vice versa. Hence the fiscal theory maxim: *the price level adjust so that the real value of nominal government debt equals the present value of future primary surpluses.*

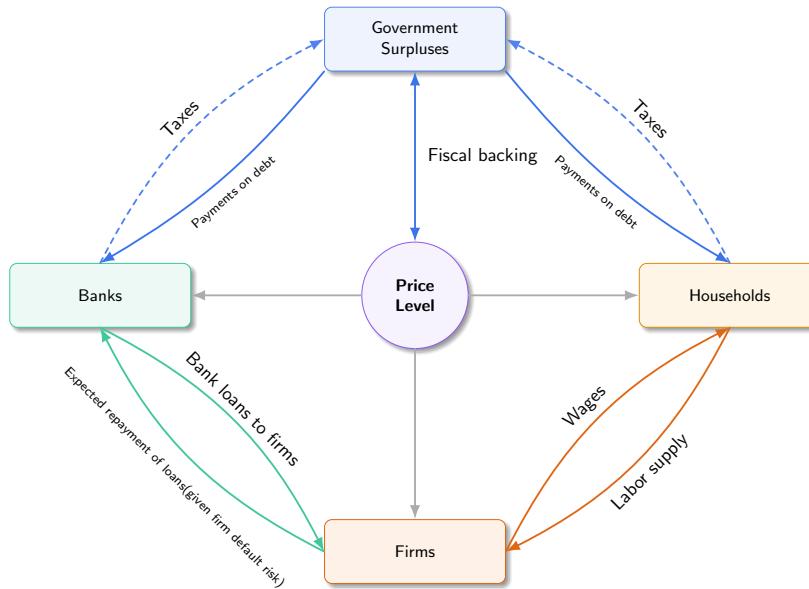


Figure 3: Model Overview

Thus, the government's surpluses affect the entire economy through its effects on the price level. Banks affect, who carry large amounts of long-term debt, can unilaterally move

the price of long-term debt by their investment decisions. This, in turn, affects the value of government debt, which ultimately influences the dynamics of inflation. The health of the bank's balance sheet is tied to firm performance. Firms can default on the loans they receive from the bank.

4.1 Brief Remarks On Long-Term Debt

In this model, we will be incorporating long-term debt. The reason long-term debt is useful is threefold. First, in the real world, the government issues debt that spans several decades before maturity — 10-year Treasuries, for example, are a key instrument in interbank dealings.

Second, the inclusion of long-term debt makes the dynamics of the model more realistic. For instance, it draws out the response of inflation to monetary and fiscal shocks, instead of generating a one or two period response in inflation to these disturbances, which is what you get when you only include short-term debt.

Third, restricting the government to short-term debt issuance creates unrealistic dynamics (for the U.S.)⁸ in the *direction* of inflation's response to monetary disturbances. For instance, take the following simple two period model of the government's debt valuation equation:

$$\frac{B_{-1}}{P_0} = s_0 + \beta \mathbb{E}_0[s_1] \quad (1)$$

$$= s_0 + \frac{1}{1+i_0} \frac{B_0}{P_0} \quad (2)$$

$$= s_0 + \beta_0 \mathbb{E} \left[\frac{P_0}{P_1} \right] \frac{B_0}{P_0} \quad (3)$$

If the central bank raises interest rates at t_0 , then i_0 will increase in equation 2. Since P_0 is already determined at t_0 , it must be that P_1 — next period's inflation — will increase.

⁸I emphasize that these dynamics are unrealistic "for the U.S." because the U.S. government issues much long-term debt, in addition to short-term debt. However, there *are* countries that issue primarily, or even overwhelmingly, short-term debt in their own currency. For these economies, the dynamics of short-term debt models might well be realistic, especially in the case of a rollover crisis

Therefore, an increase in interest rates today leads to inflation tomorrow. This is the natural frictionless benchmark; absent any frictions, inflation is increasing in nominal interest rates.⁹

Introducing long-term debt, deals with this issue by enabling bond prices to absorb the impact of unexpectedly higher interest rates. As interest rates rise, long-term bond prices fall, which temporarily pushes inflation down. However, this is only temporary, since in a fiscal-dominant regime monetary policy can only manipulate the path of the price level, but it can't determine the overall price level in the long-run.

4.2 Fiscal Theory's Core Ingredients

For the core ingredients of the fiscal theory mechanism, I follow [Cochrane \(2022b\)](#) and the notation employed in that paper. Let's turn to the government's budget constraint, which is the following:

$$\sum_{j=0}^{\infty} Q_t^{(t+j)} B_{t-1}^{(t+j)} + M_{t-1} = P_t s_t + \sum_{j=0}^{\infty} Q_t^{(t+1+j)} B_t^{(t+1+j)} + M_t \quad (4)$$

where M_t is money, which does not earn interest.¹⁰ B_{t-1}^{t+j} is zero-coupon nominal debt outstanding at $t-1$ that is due at the beginning of period $t+j$. Q_t^{t+j} is the price of the bond at time t . s_t is the real primary surplus, which, if negative, becomes a real primary deficit. P_t is the price level. Equation 4 says that the government's primary surplus is equal to the change in debt between period $t-1$ and period t . Equivalently, it says that the previous period's debt is financed by today's surpluses, plus whatever borrowing is needed to finance the residual.

Therefore, the end-of-period market value of debt is:

$$V_t = M_t + \sum_{j=0}^{\infty} Q_t^{(t+1+j)} B_t^{(t+1+j)}$$

⁹This is true anyway, though. As discussed on page 11 of [Cochrane \(2023\)](#), higher interest rates lead to inflation in the *long-run*. It's only due to frictions that we get the phenomenon of higher interest rate → lower inflation in the short run.

¹⁰This is considered a form of short-term debt.

We can specify the return on the entire government bond portfolio as follows:

$$R_{t+1}^n = \frac{M_t + \sum_{j=1}^{\infty} Q_{t+1}^{(t+j)} B_t^{(t+j)}}{M_t + \sum_{j=1}^{\infty} Q_t^{(t+j)} B_t^{(t+j)}} \quad (5)$$

This equation tells us that the return on government debt is determined by how bond prices change from one day to another. After a series of substitutions and log-linearizing, we end up with the debt accumulation equation:

$$\rho v_{t+1} = v_t + r_{t+1}^n - \pi_{t+1} - s_{t+1} \quad (6)$$

Where lowercase variables represent deviations from the steady state and π is inflation. The other equation of relevance to fiscal theory is the surplus process. As we will see, the surplus process serves much like the Taylor rule in that it eliminates equilibria. When fiscal policy is active and monetary policy passive, the surplus process, in tandem with a passive Taylor rule, ultimately selects a unique solution. In particular, “expected inflation” is determined by the interest rate rule, whereas “unexpected inflation” is pinned down by the surplus process. This mechanism is called a *fiscal theory of monetary policy*, which implies that the central bank, through interest rate manipulation, can alter the time path of inflation, but not the long-run level.

To get a realistic surplus process, we want something that is s-shaped — which means that a deficit shock (negative surplus) must eventually be followed by (positive) surpluses. To that end, the surplus process is written as a moving average:

$$s_t = a(L)\varepsilon_t = \sum_{j=0}^{\infty} a_j \varepsilon_{t-j} \quad (7)$$

When paired with the following conditions, we get a clearer picture of how the surplus process will be specified and its parameters calibrated to make the model consistent with

empirical facts:¹¹

$$\Delta \mathbb{E}_{t+1} \pi_{t+1} = -\Delta \mathbb{E}_{t+1} \sum_{j=0}^{\infty} \rho^j s_{t+1+j} \quad (8)$$

$$v_t = \mathbb{E}_t \sum_{j=0}^{\infty} \rho^j s_{t+1+j} \quad (9)$$

Combining equation 7 with 8 and 9, we have:

$$\Delta \mathbb{E}_{t+1} \pi_{t+1} = -\Delta \mathbb{E}_{t+1} \sum_{j=0}^{\infty} \rho^j a_j \varepsilon_{t+1} \quad (10)$$

$$v_t = \mathbb{E}_t \sum_{j=0}^{\infty} \rho^j a_j \varepsilon_{t+1} \quad (11)$$

Therefore, the MA coefficients of $a(\rho)$ are what ultimately determine the extent to which inflation devalues debt following shocks to the surplus process. There are four possibilities:

- i) $a(\rho) \gg 1$ ii) $a(\rho) = 1$ iii) $a(\rho) \ll 1$ and iv) $a(\rho) = 0$.

Case i implies that an unexpectedly high surplus will be followed by high surpluses in the future, which will raise the value of debt, or, equivalently, that deficit shocks will lower the value of debt, both of which are counterfactual. Case ii means that there will be no change in the value of debt after a deficit shock. The intuition is that inflation will devalue the new debt by exactly the amount of the deficit, leaving total debt unchanged. In both cases i and ii, the government finances deficits by inflating them away. However, in case i, inflation reacts *more* than one-for-one to the deficit shock, since agents believe that current deficits will be followed by future deficits. Case iv means that a deficit shock has no impact on inflation. This is because all deficits are anticipated to be repaid in full.

Case iii is ultimately the one that is worked with in the literature, and therefore, the one we will be assuming here. When $a(\rho) \ll 1$, a deficit shock raises the value of debt as the government commits to covering at least a portion of its deficits by borrowing and repaying

¹¹The derivations for equations 6-8 can be found in [Cochrane \(2022a,b\)](#). The formula that gives us unexpected inflation in terms of surpluses comes from [Hansen et al. \(2019\)](#).

new debts with future surpluses. Clearly, this is the most realistic case when applied to the U.S. and Western Europe.¹²

A plausible specification for the surplus process is $s_{t+1} = \alpha v_t + u_{t+1}^s$. Governments spend money in excess of tax receipts, generating deficits that they repay a fraction α of. So far, we've specified the *shape* of the surplus process through a moving average representation. However, in reality, the data shows that surpluses move with the business cycle. Taxes revenues rise during expansions, and fall during contractions. It would also make sense that inflation affects surpluses to some extent since tax brackets adjust slowly (or not at all) to inflation, generating more government revenue, while government continues its spending without indexing to inflation, thereby potentially lowering real spending. Although the data isn't clear on this, we will follow the literature in assuming a moderately positive response in surpluses to inflation.

Hence, our final specification for the surplus process turns out to be:

$$s_{t+1} = \theta_{s\pi}\pi_{t+1} + \theta_{sx}x_{t+1} + \alpha v_t + u_{t+1}^s \quad (12)$$

Where $\theta_{s\pi} = 0.25$, $\theta_{sx} = 1$, and $\alpha = 0.2$.¹³ This is what will go into our final model and will be the fiscal theory analog of the Taylor rule. The surplus process, alongside the Taylor rule, will determine inflation uniquely.

Equations 6 and 12, then, are the key elements of fiscal theory. Following the standard recipe, we will include a Taylor rule, along with a New-Keynsian Phillip's Curve (NKPC) and IS equation. We will also specify the evolution of the return on the government debt portfolio as $r_{t+1}^n = \omega q_{t+1} - q_t$, where q_t is the log-linearized price of the government debt portfolio at time t . The contribution of this paper is to connect q_t to the financial sector and the balance sheets of intermediaries. Therefore, movements in bank net worth, leverage, SDFs, and other factors will pin down q_t , which ultimately determines r_t^n , the return on the

¹²See data in [Cochrane \(2022a\)](#)

¹³Source: *ibid*

government debt portfolio, which directly influences debt.

Up to now, I've given a lay of the land as it stands in the existing FTPL literature. At this point we turn to the household block, and then the financial block, which is the contribution of this paper. I import the core fiscal ingredients discussed in this previous section, which are the return equation in the previous paragraph, along with equations 6 and 12. The remainder of the model's equilibrium conditions will be adjusted in accordance with the introduction of financial frictions.

4.3 Households

There is a representative household that maximizes utility:

$$E_0 \sum_{t=0}^{\infty} \beta^t \left[U(C_t, N_{h,t}) + V\left(\frac{D_t}{P_t}\right) \right]$$

$U(\cdot)$ and $V(\cdot)$ are increasing and concave in their arguments. C_t is consumption at period t , $N_{h,t}$ is the household's labor supply at time t . The household also receive liquidity services from holding deposits D_t . Households respect a budget constraint:

$$P_t C_t + B_{h,t} + D_t \leq W_t N_{h,t} + \Pi_{f,t} + \Psi_{b,t} + (1 + i_{t-1})(B_{h,t-1} + D_{t-1})$$

Where P_t is the price of the consumption good. The household's labor earns it a wage rate W_t . The household places its savings into either *short-term* government debt $B_{h,t}$ or deposits that are both remunerated at the rate i . The household also receives the profits of the firm and bank — $\Pi_{f,t}$ and $\Psi_{b,t}$.

Household holdings of short-term government debt and deposits are remunerated at the same interest rate since both are backed by guarantees of repayment (at least partially in the case of deposits). The central bank effectively backs the government debt, and the banks partially back deposits with reserves. This is the intuition for remunerating both at the same rate. I don't include reserves on the intermediaries balance sheet. This would be an

interesting extension of financial frictions in the FTPL setting, especially for looking at how the central bank's adjustments to the required reserve ratio might affect the dynamics of the model.

The Euler equation yields us the following specification for the stochastic discount factor (SDF):

$$\mathbb{E}_t[\Lambda_{t,t+1}] = \frac{1}{1+i_t} \quad (13)$$

Thus, the expected value of the SDF is equal to the inverse of the gross nominal rate of interest. The SDF is specified as:

$$\Lambda_{t,t+1} = \beta \frac{U_c(C_{t+1})}{U_c(C_t)} \frac{P_t}{P_{t+1}}$$

Finally, linearizing the household Euler equation gives us the IS equation:

$$y_t = E_t y_{t+1} - \gamma_x (i_t - E_t \pi_{t+1}) \quad (14)$$

Where y is output.

4.4 Firms

An important element of the financial frictions is the fact that firms will ultimately borrow from the bank in order to finance their inputs, which consists of wages paid to their workers. Hence, the firm borrows to finance its payroll:

$$W_t N_{h,t} = L_t$$

Where W_t is the wage and $N_{h,t}$ is labor. Firms take out a loan L_t which is remunerated at the interest rate i_t^L , with endogenous probability of default $\phi_{d,t+1}$. Therefore, the expected

value of loan repayment is:

$$(1 + i_t^L)(1 - \phi_{d,t+1})L_t$$

The monopolistic competitor i 's profit function, therefore, is given by:

$$\Psi_t(i) = P_t(i)Y_t(i) - (1 + i_t^L)(1 - \phi_{d,t+1}(i))W_tN_{h,t}(i)$$

with real marginal cost equal to:

$$MC_t(i) = (1 + i_t^L)(1 - \phi_{d,t+1}(i))\frac{W_t}{P_t}$$

These ingredients ultimately give us a representation of the NKPC that includes the firm's marginal cost in its determination. The details of its derivation are given in the appendix. The NKPC becomes:

$$\pi_t = \beta E_t \pi_{t+1} + \lambda mc_t \quad (15)$$

4.5 Financial Frictions

The financial frictions incorporated into this model are borrowed from [Gertler and Kiyotaki \(2010\)](#).¹⁴ I incorporate the bank's balance sheet setup from GK, with the addition of bank holdings of long-term government debt. In order to issue loans and purchase government debt, banks must draw from their assets, which consists of their deposits and net worth. Therefore, shocks to the value of government debt shock the bank's net worth.

At date t the bank chooses loans L_t with ex post real gross return R_{t+1}^L , and deposits D_t that must be repaid at the ex post real gross deposit rate R_{t+1}^D .

Net worth at t is N_t . Let the household stochastic discount factor be $\Lambda_{t,t+1}$, and let Ω_{t+1} denote the shadow value of one unit of bank net worth next period.

¹⁴Henceforth "GK."

The bank's balance sheet is defined as:

$$A_t \equiv L_t + Q_t B_{b,t} = N_t + D_t \quad (16)$$

Here, $Q_t B_{b,t}$ is the nominal market value of the bank's portfolio of government debt. Asset-market equilibrium entails that all bonds issued by the government are held by the banks and households: $B_{b,t} + B_{h,t} = B_t$. All elements of the bank's balance sheet are in nominal terms. The reason only $B_{b,t}$ needs a "price" is because all other instruments are one-period nominal claims whose market value equals their face value. Long-term government debt, on the other hand, is a multi-period asset whose current value depends on the present value of future coupon payments. For this reason, what matters for banks is $Q_t B_{b,t}$ rather than the face value $B_{b,t}$ so that their balance sheet reflects the *market value* of the long-term bond portfolio.

Following Cochrane (2022), the market value of the bank's government debt portfolio is defined as:

$$Q_t B_{b,t} \equiv \sum_{j=1}^{\infty} B_{b,t}^{t+j} Q_t^{t+j} = B_{b,t} \sum_{j=1}^{\infty} \omega^{j-1} Q_t^{t+j}$$

As $B_{b,t}^{(t+j)} = B_{b,t} \omega^{j-1}$ and $Q_t = \sum_{j=1}^{\infty} \omega^{j-1} Q_t^{t+j}$

Gross returns on assets pay out next period. Net worth at $t+1$ is

$$N_{t+1} = R_{t+1}^L L_t + R_{t+1}^n Q_t B_{b,t} - R_{t+1}^D D_t. \quad (17)$$

Where R_{t+1}^n is the return on the government debt portfolio.

I use 1 to eliminate D_t and organize everything into a risk-free part plus excess returns.

First add and subtract $R_{t+1}^D L_t$, $R_{t+1}^D Q_t B_{b,t}$ and $R_{t+1}^D R_t$ inside 16: Which gives us:

$$N_{t+1} = R_{t+1}^D N_t + (R_{t+1}^L - R_{t+1}^D) L_t + (R_{t+1}^n - R_{t+1}^D) Q_t B_{b,t} \quad (18)$$

It's important to note here that $E_t R_{t+1}^L = (1 + i_t^L)(1 - \phi_{d,t+1})/\Pi_{t+1}$. The expected return on loans accounts for the endogenous probability of default, $\phi_{d,t+1}$. The objective of the bank is to maximize its expected wealth over time:

$$\mathcal{V}_t = \mathbb{E}_t \sum_{i=1}^{\infty} (1 - \sigma_B) \sigma_B^{i-1} \Lambda_{t,t+i} N_{t+i} \quad (19)$$

Here, we introduce key elements from the GK framework. The parameter σ_B represents the fact that the banker exits at the end of period t with probability $(1 - \sigma_B)$, in which case he simply consumes N_t , and survives with probability σ_B , in which case he continues operating the bank and earns continuation value $\mathcal{V}_t(n_t)$. What's the purpose of this? If bankers did not exit and become consumers with probability $(1 - \sigma_B)$, then, as banks earn positive profits each period, N_t would accumulate to a point where bankers would be able to self-finance, no longer needing deposits, eliminating loan-deposit spreads, and with it, the financial frictions.

We guess the following form for the value function of the bank:

$$\mathcal{V}_t = \mathbb{E}_t[\Lambda_{t,t+1} \Omega_{t+1} N_{t+1}] . \quad (20)$$

Where Ω_{t+1} is the bank's shadow value of a unit of net worth. From the banker's Bellman equation,

$$\mathcal{V}_{t-1}(N_t) = E_{t-1} \left[\Lambda_{t-1,t} \left((1 - \sigma_B) N_t + \sigma_B \max_{L_t, B_{b,t}} \mathcal{V}_t(N_{t+1}) \right) \right] \quad (21)$$

Which means that we maximize

$$\mathcal{V}_t = E_t \left\{ \Lambda_{t,t+1} \Omega_{t+1} [R_{t+1}^D N_t + (R_{t+1}^L - R_{t+1}^D) L_t + (R_{t+1}^n - R_{t+1}^D) Q_t B_{b,t}] \right\} . \quad (22)$$

subject to:

$$\mathcal{V}_t \geq \Theta_B (L_t + Q_t B_{b,t}) \quad (23)$$

This constraint is a limit on the divertability of funds by bankers. When banks obtain funds from households, the bank's manager may divert a fraction of the assets it receives to their own family. This constraint in equation 23 says that a fraction $(1 - \Theta_B)$ of funds can be reclaimed by creditors. Therefore, the bank's franchise value \mathcal{V}_t must be at least as great as its gain from diverting funds.

In equilibrium the constraint binds. Divide 23 by N_t and use $\phi_t \equiv \frac{L_t + Q_t B_{b,t}}{N_t}$,

$$\frac{\mathcal{V}_t}{N_t} = \Theta_B \phi_t. \quad (24)$$

I call ϕ_t the bank's leverage. Solving for the bond portfolio price, we end up with:

$$Q_t = \frac{E_t[\Lambda_{t,t+1}\Omega_{t+1}(1 + \omega Q_{t+1})]}{E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] - \mu_t \Theta_B} \quad (25)$$

Where the Lagrange multiplier μ_t comes out to:

$$\mu_t = \frac{E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]}{\Theta_B - E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]} \quad (26)$$

Where R_{t+1}^L and R_{t+1}^D are the returns on loans and deposits, respectively. The price of the government debt portfolio now depends upon credit spreads, the SDF, and the bank's shadow value of net worth. We see that today's price of the debt portfolio is increasing in its continuation value, Q_{t+1} . As bonds are expected to appreciate in the future, people demand more of them today, bidding up the price.

When the spread $R^L - R^D$ increases, the bank would like to issue more loans. However, they are constrained by the incentive constraint. Although both loans and government bonds appear in the incentive constraint 23, loans tighten the constraint because they generate non-pledgeable and state-contingent returns. Government bonds, on the other hand, raise the bank's net worth without worsening diversion incentives. Hence, an increase in the loan-deposit spread tightens the constraint, raising the value of assets like government bonds.

Therefore, an increase in $R^L - R^D$ increases the incentive for the bank to expand lending. As the bank approaches the IC constraint in 23, this raises μ_t , which pushes bond prices up.

However, the effects of $R^L - R^D$ are counterbalanced by the effects of the intermediary pricing kernel $\Lambda\Omega$. The price of the debt portfolio is *decreasing* in the bank's pricing kernel. When this object rises, it either means the economy is in a bad state, or the bank, for whatever reason, is experiencing balance-sheet tightness, pushing up its shadow value of net worth. As a result, banks discount future bond payoffs more heavily, which lowers their present value. The rise in bank discounting of future cash flows pushes down the price of the debt portfolio. This is analogous to the baseline responses of bond prices in FTPL models [Cochrane \(2022a,b\)](#) with long-term debt, where rises in discount rates lower Q_t .

Recall that Ω is the bank's shadow value of net worth. It has the following specification:

$$\Omega_t = (1 - \sigma_B) \cdot 1 + \sigma_B \cdot \Theta_B \phi_t \quad (27)$$

which is an increasing function of leverage ϕ_t , which itself is a function of net worth and bank assets. Therefore, bank leverage and net worth are key elements that determine the intermediary pricing kernel, which in turn is a major of the price of government debt. Also recall that, log-linearizing equation 5, we end up with:¹⁵

$$r_{t+1}^n = \omega q_{t+1} - q_t \quad (28)$$

Alas, we have our link between the valuation equation of government debt and financial intermediaries. Bank leverage in equation 27 determines the shadow value of bank net worth Ω , which, along with the SDF, determines the intermediary's pricing kernel and, furthermore, bond prices. As bank net worth falls, leverage (and therefore Ω) rise, which causes Q to fall — transmitting directly into 27. Therefore, since we know there is a strong relationship between discount rates and inflation, and since we now see the link between the financial

¹⁵See appendix of [Cochrane \(2022a\)](#) for derivation.

sector and discount rate determination, we can now more fully understand how financial frictions will operate in the FTPL environment as we turn to the IRFs.

For closure, we have a basic Taylor Rule:

$$i_t = \phi_{i\pi}\pi_t + \phi_{iy}y_t + u_t^i$$

Where $\phi_{i\pi} = 0.80$, $\phi_{iy} = 0.50$, and u_t follows an AR process, $u_{t+1} = \rho_i u_t^i + \varepsilon_{t+1}^i$, with $\rho_i = 0.7$. The first of these, $(\phi_{i\pi})$, is what gives us the passive-money setup.

5 Impulse Responses

At this point we turn to the analysis of the impulse response functions. It seemed appropriate to me to provide a benchmark against which one could compare the model with financial frictions. This will clarify the role of these frictions and how they alter the dynamics of the model. Since the virtually the entirety of the FTPL block in the model is imported from [Cochrane \(2022b\)](#), this will be our baseline. Cochrane’s “Fiscal Theory of Monetary Policy” contains frictions in the form of price stickiness, which I include in my paper as well. However, the NKPC now includes firms’ marginal cost, as opposed to output.

The key differentiating factor between the fiscal block in the baseline model and mine is the determination of bond prices, which is ultimately an AR(1) process that also responds to output and inflation in the baseline setup. At the end of the previous section I discussed what drives bond prices in my model, which are now intimately linked to the financial sector.

We will conduct four experiments that will enable us to compare the results of our model against the baseline (no financial frictions) model: 1) A monetary policy shock in an environment with no policy rules (fiscal and monetary policy rules are shut off). 2) A monetary policy shock with policy rules. 3) A fiscal policy shock with no policy rules. 4) A fiscal policy shock with policy rules.

Denote $\vec{\theta} = [\theta_{ix} \ \theta_{i\pi} \ \theta_{sx} \ \theta_{s\pi}]$ as the vector (or set) of policy rule parameters. To say that

we are shutting off the policy rules in two of these experiments, it simply means that $\vec{\theta} = \mathbf{0}$. This exercise gives us a look into how FTPL alone can produce realistic dynamics of inflation and output, with the aid of policy tools — the impulse responses with policy rules turned off can be found in the appendix. Of particular interest are the simulations with policy rules, which is what we turn our attention to here.

[Figure 4](#) compares the impulse responses of the baseline model to the financial frictions (FF) model in the context of a monetary policy shock with policy rules.

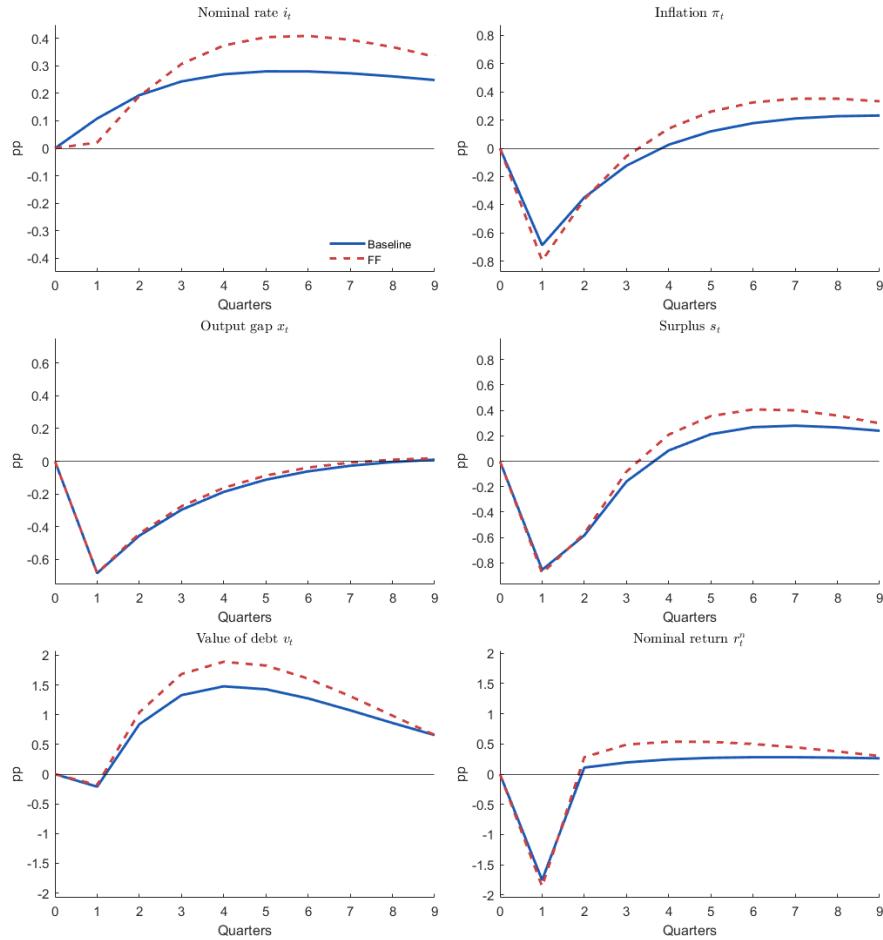


Figure 4: MP Shock - With Rules

Impulse responses to a monetary policy shock where rules are on $\vec{\theta} \gg \mathbf{0}$. The solid blue lines represent the baseline model from [Cochrane \(2022b\)](#). The orange dashed lines represent the model with financial frictions (FF).

As we'd hope, a monetary policy shock that *increases* interest rates pushes inflation and

output down at near-term horizons. The relatively flat response of i_t is owing to the policy rule's response to the immediate drop in output and inflation, which leads i_t to rise by substantially less than its shock. In the baseline specification we get immediate liftoff, but under FF, the interest rate doesn't lift off until after period 1. After period two, we see both higher amplitude and persistence in the interest rate's dynamics under FF than the baseline.

The reason for the one period lag in the interest rate rise under FF is the fact that inflation falls by about an additional 0.11 percentage points compared to the baseline. When then see larger inflation over the medium and long term in the FF model.

There are several forces behind the larger and more persistent inflation response relative to the baseline. First, the Phillips curve now responds to firms' marginal costs, which in this model depend not only on output but also on bank credit conditions, including lending volumes, lending rates, and default risk. As the policy rate rises, bank lending contracts sharply.¹⁶ Since, in this model, marginal cost effectively depends on the gap between output and credit, a fall in lending that is larger and more persistent than the fall in output raises marginal cost. On impact, both output and lending drop, but lending drops by more, and over the medium term the continued shortfall of credit relative to activity keeps marginal costs elevated. This additional and persistent pressure on marginal cost feeds into the Phillips curve and generates stronger and more drawn-out inflation dynamics than in the baseline model without financial frictions.

Model	$\Delta E_1 \pi_1$	$-\Delta E_1(r_1^n)$	$=$	$-\sum_{j=0}^{\infty} \Delta E_1 s_{1+j}$	$+\sum_{j=1}^{\infty} \Delta E_1(r_{1+j}^n - \pi_{1+j})$
Baseline	(-0.69)	-(-1.75)	=	-(0.28)	+(1.34)
FF	(-0.80)	-(-1.86)	=	-(-1.57)	+(-0.51)

Table 1: Decomposition for a monetary shock with policy responses.

Table 1 follows Cochrane (2022a,b) in analyzing the decomposition of inflation.¹⁷ The 1% contractionary monetary policy shock leads to an immediate fall in inflation of 0.69%

¹⁶See appendix figures for IRFs and other details.

¹⁷See online appendix (section 6.1) of Cochrane (2022a) for derivation of this identity.

in the baseline model, as opposed to 0.80% under FF — a 16% greater fall in inflation over the immediate term. Although lending rates rise in wake of the policy rate shock, lending volume falls by *less* than economic activity (output), which means that marginal costs actually create additional downward pressure on inflation over the immediate term. Of course, as explained above, this trend reverses over longer horizons. Although marginal cost isn't included in the decomposition of [Table 1](#), the table provides us with some interesting contrasts in variables that *are* influenced by marginal cost.

In the baseline model we see that real interest rates rise, which entails a higher real returns on government debt. This contributes positively to inflation and is offset by the ensuing rise in expected future surpluses raised in response to these higher returns.

Under FF, the signs are reversed. Real returns on debt fall over time, which create deflationary pressure. However, this is partially offset by the fall in future surpluses that follow as a result of the decrease in the expected rate of return on the debt, which results in inflationary pressure. However, the magnitude of the fall in government debt returns dominates, which leads generates, overall, disinflation.

Consequently, FFs lead to the same directional change in inflation as the baseline model (a fall in inflation), but for quite different reasons. The amplification of interest rates over the medium term leads to higher inflation over the same horizon. This is an artifact of fiscal dominance. Over the short-term, in both models, yields on long-term bonds rise, which means that bond returns r^n fall immediately. However, as interest rates continue to rise, so do expected bond returns, and with it, debt.

The movement of r^n is tied to the behavior of the bank's balance sheet. Recall what equation 29 tells us about the determination of bond returns: they are determined by the evolution of bond prices. As stated above, as bank balance sheets deteriorate, bond prices rise today (at time t), which causes r_{t+1}^n to fall. This story is precisely what we see in the early horizons of r^n in figure two. There is very little change in the initial fall of r^n . However, over medium and longer term horizons, the nominal return on government debt

exceeds the baseline. Why is this happening? The answer is simple: in the FF model, after the immediate rate hike, bank net worth falls faster than assets, which means leverage increases. Once leverage spikes, the no-diversion constraint becomes more binding. As a result, μ_t increases, which means banks value government debt in so far as it relaxes this constraint. This immediately raises the bond price Q_t , leading to lower returns on nominal debt r_{t+1}^n , which the bank accepts due to the fact that these assets provide a kind of “collateral premium.” After a few quarters have elapsed, lending has dropped off significantly, which leads μ_t to decrease. The SDF is a decreasing function of interest rates.

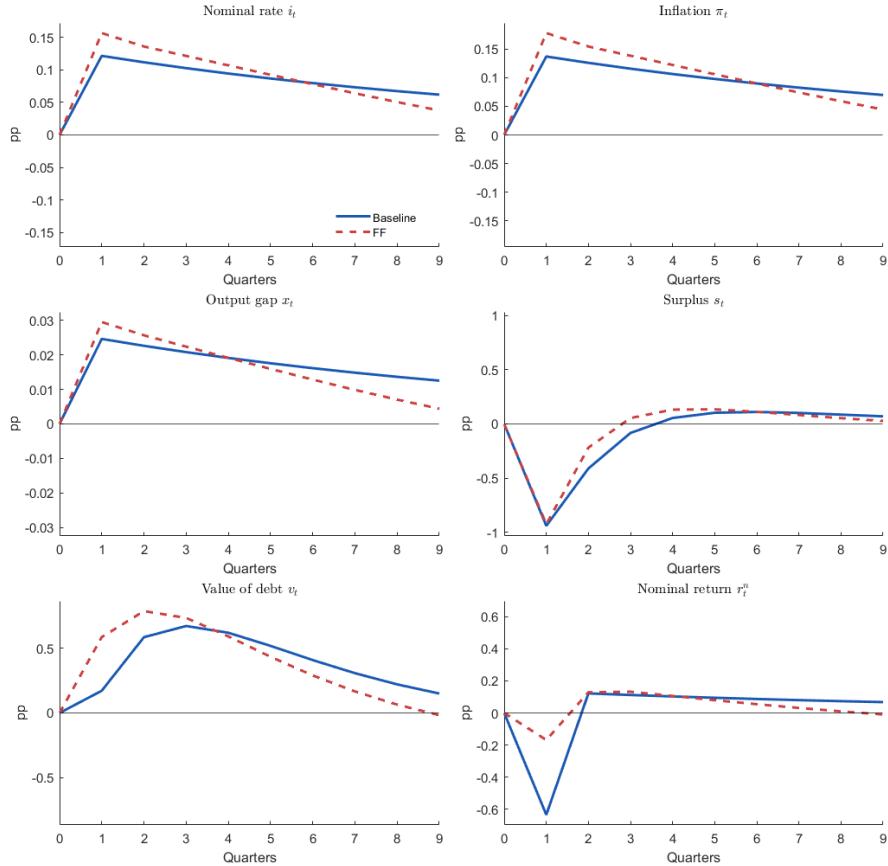


Figure 5: FP Shock - With Rules

Therefore, nominal interest rates operate through the financial sector in a manner that amplifies virtually every ingredient of interest in wake of a monetary policy shock. This is due to the fact that surpluses only cover a portion of the debt accumulated, which means

inflationary pressure arises over the medium term. Therefore, we have marginal costs amplifying interest rates over the medium term, which pushes the rate of return on government debt up, and therefore the value of debt, which generates additional inflation due to the inability of surpluses to fully cover the increase in the value of debt.

We move on to a fiscal policy shock in an environment of policy rules. A “fiscal shock” entails a sudden 1% decrease in expected government surpluses.

Model	$\Delta E_1 \pi_1$	$-\Delta E_1(r_1^n)$	$=$	$-\sum_{j=0}^{\infty} \Delta E_1 s_{1+j}$	$+\sum_{j=1}^{\infty} \Delta E_1(r_{1+j}^n - \pi_{1+j})$
Baseline	(0.14)	$-(-0.63)$	$=$	$-(-0.82)$	$+(-0.04)$
FF	(0.18)	$-(-0.17)$	$=$	$-(-1.16)$	$+(-0.81)$

Model	$\sum_{j=0}^{\infty} \omega^j \Delta E_1 \pi_{1+j}$	$=$	$-\sum_{j=0}^{\infty} \rho^j \Delta E_1 s_{1+j}$	$+\sum_{j=1}^{\infty} (\rho^j - \omega^j) \Delta E_1 r_{1+j}$
Baseline	(0.79)	$=$	$-(-0.82)$	$+(-0.02)$
FF	(0.66)	$=$	$-(-1.16)$	$+(-0.50)$

Table 2: Decomposition for a fiscal shock with policy responses.

Derivations for these decompositions are found in [Cochrane \(2022b\)](#).

The initial shock to surpluses is -1%. However, the sum of the exogenous shock’s contribution to changes in surpluses is -2%. In the baseline model, the shock results in a -0.82% change in expected future surpluses. The instantaneous change in inflation is 0.14 in the baseline model and 0.18 in the model with financial frictions. However, total weighted inflation goes up by 0.79% in the baseline, and by 0.66% under FF.¹⁸

Additionally, the weighted sum of surpluses is even more negative under FF than the baseline, yet we get less cumulative inflation. How is this possible, given fiscal theory’s predictions that the price level should adjust so that the real value of nominal government debt equals the present value of future primary surpluses? Surpluses fall by an additional 0.34% *more* under FF than under the baseline, yet we get 0.13% less inflation under FF.

¹⁸The “weight” ω^j is the geometric maturity structure of long-term debt.

As can be seen in Table 2, clearly the discount rate variation accounts for the fact that we have a larger unfunded deficit under FF with less inflation. Note that $r_{t+1} = r_{t+1}^n - \pi_{t+1}$ is *real* return on government debt. Look at the bottom right panel of [Figure 5](#). The fall in the nominal returns on government debt in the immediate aftermath of the shock is less than under the baseline. However, the peak of the recovery at horizon 2 is just as large as the baseline, but we see a much quicker reversion to trend under FF. Therefore, we have a more negative cumulative change in nominal and real discount rates. This raises the value of debt, and acts a deflationary countermeasure to the inflationary pressure brought on by the fall in future surpluses. So what's behind the change in discount rates? To answer this, we need to see what's happening on the financial side.

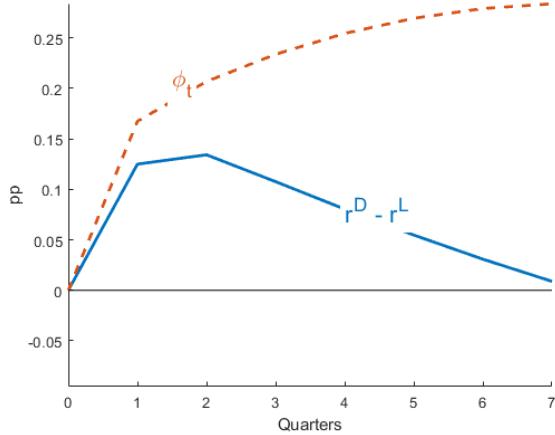


Figure 6: Impulse Responses of Leverage and Interest Rate Spreads

The orange dashed line ϕ_t is bank leverage from equation 24. The blue line is the spread between real deposit and loan rates.

[Figure 6](#) plots the bank leverage ϕ_t and the spread between real deposit and loan rates. The rise in leverage causes the bank's shadow value of net worth Ω to increase, which puts upward pressure on Q_t , which pushes r^n down. The interest rate on deposits responds more strongly to the fiscal shock than loan rates. Both nominal rates increase, but deposit rates increase by more. Bond prices are decreasing in this spread, which puts upward pressure on r^n , counterbalancing the downward pressure created by Ω . Since r^n falls in wake of the

shock, this shows that the effects of the leverage (net worth) channel dominate overall. This explains the smaller response of r^n in the immediate aftermath of the shock — Q_t falls by less under FF than in the baseline.

It should be noted that this explains the front-loaded accumulation of debt under FF, relative to the baseline. The debt accumulation equation is increasing in bond returns. Since the initial fall in nominal returns is muted under FF relative to the baseline, the accumulation of debt at early horizons is amplified. However, after a few quarters, the additional inflation pressure and stronger recovery of surpluses bring the accumulation of debt below the rate of increase displayed in the baseline model.

So how do discount rates experience a larger cumulative fall under FF than in the baseline? What is obscured from [Figure 5](#) is that, after quarter 10, nominal returns fall slightly below zero for a few quarters before returning to trend, along with inflation. This mimics the s-shaped pattern of surpluses over longer horizons. Surpluses, by construction, follow an s-shaped pattern: when we have a fiscal shock that leads to a fall in surpluses and accumulation of debt, the government must raise future surpluses to at least partially repay the debt.

The surplus process feeds in equation 12 feeds into the debt accumulation equation 6. This means the surplus equation affects the price of the debt portfolio and, therefore, nominal returns r^n . In the baseline model, bond price variation follows the future path of the policy rate, which leads to largely smooth dynamics that result in r^n settling at zero after recovery without any oscillations. However, in my model, financial sector dynamics feed directly into the bond pricing equation. Moreover, bond pricing feed into the bank's balance sheet and leverage. This generates a feedback mechanism where changes in bond prices Q_t change the banks asset holdings, which directly affects leverage ϕ_t that then affects the bank's shadow value of net worth Ω_{t+1} , which feeds back into Q_t .

Therefore, the s-shaped surplus process, along with the bond-price feedback mechanism on the financial side, help contribute to the s-shaped responses in the returns on government

debt and inflation. However, the main driver of the s-shaped dynamics in r^n and inflation are the differing degrees of persistence among key variables on the financial side. Referring again to [Figure 6](#), we see that there is more persistence in leverage than in the interest rate spread. Recall that increasing leverage results in decreasing r^n . After the initial rise of $r^D - r^L$, which pushes r^n up, it corrects and begins to revert back to trend faster than leverage. Since leverage remains elevated, this puts upward pressure on Q_t , pushing r^n down. Hence the oscillations in r^n over time — they are owing to differential persistence in bank-level variables that pin down Q .

Altogether, this enables us to make sense of the fact that, although we have a larger cumulative fall in surpluses under FF, we get less cumulative inflation — discount rates absorb much of the effect. This is precisely what we wanted when adding financial frictions into the FTPL environment — a story that connects discount rates (a major driver of inflation dynamics) to a financial sector, and see how these ingredients affect the story.

The appendix includes the IRFs of specific financial variables like loans, net worth, leverage, and bond prices, which aid in visualizing the dynamics of the variables plotted in [Figure 4](#) and [Figure 5](#). I've also included the results of these simulations when the policy rules are shut off.

5.1 Extensions

A worthy extension of this kind of model would naturally be to extend this into a continuous time setting à la [Brunnermeier and Sannikov \(2014\)](#) or [He and Krishnamurthy \(2013\)](#). Fiscal and monetary shocks, by their nature, generate financial market volatility that transmits to asset prices. See how changes in risk premia transmit to bond prices would be of extreme interest. The latter paper would especially be interesting for understanding how pricing kernels and discount rates interact, and in turn, inflation.

In the discrete-time setting laid out in this paper, it would also be interesting to incorporate reserve balances into the bank balance sheet that are remunerated at the policy rate.

Then one could incorporate a reserve requirement that could be manipulated by the monetary authority. Under active fiscal policy, manipulating reserve ratios would, again, only alter the path of inflation, not the cumulative change. Nonetheless, it would be interesting to see how it affects the dynamics.

6 Conclusion

Incorporating financial frictions into a fiscal theory framework doesn't fundamentally alter the logic of FTPL. However, it does add some color to the story. The story is that, by adding financial frictions, the financial sector amplifies the responses of macro-aggregates across all horizons in wake of a monetary policy shock, and across near-term horizons following a fiscal shock. A major driver of the monetary shock dynamics are, obviously, the policy rate, but also credit as it responds to the policy rate. This affects default risk and lending rates, all of which affect firms' marginal costs, leading to more drawn-out inflation via the Phillips curve.

On the fiscal side, a shock to surpluses leads to immediate amplification of virtually all macro-aggregates over and above what is observed in the baseline model, with the exception of discount rates. Although surpluses fall more over time, we get less inflation under FF as discount rates do the work of acting as a shock absorber. This is owing to the dynamics of bank leverage and interest rate spreads that help pin down bond prices. Higher and more persistent bank leverage relative to the deposit-loan spread creates oscillations in discount rates over the long term that absorb much cumulative inflation. However, the immediate impact of inflation is more front loaded under financial frictions for similar reasons as what happens under monetary policy shocks — namely, loan and default rates play a major role through marginal costs.

References

- Bassetto, M. (2002). A game-theoretic view of the fiscal theory of the price level. *Econometrica* 70(6), 2167–2195.
- Bernanke, B. and O. Blanchard (2025). What caused the us pandemic-era inflation? *American Economic Journal: Macroeconomics* 17(3), 1–35.
- Brunnermeier, M. K. and Y. Sannikov (2014). A macroeconomic model with a financial sector. *American Economic Review* 104(2), 379–421.
- Buiter, W. H. (2002). The fiscal theory of the price level: A critique. *The Economic Journal* 112(481), 459–480.
- Cochrane, J. (2023). *The Fiscal Theory of the Price Level*. Princeton University Press.
- Cochrane, J. (2025). <https://www.johnhcochrane.com/research/articles/macro-money-fiscal-theory>.
- Cochrane, J. H. (2005). Money as stock. *Journal of Monetary Economics* 52(3), 501–528.
- Cochrane, J. H. (2022a). The fiscal roots of inflation. *Review of Economic Dynamics* 45, 22–40.
- Cochrane, J. H. (2022b). A fiscal theory of monetary policy with partially-repaid long-term debt. *Review of Economic Dynamics* 45, 1–21.
- Gertler, M. and N. Kiyotaki (2010). Financial intermediation and credit policy in business cycle analysis. In *Handbook of monetary economics*, Volume 3, pp. 547–599. Elsevier.
- Hansen, L. P., W. Roberds, and T. J. Sargent (2019). Time series implications of present value budget balance and of martingale models of consumption and taxes. In *Rational expectations econometrics*, pp. 121–161. CRC Press.

- He, Z. and A. Krishnamurthy (2013). Intermediary asset pricing. *American Economic Review* 103(2), 732–770.
- Kocherlakota, N., C. Phelan, et al. (1999). Explaining the fiscal theory of the price level. *Federal Reserve Bank of Minneapolis Quarterly Review* 23(4), 14–23.
- Leeper, E. M. (1991). Equilibria under ‘active’and ‘passive’monetary and fiscal policies. *Journal of monetary Economics* 27(1), 129–147.
- Marimon, R. (2001). The fiscal theory of money as an unorthodox financial theory of the firm. In *Monetary theory as a basis for monetary policy*, pp. 72–95. Springer.
- McCallum, B. T. (1984). Are bond-financed deficits inflationary? a ricardian analysis. *Journal of political economy* 92(1), 123–135.
- Sargent, T. J. and N. Wallace (1981). Some unpleasant monetarist arithmetic. In *Federal Reserve Bank of Minneapolis Quarterly Review*, pp. 5:1–17.
- Sims, C. A. (1994). A simple model for study of the determination of the price level and the interaction of monetary and fiscal policy. *Economic theory* 4(3), 381–399.
- Sims, C. A. (2011). Stepping on a rake: The role of fiscal policy in the inflation of the 1970s. *European Economic Review* 55(1), 48–56.
- Woodford, M. (1995). Price-level determinacy without control of a monetary aggregate. In *Carnegie-Rochester conference series on public policy*, Volume 43, pp. 1–46. Elsevier.
- Woodford, M. (2001). Fiscal requirements for price stability.

A Appendix

A.1 Banks

At date t the bank chooses loans L_t with ex post real gross return R_{t+1}^L , and deposits D_t that must be repaid at the ex post real gross deposit rate R_{t+1}^D .

Net worth at t is N_t . Let the household stochastic discount factor be $\Lambda_{t,t+1}$, and let Ω_{t+1} denote the shadow value of one unit of bank net worth next period. Let $(1 + g_{t+1})$ be the growth factor between t and $t + 1$.

The bank's balance sheet is defined as:

$$A_t \equiv L_t + Q_t B_{b,t} = N_t + D_t \quad (\text{A.1})$$

Here, $Q_t B_{b,t}$ is the nominal market value of the bank's portfolio of government debt. All elements of the bank's balance sheet are in nominal terms. The reason only $B_{b,t}$ needs a “price” is because all other instruments are one-period nominal claims whose market value equals their face value. Long-term government debt, on the other hand, is a multi-period asset whose current value depends on the present value of future coupon payments. For this reason, what matters for banks is $Q_t B_{b,t}$ rather than the face value $B_{b,t}$ so that their balance sheet reflects the *market value* of the long-term bond portfolio.

Following Cochrane (2022), the market value of the bank's government debt portfolio is defined as:

$$Q_t B_{b,t} \equiv \sum_{j=1}^{\infty} B_{b,t}^{t+j} Q_t^{t+j} = B_{b,t} \sum_{j=1}^{\infty} \omega^{j-1} Q_t^{t+j}$$

As $B_{b,t}^{(t+j)} = B_{b,t} \omega^{j-1}$ and $Q_t = \sum_{j=1}^{\infty} \omega^{j-1} Q_t^{t+j}$

Gross returns on assets pay out next period. Net worth at $t+1$ is

$$N_{t+1} = R_{t+1}^L L_t + R_{t+1}^n Q_t B_{b,t} - R_{t+1}^D D_t. \quad (\text{A.2})$$

Where R_{t+1}^n is the return on the government debt portfolio.

I use 1 to eliminate D_t and organize everything into a risk-free part plus excess returns.

First add and subtract $R_{t+1}^D L_t$, $R_{t+1}^D Q_t B_{b,t}$ and $R_{t+1}^D R_t$ inside 2:

$$N_{t+1} = R_{t+1}^D L_t + R_{t+1}^D Q_t B_{b,t} + -R_{t+1}^D D_t + (R_{t+1}^L - R_{t+1}^D) L_t \\ + (R_{t+1}^n - R_{t+1}^D) Q_t B_{b,t}$$

Which gives us:

$$N_{t+1} = R_{t+1}^D N_t + (R_{t+1}^L - R_{t+1}^D) L_t + (R_{t+1}^n - R_{t+1}^D) Q_t B_{b,t} \quad (\text{A.3})$$

This leads us to the following value function:

$$V_t = \mathbb{E}_t[\Lambda_{t,t+1} \Omega_{t+1} N_{t+1}] . \quad (\text{A.4})$$

Substitute 3 into 4. Since $N_t, L_t, B_{b,t}$ are chosen at t , they are outside the expectation:

$$\frac{V_t}{N_t} = \mathbb{E}_t[\Lambda_{t,t+1} \Omega_{t+1} R_{t+1}^D] + \mathbb{E}_t[\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^L - R_{t+1}^D)] \frac{L_t}{N_t} + \mathbb{E}_t[\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^n - R_{t+1}^D)] \frac{Q_t B_{b,t}}{N_t} \quad (\text{A.5})$$

Following Gertler, Kiyotaki (2010), the banker can divert a fraction of assets; households require the franchise value to exceed the diversion payoff. With $\Theta_B \in (0, 1)$ and total assets A_t ,

$$V_t \geq \Theta_B (L_t + Q_t B_{b,t}). \quad (\text{A.6})$$

In equilibrium the constraint binds. Divide 6 by N_t and use $\phi_t \equiv \frac{L_t + Q_t B_{b,t}}{N_t}$,

$$\frac{V_t}{N_t} = \Theta_B \phi_t. \quad (\text{A.7})$$

We equate 5 and 7 and solve for L_t . We end up with following loan identity:

$$L_t = \frac{\mathbb{E}_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D]N_t - \{\Theta_B - E_t[\Lambda_{t,t+1}\Omega_{t,t+1}(R_{t+1}^n - R_{t+1}^D)]\}Q_tB_{b,t}}{\Theta_B - \mathbb{E}_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]} \quad (\text{A.8})$$

I let banks hold the long-term government debt portfolio with geometric maturity parameter ω . Following Cochrane (2022), the gross return on this portfolio is

$$R_{t+1}^n = \frac{1 + \omega Q_{t+1}}{Q_t}. \quad (\text{A.9})$$

For the derivation of Ω_{t+1} we do the following:

From the banker's Bellman equation,

$$V_{t-1}(N_t) = E_{t-1}\left[\Lambda_{t-1,t}\left((1 - \sigma_B)N_t + \sigma_B \max_{L_t, B_{b,t}} V_t(N_{t+1})\right)\right] \quad (\text{A.10})$$

the banker exits at the end of period t with probability $(1 - \sigma_B)$, in which case he simply consumes n_t , and survives with probability σ_B , in which case he continues operating the bank and earns continuation value $V_t(n_t)$.

The incentive constraint binds in equilibrium,

$$V_t = \Theta_B(L_t + Q_t B_{b,t}) \quad (\text{A.11})$$

which, dividing and multiplying by N_t , gives

$$V_t = \Theta_B \frac{L_t + Q_t B_{b,t}}{N_t} N_t = \Theta_B \phi_t N_t \quad (\text{A.12})$$

where $\phi_t \equiv (L_t + Q_t B_{b,t})/N_t$ is the banker's leverage ratio.

Substituting 14 into 12 yields

$$V_{t-1}(N_t) = E_{t-1}\left[\Lambda_{t-1,t}\left((1 - \sigma_B)N_t + \sigma_B \Theta_B \phi_t N_t\right)\right] \quad (\text{A.13})$$

$$= E_{t-1} \left[\Lambda_{t-1,t} ((1 - \sigma_B) + \sigma_B \Theta_B \phi_t) N_t \right] \quad (\text{A.14})$$

Assume, as conjectured, that the value function is homogeneous of degree one in net worth:

$$V_{t-1}(N_t) = E_{t-1} [\Lambda_{t-1,t} \Omega_t N_t] \quad (\text{A.15})$$

Comparing 16 and 17, the coefficients on n_t inside the expectation must coincide, implying

$$\Omega_t = (1 - \sigma_B) + \sigma_B \Theta_B \phi_t \quad (\text{A.16})$$

A unit of net worth at t yields a payout of 1 if the banker exits (probability $1 - \sigma_B$), and a franchise value $\Theta_B \phi_t$ if she survives (probability σ_B). Thus the expected value per unit of net worth is

$$\Omega_t = (1 - \sigma_B) \cdot 1 + \sigma_B \cdot \Theta_B \phi_t.$$

To derive an equation for $B_{b,t}$, take (8) and plug it into for L_t in the bank's budget constraint (1) and solve for $B_{b,t}$. This gets us an equation for the bank's holdings of long-term government debt:

$$Q_t B_{b,t} = \frac{\Theta_B - E_t[\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^L - R_{t+1}^D)] D_t + (\Theta_B - E_t[\Lambda_{t,t+1} \Omega_{t+1} R_{t+1}^L]) N_t}{E_t[\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^n - R_{t+1}^L)]} \quad (\text{A.17})$$

In equilibrium, the constraint binds, so

$$\frac{V_t}{N_t} = \Theta_B \varphi_t. \quad (\text{A.18})$$

Given N_t and the continuation value the bank chooses $(\frac{L_t}{N_t}, \frac{Q_t B_{b,t}}{N_t})$ to maximize the value per unit of net worth subject to the incentive constraint:

$$\max \quad E_t[\Lambda_{t,t+1} \Omega_{t+1} R_{t+1}^D] + E_t[\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^L - R_{t+1}^D)] \frac{L_t}{N_t} + E_t[\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^n - R_{t+1}^D)] \frac{Q_t B_{b,t}}{N_t} \quad (\text{A.19})$$

$$\text{s.t. } E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] + E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] \frac{L_t}{N_t} + E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)] \frac{Q_t B_{b,t}}{N_t} \geq \Theta_B \left(\frac{L_t}{N_t} + \frac{Q_t B_{b,t}}{N_t} \right). \quad (\text{A.20})$$

Introduce a Lagrange multiplier $\mu_t \geq 0$ on the constraint 32. The Lagrangian for the per-unit problem is

$$\begin{aligned} \mathcal{L}_t = & E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] + E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] \frac{L_t}{N_t} + E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)] \frac{Q_t B_{b,t}}{N_t} \\ & + \mu_t(E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] + E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] \frac{L_t}{N_t} + E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)] \frac{Q_t B_{b,t}}{N_t} - \Theta_B(\frac{L_t}{N_t} + \frac{Q_t B_{b,t}}{N_t})). \end{aligned} \quad (\text{A.21})$$

Assuming an interior solution in loans, the first-order condition with respect to $\frac{L_t}{N_t}$ is

$$\frac{\partial \mathcal{L}_t}{\partial x_t} = E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] + \mu_t(E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] - \Theta_B) = 0. \quad (\text{A.22})$$

Rearrange 34:

$$E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] + \mu_t E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] - \mu_t \Theta_B = 0, \quad (\text{A.23})$$

$$E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)](1 + \mu_t) = \mu_t \Theta_B. \quad (\text{A.24})$$

Solve 36 for μ_t :

$$E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)](1 + \mu_t) = \mu_t \Theta_B \Rightarrow E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)] = \mu_t(\Theta_B - E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]) \quad (\text{A.25})$$

$$\Rightarrow \mu_t = \frac{E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]}{\Theta_B - E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]}. \quad (\text{A.26})$$

Recalling the definition of B_t , we obtain

$$\mu_t = \frac{E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]}{\Theta_B - E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^L - R_{t+1}^D)]} \quad (\text{A.27})$$

If there is also an interior solution in bond holdings y_t , we can analogously use the FOC with respect to y_t :

$$\frac{\partial \mathcal{L}_t}{\partial y_t} = E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)] + \mu_t(E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)] - \Theta_B) = 0, \quad (\text{A.28})$$

which implies

$$E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)(1 + \mu_t)] = \mu_t\Theta_B \Rightarrow \mu_t = \frac{E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)]}{\Theta_B - E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)]} = \frac{E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)]}{\Theta_B - E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)]}. \quad (\text{A.29})$$

If both L_t/N_t and $Q_t B_{b,t}/N_t$ in equilibrium, the two expressions for μ_t must coincide, imposing a relationship between the loan and bond excess returns under the bank's SDF.

The bank's net worth evolves according to

$$N_{t+1} = R_{t+1}^D N_t + (R_{t+1}^L - R_{t+1}^D) L_t + (R_{t+1}^n - R_{t+1}^D) Q_t B_{b,t}, \quad (\text{A.30})$$

and the banker values net worth using the augmented SDF

$$V_t = E_t[\Lambda_{t,t+1}\Omega_{t+1}N_{t+1}]. \quad (\text{A.31})$$

The bank faces the incentive (no-diversion) constraint

$$V_t \geq \Theta_B(L_t + Q_t B_{b,t}), \quad (\text{A.32})$$

with Lagrange multiplier $\mu_t \geq 0$.

Form the Lagrangian (suppressing terms that do not depend on $B_{b,t}$),

$$\mathcal{L}_t = E_t[\Lambda_{t,t+1}\Omega_{t+1}N_{t+1}] + \mu_t(\Theta_B(L_t + Q_t B_{b,t}) - V_t). \quad (\text{A.33})$$

Using 42, the marginal effect of $B_{b,t}$ on N_{t+1} is

$$\frac{\partial N_{t+1}}{\partial B_{b,t}} = (R_{t+1}^n - R_{t+1}^D)Q_t. \quad (\text{A.34})$$

The first-order condition with respect to $B_{b,t}$ is then

$$0 = \frac{\partial \mathcal{L}_t}{\partial B_{b,t}} = E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)Q_t] + \mu_t\Theta_B Q_t. \quad (\text{A.35})$$

Divide by Q_t to obtain

$$E_t[\Lambda_{t,t+1}\Omega_{t+1}(R_{t+1}^n - R_{t+1}^D)] = -\mu_t\Theta_B. \quad (\text{A.36})$$

Rearrange 48 as

$$E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^n] = E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] - \mu_t\Theta_B. \quad (\text{A.37})$$

The long bond has return

$$R_{t+1}^n = \frac{1 + \omega Q_{t+1}}{Q_t}, \quad (\text{A.38})$$

where $\omega \in (0, 1)$ parameterizes the geometric maturity structure.

Substitute 50 into the left-hand side of 49:

$$E_t\left[\Lambda_{t,t+1}\Omega_{t+1}\frac{1 + \omega Q_{t+1}}{Q_t}\right] = E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] - \mu_t\Theta_B. \quad (\text{A.39})$$

Since Q_t is known at time t , pull it outside the expectation:

$$\frac{1}{Q_t}E_t[\Lambda_{t,t+1}\Omega_{t+1}(1 + \omega Q_{t+1})] = E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] - \mu_t\Theta_B. \quad (\text{A.40})$$

Multiply both sides of 52 by Q_t :

$$E_t[\Lambda_{t,t+1}\Omega_{t+1}(1 + \omega Q_{t+1})] = Q_t\left(E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] - \mu_t\Theta_B\right). \quad (\text{A.41})$$

Finally, solve 53 for Q_t to obtain the new bond pricing equation:

$$Q_t = \frac{E_t[\Lambda_{t,t+1}\Omega_{t+1}(1 + \omega Q_{t+1})]}{E_t[\Lambda_{t,t+1}\Omega_{t+1}R_{t+1}^D] - \mu_t\Theta_B} \quad (\text{A.42})$$

Equation 54 shows that the long-bond price Q_t depends on the bank's augmented stochastic discount factor $\Lambda_{t,t+1}\Omega_{t+1}$ and on the tightness of the incentive constraint through the multiplier μ_t .

A.2 Households

The representative household maximizes lifetime utility:

$$\max_{\{C_t, N_{h,t}, B_{h,t}, D_t\}} E_0 \sum_{t=0}^{\infty} \beta^t \left(\frac{C_t^{1-\sigma}}{1-\sigma} - \theta \frac{N_{h,t}^{1+\eta}}{1+\eta} + \varphi_d \ln \left(\frac{D_t}{P_t} \right) \right) \quad (\text{A.43})$$

subject to the budget constraint:

$$P_t C_t + B_{h,t} + D_t \leq W_t N_{h,t} + \Pi_{f,t} + \Psi_{b,t} + (1 + i_{t-1})(B_{h,t-1} + D_{t-1}) \quad (\text{A.44})$$

The household consumes C_t , supplies labor $N_{h,t}$ at wage rate W_t , holds short-term public debt $B_{h,t}$, which is remunerated at rate i_t ; holds deposits D_t , which are remunerated at rate i_t^D . $\Pi_{f,t}$ and $\Psi_{b,t}$ are firm and bank profits, respectively.

The consumer only holds debt of near-term maturity, whereas banks hold all of the long-term debt. Taken together then, households and banks hold all of the government's debt, so:

$$B_{b,t} + B_{h,t} = B_t$$

Taking FOCs gets us the Euler equation through the following steps:

$$\mathcal{L}'(C_t) \rightarrow C_t^{-\sigma} = \lambda_t P_t \quad (\text{A.45})$$

$$\mathcal{L}'(B_{h,t+1}) = \lambda_t = \beta E_t[\lambda_{t+1}(1 + i_t)] \quad (\text{A.46})$$

$$\Rightarrow 1 = E_t \left[\beta \left(\frac{C_{t+1}}{C_t} \right)^{-\sigma} \left(\frac{P_t}{P_{t+1}} \right) (1 + i_t) \right] \quad (\text{A.47})$$

which is our Euler equation.

This gives us our SDF:

$$1 = E_t[\Lambda_{t,t+1}(1 + i_t)] \quad (\text{A.48})$$

Linearizing (24), we get:

$$E_t[c_{t+1} - c_t] = \gamma_x \omega + \gamma_x(i_t - E_t \pi_{t+1}) \quad (\text{A.49})$$

where $\gamma_x = \frac{1}{\sigma}$ and $\omega = -\log \beta$. Setting consumption equal to output $c_t = y_t$, we get the IS equation:

$$y_t = E_t y_{t+1} - \gamma_x(i_t - E_t \pi_{t+1}) \quad (\text{A.50})$$

From the Household FOCs we also have:

$$\lambda w_t = \theta N_{h,t}^\eta \quad (\text{A.51})$$

with $y_t = \frac{C_t}{P_t}$, we get:

$$y_t^{-\sigma} w_t = \theta N_{h,t}^\eta \quad (\text{A.52})$$

In the case of firms, we will see that: $L_t = w_t N_{h,t}$. Therefore, after some rearranging:

$$w_t = (\theta y_t^\sigma L_t^\eta)^{\frac{1}{1+\eta}} \quad (\text{A.53})$$

Taking the FOC of the household's equation with respect to D_t , rearranging terms, and

substituting definitions of λ_t from the household block and D_t from the banking block, we end up with:

$$(1 + i_t^D) = \frac{1}{\beta} \left(\Pi_{t+1} \left(\frac{C_{t+1}}{C_t} \right)^\sigma - \phi_d C_{t+1}^\sigma P_{t+1} \frac{\phi_d}{D_t} \right)$$

Where:

- $y_t = \frac{C_t}{P_t}$
- $l_t = \frac{L_t}{P_t}$
- $n_{h,t} = \frac{N_{h,t}}{P_t}$
- $R_{t+1}^D = \frac{1+i_t^D}{\Pi_{t+1}}$

Which gives us:

$$D_t = \frac{\varphi_d y_t^\sigma}{1 - E_t \Lambda_{t,t+1} (1 + i_t^D)} = \frac{\varphi_d y_t^\sigma}{1 - \frac{1+i_t^D}{1+i_t^B}}$$

A.3 Firms

Demand for the individual monopolist $i \in [0, 1]$ is:

$$Q_i = \left(\frac{P_i}{P} \right)^{-\eta} Y \quad (\text{A.54})$$

The firm uses labor N_h to produce output Y .

Firms take out loans from the banks to finance input (labor) costs:

$$W_t N_{h,t} = L_t \quad (\text{A.55})$$

Where W_t is the wage and $N_{h,t}$ is labor. Firms take out a loan L_t which is remunerated at the interest rate i_t^L , with probability of default $\phi_{d,t+1}$. Therefore, the expected value of loan repayment is:

$$(1 + i_t^L)(1 - \phi_{d,t+1})L_t \quad (\text{A.56})$$

The monopolistic competitor's profit function, therefore, is given by:

$$\Psi_t(i) = P_t(i)Y_t(i) - (1 + i_t^L)(1 - \phi_{d,t+1}(i))W_tN_{h,t}(i) \quad (\text{A.57})$$

with real marginal cost equal to:

$$MC_t(i) = (1 + i_t^L)(1 - \phi_{d,t+1}(i))\frac{W_t}{P_t} \quad (\text{A.58})$$

The optimal price is mark-up over the marginal cost:

$$\frac{P_i^*}{P} = \frac{\eta}{\eta - 1} MC(i) \quad (\text{A.59})$$

This gives us our optimal price formula:

$$p_t^* = p_t + mc_t \quad (\text{A.60})$$

Where $\log\left(\frac{\eta}{\eta-1}\right)$ drops out when examining deviations from steady state.

From here, we can consider the profit function $\Psi_t(x_t)$ for the representative monopolistically competitive firm with current price x_t . We write the quadratic loss function of the firm as:

$$L_t = \frac{K}{2}(p_t^* - x_t)^2 \quad (\text{A.61})$$

where K is the absolute value of the second derivative of the profit function.

The representative firm gets to reset its price at any period with probability $(1 - \theta)$. the objective of the the firm resetting its price at period t is:

$$\min_{x_t} = \sum_{j=0}^{\infty} (1-\theta)\theta^j \beta^j \frac{K}{2} (E_t p_{t+j}^* - x_t)^2 \quad (\text{A.62})$$

where β is the discount factor and $(1-\theta)\theta^j$ is the probability that the firm will not reset its price until period $t+j+1$.

Optimizing this objective function and doing some algebra yields us the classic New Keynesian Phillips Curve:

$$\pi_t = \beta E_t \pi_{t+1} + \lambda m c_t \quad (\text{A.63})$$

$$\text{where } \lambda = \frac{(1-\theta)(1-\beta\theta)}{\theta}$$

Recall that the firm's MC as defined in (35). Combining equations (33) and (34), we arrive at the condition for default:

$$\phi_{d,t+1} = 1 - \frac{Y_t}{(1+i_t^L)L_t/P_t} \quad (\text{A.64})$$

Plugging this into the firm's MC equation we get

$$m c_t = \frac{Y_t}{L_t} w_t \quad (\text{A.65})$$

Using the FOC for labor

$$\lambda_t w_t = \theta N_{h,t}^\eta \quad \text{with} \quad \lambda_t = \frac{C_t^{-\sigma}}{P_t} \quad \text{and} \quad C_t = Y_t \quad (\text{A.66})$$

Along with $W_t = \frac{L_t}{N_{h,t}}$ from (32), we get:

$$w_t = (\theta Y_t^\sigma L_t^\eta)^{\frac{1}{1+\eta}} \quad (\text{A.67})$$

$$m c_t = \frac{Y_t}{L_t} \left(\theta^{\frac{1}{1+\eta}} Y_t^{\frac{\sigma}{1+\eta}} L_t^{\frac{\eta}{1+\eta}} \right)$$

n

$$mc_t = \left(\theta^{\frac{1}{1+\eta}} Y_t^{\frac{1+\sigma+\eta}{1+\eta}} L_t^{\frac{-1}{1+\eta}} \right) \quad (\text{A.68})$$

$$mc_t = \left(\frac{\theta}{L_t} \right)^{\frac{1}{1+\eta}} Y_t^{\frac{1+\sigma+\eta}{1+\eta}} \quad (\text{A.69})$$

To get R_{t+1}^L , observe that $E_t R_{t+1}^L = \frac{(1+i_t^L)(1-\phi_{d,t+1})}{\Pi_{t+1}}$. But since we have already derived $mc_t = (1+i_t^L)(1-\phi_{d,t+1})w_t$, we simply have

$$R_{t+1}^L = \frac{mc_t/w_t}{\Pi_{t+1}}$$

A.4 Cochrane Core Eq. Conditions

$$y_t = E_t y_{t+1} - \gamma_x (i_t - E_t \pi_{t+1}) \quad (\text{A.70})$$

$$\pi_t = \beta E_t \pi_{t+1} + \lambda mc_t \quad (\text{A.71})$$

These two equations above are slightly different from Cochrane's.

$$i_t = \theta_{i\pi} \pi_t + \theta_{ix} y_t + u_t^i \quad (\text{A.72})$$

$$s_t = \theta_{s\pi} \pi_t + \theta_{sx} y_t + \alpha v_t^* + u_t^s \quad (\text{A.73})$$

$$\rho v_{t+1}^* = v_t^* + r_{t+1}^n - E_t \pi_{t+1}^* - s_{t+1} \quad (\text{A.74})$$

$$\rho v_{t+1} = v_t + r_{t+1}^n - \pi_{t+1} - s_{t+1} \quad (\text{A.75})$$

$$r_{t+1}^n = \omega q_{t+1} - q_t \quad (\text{A.76})$$

$$u_{t+1}^i = \rho_i u_t^i + \varepsilon_{t+1}^i, \quad (\text{A.77})$$

$$u_{t+1}^s = \rho_s u_t^s + \varepsilon_{t+1}^s \quad (\text{A.78})$$

A.5 New Equilibrium Conditions

$$Y_t = C_t \quad (\text{A.79})$$

$$w_t = (\theta y_t^\sigma L_t^\eta)^{\frac{1}{1+\eta}} \quad (\text{A.80})$$

$$mc_t = \left(\frac{\theta}{L_t} \right)^{\frac{1}{1+\eta}} Y_t^{\frac{1+\sigma+\eta}{1+\eta}} \quad (\text{A.81})$$

$$D_t = Q_t B_{b,t} + L_t - N_t \quad (\text{A.82})$$

$$R_{t+1}^D = \frac{1+i_t}{\Pi_{t+1}} \quad (\text{A.83})$$

$$R_{t+1}^L = \frac{mc_t/w_t}{\Pi_{t+1}} \quad (\text{A.84})$$

$$R_{t+1}^n = \frac{1+\omega Q_{t+1}}{Q_t} \quad (\text{A.85})$$

$$E_t \Lambda_{t,t+1} = \frac{1}{1+i_t} \quad (\text{A.86})$$

$$\Omega_t = (1 - \sigma_B) + \sigma_B \Theta_B \phi_t \quad (\text{A.87})$$

$$\phi_t = \frac{L_t + Q_t B_{b,t}}{N_t} \quad (\text{A.88})$$

$$N_{t+1} = R_{t+1}^D N_t + (R_{t+1}^L - R_{t+1}^D) L_t + (R_{t+1}^n - R_{t+1}^D) Q_t B_{b,t} \quad (\text{A.89})$$

$$L_t = \frac{\mathbb{E}_t [\Lambda_{t,t+1} \Omega_{t+1} R_{t+1}^D] N_t - \{\Theta_B - E_t [\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^n - R_{t+1}^D)]\} Q_t B_{b,t}}{\Theta_B - \mathbb{E}_t [\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^L - R_{t+1}^D)]} \quad (\text{A.90})$$

$$Q_t B_{b,t} = \frac{\Theta_B - E_t [\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^L - R_{t+1}^D)] D_t + (\Theta_B - E_t [\Lambda_{t,t+1} \Omega_{t+1} R_{t+1}^L]) N_t}{E_t [\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^n - R_{t+1}^L)]} \quad (\text{A.91})$$

$$Q_t = \frac{E_t [\Lambda_{t,t+1} \Omega_{t+1} (1 + \omega Q_{t+1})]}{E_t [\Lambda_{t,t+1} \Omega_{t+1} R_{t+1}^D] - \mu_t \Theta_B} \quad (\text{A.92})$$

$$\mu_t = \frac{E_t [\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^L - R_{t+1}^D)]}{\Theta_B - E_t [\Lambda_{t,t+1} \Omega_{t+1} (R_{t+1}^L - R_{t+1}^D)]} \quad (\text{A.93})$$

$$\Theta_B (Q_t B_{b,t} + L_t) = E_t [\Lambda_{t,t+1} \Omega_{t+1} N_{t+1}] \quad (\text{A.94})$$

A.6 Steady State:

In steady state, first note from equation 24 that we have:

$$1 + i = \frac{\Pi}{\beta}$$

Which, from 63, means that we also have:

$$\Lambda = \frac{\beta}{\Pi}$$

The steady state of $Y, w, mc, D, R^D, R^L, R^n, \Omega$, and ϕ are as follows:

$$Y = C$$

$$w = (\theta Y^\sigma L^\eta)^{\frac{1}{1+\eta}}$$

$$mc = \left(\frac{\theta}{L}\right)^{\frac{1}{1+\eta}} Y^{\frac{1+\sigma+\eta}{1+\eta}}$$

Since we have $R^L = (mc/w)/\Pi$, combining the steady state conditions of mc and w , assuming $Y = 1$, gives us:

$$R^L = \frac{1}{L}$$

We already have R^D pinned down above, but here I assume a spread between R^L and R^D that gives us R^L , and thus, L . I also normalize $N = 1$. At this point, the following conditions enable us to solve for steady state:

$$\begin{aligned}
D &= QB_b + L - N \\
R^D &= \frac{1+i^D}{\Pi} \\
R^L &= \frac{mc/w}{\Pi} \\
R^n &= \frac{1+\omega Q}{Q} \\
\Omega &= (1-\sigma_B) + \sigma_B \Theta_B \phi \\
\phi &= \frac{L+QB_b}{N}
\end{aligned}$$

Equation 104 can be rearranged to find the steady state price of the government debt portfolio, which is:

$$Q = \frac{\Lambda\Omega}{\Lambda\Omega(R^D - \omega) - \mu\Theta_B}$$

Then we have our multiplier μ_t :

$$\mu = \frac{\Lambda\Omega(R^L - R^D)}{\Theta_B - \Lambda\Omega(R^L - R^D)}$$

And finally, from equations 100 and 106, we get:

$$\Theta_B \phi = \Lambda\Omega$$

Plugging in the definition of Ω , we get:

$$\Theta_B \phi = \Lambda((1 - \sigma_B) + \sigma_B \Theta_B \phi)$$

Which enables us, from our parameter calibrations to recover steady state leverage ϕ , which tells us steady state Ω , then μ , then R^n and so on.

A.7 Calibration

Parameter / Steady State	Value
Discount factor β	0.99
Risk aversion σ	2
Labor elasticity η	1
Calvo stickiness θ	0.5
NKPC slope λ	0.50
Maturity structure ω	0.90
Bank survival probability σ_B	0.975
Stochastic Discount Factor Λ	0.99
Fraction of assets divertable Θ_B	0.383
$\theta_{i\pi}$	0.80
θ_{ix}	0.50
Steady-state leverage ϕ	1.8596
Steady-state nominal rate $1 + i$	1.01
Steady-state inflation Π	1
Steady-state output Y	1
Steady-state shadow value of net worth Ω	0.7194

Parameter / Steady State	Value
Steady-state multiplier μ	0.0151
Steady-state bond price Q	9.82
Steady-state bond return R^n	1.0019
Steady-state loan return R^L	1.018
Steady-state deposit return R^D	1.01
Steady-state loans L	0.9823
Steady-state deposits D	0.85628
Steady-state bonds B_b	0.089
Steady-state equity N	1

A.8 Linearized Conditions

$$y_t = E_t y_{t+1} - \gamma_x (i_t - E_t \pi_{t+1}) \quad (\text{A.95})$$

$$\pi_t = \beta E_t \pi_{t+1} + \lambda m c_t \quad (\text{A.96})$$

$$i_t = \theta_{i\pi} \pi_t + \theta_{ix} y_t + u_t^i \quad (\text{A.97})$$

$$s_t = \theta_{s\pi} \pi_t + \theta_{sx} y_t + \alpha v_t^* + u_t^s \quad (\text{A.98})$$

$$\rho v_{t+1}^* = v_t^* + r_{t+1}^n - E_t \pi_{t+1}^* - s_{t+1} \quad (\text{A.99})$$

$$\rho v_{t+1} = v_t + r_{t+1}^n - \pi_{t+1} - s_{t+1} \quad (\text{A.100})$$

$$r_{t+1}^n = \omega q_{t+1} - q_t \quad (\text{A.101})$$

$$u_{t+1}^i = \rho_i u_t^i + \varepsilon_{t+1}^i, \quad (\text{A.102})$$

$$u_{t+1}^s = \rho_s u_t^s + \varepsilon_{t+1}^s \quad (\text{A.103})$$

$$w_t = \omega_x y_t + \mu_\ell \ell_t \quad (\text{A.104})$$

$$m c_t = \gamma y_t - \delta_\ell \ell_t \quad (\text{A.105})$$

$$d_t = \phi_{qb}(q_t + b_{b,t}) + \phi_l \ell_t - \phi_n n_t \quad (\text{A.106})$$

$$r_{t+1}^L = mc_t - w_t - \pi_{t+1} \quad (\text{A.107})$$

$$r_{t+1}^D = i_t - \pi_{t+1} \quad (\text{A.108})$$

$$i_t + \tilde{\lambda}_{t,t+1} = 0 \quad (\text{A.109})$$

$$\tilde{\omega}_{t,t+1} = \#\phi_t \quad (\text{A.110})$$

$$\gamma_L \ell_t + \xi_{qb}(q_t + b_{b,t}) = \tilde{\lambda}_{t,t+1} + \tilde{\omega}_{t,t+1} + n_t \quad (\text{A.111})$$

$$\tilde{\phi}_t = \gamma_l \ell_t + \xi_{qb}(q_t + b_{b,t}) - n_t \quad (\text{A.112})$$

$$n_{t+1} = \gamma_n n_t + \alpha_{r\ell} r_{t+1}^L + \alpha_\ell \ell_t + \alpha_{rn} r_{t+1}^n - \alpha_{rd} r_{t+1}^D - \alpha_{qb}(q_t + b_{b,t}) \quad (\text{A.113})$$

$$\begin{aligned} \ell_t &= \psi_{lo}(\tilde{\lambda}_{t+1} + \tilde{\omega}_{t+1}) + \sigma_n n_t + \sigma_{rn} r_{t+1}^n + \sigma_{r\ell} r_{t+1}^L - \sigma_{rd} r_{t+1}^D - \sigma_{qb}(q_t + b_{b,t}) \\ &\quad (\text{A.114}) \end{aligned}$$

$$q_t + b_{b,t} = \beta_{rn} r_{t+1}^n + \beta_{rd} r_{t+1}^D - \beta_{lo}(\tilde{\lambda}_{t+1} + \tilde{\omega}_{t+1}) - \beta_{r\ell} r_{t+1}^L - \beta_d d_t - \beta_n n_t \quad (\text{A.115})$$

$$q_t = \delta_q q_{t+1} + \delta_\mu \tilde{\mu}_t - \delta_{lo}(\tilde{\lambda}_{t+1} + \tilde{\omega}_{t+1}) - \delta_{rd} r_{t+1}^D \quad (\text{A.116})$$

$$\tilde{\mu}_t = \kappa_{lo}(\tilde{\lambda}_{t+1} + \tilde{\omega}_{t+1}) + \kappa_{r\ell} r_{t+1}^L - \kappa_{rd} r_{t+1}^D \quad (\text{A.117})$$

$$\begin{aligned} \ell_t &= \psi_{lo}\{(-\theta_{i\pi} \pi_t - \theta_{ix} y_t - u_t^i + \pi_{t+1}) + \#[\gamma_\ell \ell_t + \xi_{qb}(q_t + b_{b,t}) - n_t]\} + \\ &\quad \sigma_n \{\gamma_n n_{t-1} + \alpha_{r\ell}(y_{t-1} - \ell_{t-1} - \pi_t) + \alpha_\ell \ell_{t-1} + \alpha_{rn}(\omega q_t - q_{t-1}) - \\ &\quad \alpha_{rd}[\theta_{i\pi} \pi_{t-1} + \theta_{ix} y_{t-1} + u_{t-1}^i - \pi_t] - \alpha_{qb}(q_{t-1} + b_{b,t-1})\} + \\ &\quad \sigma_{rn}(\omega q_{t+1} - q_t) - \sigma_{qb}(q_t + b_{b,t}) + \sigma_{r\ell}(y_t - \ell_t - \pi_{t+1}) - \\ &\quad \sigma_{rd}(\theta_{i\pi} \pi_t + \theta_{ix} y_t + u_t^i - \pi_{t+1}) \end{aligned}$$

$$\begin{aligned}
(1 - \psi_{lo} \# \gamma_L + \sigma_{r\ell}) \ell_t &= \left[\sigma_n (\alpha_{rd} - \alpha_{r\ell}) - \psi_{lo} \theta_{i\pi} - \sigma_{rd} \theta_{i\pi} \right] \pi_t \\
&\quad + (\psi_{lo} - \sigma_{r\ell} + \sigma_{rd}) \pi_{t+1} - \sigma_n \alpha_{rd} \theta_{i\pi} \pi_{t-1} \\
&\quad + (\sigma_{r\ell} - \psi_{lo} \theta_{ix} - \sigma_{rd} \theta_{ix}) y_t + \sigma_n (\alpha_{r\ell} - \alpha_{rd} \theta_{ix}) y_{t-1} \\
&\quad + (\psi_{lo} \# \xi_{qb} + \sigma_n \alpha_{rn} \omega - \sigma_{rn} - \sigma_{qb}) q_t + \sigma_{rn} \omega q_{t+1} \\
&\quad - \sigma_n (\alpha_{rn} + \alpha_{qb}) q_{t-1} \\
&\quad + (\psi_{lo} \# \xi_{qb} - \sigma_{qb}) bb_t - \sigma_n \alpha_{qb} bb_{t-1} \\
&\quad - \psi_{lo} \# n_t + \sigma_n \gamma_n n_{t-1} \\
&\quad + \sigma_n (\alpha_\ell - \alpha_{r\ell}) \ell_{t-1} \\
&\quad - (\psi_{lo} + \sigma_{rd}) u_{i,t} - \sigma_n \alpha_{rd} u_{i,t-1}.
\end{aligned}$$

$$\begin{aligned}
\Gamma_\ell \ell_t &= \Gamma_\pi \pi_{t+1} - \Phi_\pi \pi_t - A_\pi \pi_{t-1} - \Gamma_y y_t + \Phi_y y_{t-1} + \Gamma_q q_{t+1} + \Phi_q q_t - A_q q_{t-1} + \Gamma_b b_{b,t} - \Phi_b b_{b,t-1} - \\
&\quad \Gamma_n n_t + \Phi_n n_{t-1} - \Phi_\ell \ell_{t-1} + \Gamma_u u_t^i - \Phi_u u_{t-1}^i
\end{aligned} \tag{A.118}$$

$$\begin{aligned}
\delta_q q_{t+1} &= \left[1 + (\delta_{lo} - \delta_\mu \kappa_{lo}) \xi_{qb} \right] q_t + \left[(\delta_{lo} - \delta_\mu \kappa_{lo}) \gamma_L + \delta_\mu \kappa_{r\ell} \right] \ell_t \\
&\quad + (\delta_{lo} - \delta_\mu \kappa_{lo}) \xi_{qb} bb_t - (\delta_{lo} - \delta_\mu \kappa_{lo}) n_t + \left[- \delta_\mu \kappa_{r\ell} + (\delta_\mu \kappa_{rd} + \delta_{rd}) \theta_{ix} \right] y_t \\
&\quad + (\delta_\mu \kappa_{rd} + \delta_{rd}) \theta_{i\pi} \pi_t + \left[\delta_\mu \kappa_{r\ell} - (\delta_\mu \kappa_{rd} + \delta_{rd}) \right] \pi_{t+1} + (\delta_\mu \kappa_{rd} + \delta_{rd}) u_t^i.
\end{aligned}$$

Parameters consolidated and computed gives:

$$q_{t+1} = \Psi_q q_t + \Psi_\ell \ell_t - \Psi_b b_{b,t} + \Psi_n n_t - \Psi_y y_t + \Lambda_\pi \pi_t - \Psi_\pi \pi_{t+1} + \Psi_u u_t^i. \quad (\text{A.119})$$

Rearranging the NKPC, we have:

$$\pi_{t+1} = \frac{1}{\beta} \pi_t - \frac{\lambda}{\beta} (\gamma y_t - \delta_l \ell_t) \quad (\text{A.120})$$

Forwarding equation 130 by one period:

$$\begin{aligned} \Gamma_\ell \ell_{t+1} &= \Gamma_\pi \pi_{t+2} - \Phi_\pi \pi_{t+1} - A_\pi \pi_t - \Gamma_y y_{t+1} + \Phi_y y_t + \Gamma_q q_{t+2} + \Phi_q q_{t+1} - A_q q_t + \\ &\quad \Gamma_b b_{b,t+1} - \Phi_b b_{b,t} - \Gamma_n n_{t+1} + \Phi_n n_t - \Phi_\ell \ell_t + \Gamma_u u_{t+1}^i - \Phi_u u_t^i \end{aligned} \quad (130')$$

Plugging 131 and 132 into 130', we get:

$$\begin{aligned} -\Omega_\ell \ell_{t+1} &= \Pi_\pi \pi_{t+1} - \Upsilon_y y_{t+1} + \Theta_q q_{t+1} + B_b b_{b,t+1} - N_n n_{t+1} + \Psi_\mu u_{t+1}^i \\ &\quad - \Phi_\pi \pi_t + \Gamma_y y_t - R_q q_t - X_b b_{b,t} + P_n n_t - \Lambda_\ell \ell_t - \S_u u_t^i. \end{aligned} \quad (\text{A.121})$$

Eliminating redundant equations in 127:

$$\begin{aligned} \beta_{lo} \# \xi_{qb} b_{b,t+1} &= (\beta_{rn} \omega - \beta_{lo} \# \xi_{qb}) q_{t+1} - (1 + \beta_{rn} + \beta_d \phi_{qb}) q_t - (1 + \beta_d \phi_{qb}) b_{b,t} \\ &\quad - \beta_{lo} \# \gamma_\ell \ell_{t+1} + (\beta_{r\ell} - \beta_d \phi_\ell) \ell_t + (\beta_{rd} \theta_{ix} + \beta_{lo} \theta_{ix} - \beta_{r\ell}) y_t \\ &\quad + \beta_{lo} \# n_{t+1} + (\beta_d \phi_n - \beta_n) n_t + (\beta_{rd} \theta_{i\pi} + \beta_{lo} \theta_{i\pi}) \pi_t + (\beta_{r\ell} - \beta_{rd}) \pi_{t+1} \\ &\quad + (\beta_{rd} + \beta_{lo}) u_t^i. \end{aligned}$$

Then we have:

$$\begin{aligned}\Upsilon_b b_{b,t+1} &= \Gamma_{qf} q_{t+1} - \Gamma_{qp} q_t - \Upsilon_{bp} b_{b,t} - \Psi_{ellf} \ell_{t+1} + \Psi_{ellp} \ell_t \\ &\quad - \Lambda_y y_t + \Xi_{nf} n_{t+1} - \Xi_{np} n_t + \Theta_\pi \pi_t + \Theta_{\pi f} \pi_{t+1} + \Omega_u u_t^i + \delta_{b,t+1}.\end{aligned}$$

Eliminating redundant equations in 125:

$$\begin{aligned}n_{t+1} &= \gamma_n n_t + (\alpha_{r\ell} - \alpha_{rd} \theta_{ix}) y_t + (\alpha_\ell - \alpha_{r\ell}) \ell_t - \alpha_{rd} \theta_{i\pi} \pi_t + (\alpha_{rd} - \alpha_{r\ell}) \pi_{t+1} \\ &\quad + \alpha_{rn} \omega q_{t+1} - (\alpha_{rn} + \alpha_{qb}) q_t - \alpha_{qb} b_{b,t} - \alpha_{rd} u_t^i.\end{aligned}$$

Then we have:

$$\begin{aligned}n_{t+1} &= \Upsilon_n n_t + P_y y_t - \Upsilon_\ell \ell_t - \Xi_\pi \pi_t - P_{\pi f} \pi_{t+1} \\ &\quad + \Omega_{qf} q_{t+1} - \Omega_{qp} q_t - \Xi_b b_{b,t} - \Lambda_u u_t^i.\end{aligned}$$

A.9 MODEL

$$q_{t+1} + \Psi_\pi \pi_{t+1} = \Psi_q q_t + \Psi_\ell \ell_t - \Psi_b b_{b,t} + \Psi_n n_t - \Psi_y y_t + \Lambda_\pi \pi_t + \Psi_u u_t^i + \delta_{rn,t+1}$$

$$-\Omega_\ell \ell_{t+1} - \Pi_\pi \pi_{t+1} + \Upsilon_y y_{t+1} - \Theta_q q_{t+1} - B_b b_{b,t+1} + N_n n_{t+1} - \Psi_\mu u_{t+1}^i = -\Phi_\pi \pi_t + \Gamma_y y_t - R_q q_t - X_b b_{b,t} + P_n n_t - \Lambda_\ell \ell_t - \S_u u_t^i$$

$$\boxed{\Upsilon_b b_{b,t+1} + \Psi_{ellf} \ell_{t+1} - \Gamma_{qf} q_{t+1} - \Xi_{nf} n_{t+1} - \Theta_{\pi f} \pi_{t+1} = -\Gamma_{qp} q_t - \Upsilon_{bp} b_{b,t} + \Psi_{ellp} \ell_t - \Lambda_y y_t - \Xi_{np} n_t + \Theta_\pi \pi_t + \Omega_u u_t^i + \delta_{b,t+1}}$$

$$\boxed{n_{t+1} + P_{\pi f} \pi_{t+1} - \Omega_{qf} q_{t+1} = \Upsilon_n n_t + P_y y_t - \Upsilon_\ell \ell_t - \Xi_\pi \pi_t - \Omega_{qp} q_t - \Xi_b b_{b,t} - \Lambda_u u_t^i}$$

$$\boxed{y_{t+1} = \left(1 + \sigma \theta_{ix} + \frac{\sigma \lambda}{\beta}\right) y_t + \sigma \left(\theta_{i\pi} - \frac{1}{\beta}\right) \pi_t + \sigma u_{i,t} + \delta_{x,t+1}.}$$

$$\boxed{\pi_{t+1} = \frac{1}{\beta} \pi_t - \frac{\lambda \gamma}{\beta} y_t + \frac{\lambda \delta}{\beta} \ell_t - \beta_i \varepsilon_{i,t+1} - \beta_s \varepsilon_{s,t+1}}$$

$$u_{i,t+1} = \rho_i u_{i,t} + \varepsilon_{i,t+1}.$$

$$u_{s,t+1} = \rho_s u_{s,t} + \varepsilon_{s,t+1}.$$

$$\mathbf{z}_t \equiv \begin{bmatrix} y_t \\ \pi_t \\ q_t \\ u_t^i \\ u_t^s \\ \ell_t \\ b_{b,t} \\ n_t \end{bmatrix}, \quad \boldsymbol{\varepsilon}_{t+1} \equiv \begin{bmatrix} \varepsilon_{i,t+1} \\ \varepsilon_{s,t+1} \end{bmatrix}, \quad \boldsymbol{\eta}_{t+1} \equiv \begin{bmatrix} \delta_{x,t+1} \\ \delta_{rn,t+1} \\ \delta_{b,t+1} \end{bmatrix}.$$

The model is written as

$$\underbrace{\mathbf{A}}_{8 \times 8} \mathbf{z}_{t+1} = \underbrace{\mathbf{B}}_{8 \times 8} \mathbf{z}_t + \underbrace{\mathbf{C}}_{8 \times 2} \boldsymbol{\varepsilon}_{t+1} + \underbrace{\mathbf{D}}_{8 \times 3} \boldsymbol{\eta}_{t+1}.$$

Matrices. With the following ordering $[x, \pi, q, u^i, u^s, \ell, b_b, n]$,

$$\mathbf{A} = \begin{pmatrix} 1 & 0 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & 1 & 0 & 0 & 0 & 0 & 0 & 0 \\ 0 & \Psi_\pi & 1 & 0 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 1 & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & 1 & 0 & 0 & 0 \\ \Upsilon_y & -\Pi_\pi & -\Theta_q & -\Psi_\mu & 0 & -\Omega_\ell & -B_b & N_n \\ 0 & -\Theta_{\pi f} & -\Gamma_{qf} & 0 & 0 & \Psi_{\text{ellf}} & \Upsilon_b & -\Xi_{\text{nf}} \\ 0 & P_{\pi f} & -\Omega_{qf} & 0 & 0 & 0 & 0 & 1 \end{pmatrix}.$$

$$\mathbf{B} = \begin{pmatrix} 1 + \sigma t_{ix} + \frac{\sigma\lambda}{\beta} & \sigma t_{i\pi} - \frac{\sigma}{\beta} & 0 & \sigma & 0 & 0 & 0 & 0 \\ -\frac{\lambda\gamma}{\beta} & \frac{1}{\beta} & 0 & 0 & 0 & \frac{\lambda\delta_\ell}{\beta} & 0 & 0 \\ -\Psi_y & \Lambda_\pi & \Psi_q & \Psi_u & 0 & \Psi_\ell & -\Psi_b & \Psi_n \\ 0 & 0 & 0 & \rho_i & 0 & 0 & 0 & 0 \\ 0 & 0 & 0 & 0 & \rho_s & 0 & 0 & 0 \\ \Gamma_y & -\Phi_\pi & -R_q & -\S_u & 0 & -\Lambda_\ell & -X_b & P_n \\ -\Lambda_y & \Theta_\pi & -\Gamma_{qp} & \Omega_u & 0 & \Psi_{ellp} & -\Upsilon_{bp} & -\Xi_{np} \\ P_y & -\Xi_\pi & -\Omega_{qp} & -\Lambda_u & 0 & -\Upsilon_\ell & -\Xi_b & \Upsilon_n \end{pmatrix}.$$

$$\mathbf{C} = \begin{pmatrix} 0 & 0 \\ -\beta_i & -\beta_s \\ 0 & 0 \\ 1 & 0 \\ 0 & 1 \\ 0 & 0 \\ 0 & 0 \\ 0 & 0 \end{pmatrix}, \quad \mathbf{D} = \begin{pmatrix} 1 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 1 & 0 \\ 0 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 0 & 0 \\ 0 & 0 & 1 \\ 0 & 0 & 0 \end{pmatrix}.$$

Solution Define

$$\mathbf{F} \equiv \mathbf{A}^{-1}\mathbf{B}, \quad \mathbf{F} = \mathbf{Q}\boldsymbol{\Lambda}\mathbf{Q}^{-1} \text{ (eigenvalue decomposition).}$$

Let the index set of unstable roots be $\mathcal{F} \equiv \{j : |\lambda_j| \geq 1\}$, and stable roots $\mathcal{B} \equiv \{j : |\lambda_j| < 1\}$.

Form the selector matrices

$$\mathbf{E}_f \in \mathbb{R}^{|\mathcal{F}| \times 8}, \quad (\mathbf{E}_f)_{k, j_k} = 1 \text{ for } j_k \in \mathcal{F}; \quad \mathbf{E}_b \in \mathbb{R}^{|\mathcal{B}| \times 8}, \quad (\mathbf{E}_b)_{k, j_k} = 1 \text{ for } j_k \in \mathcal{B}.$$

The mapping from shocks to the stable eigenspace is

$$\zeta = \mathbf{E}_b \mathbf{Q}^{-1} \mathbf{A}^{-1} \left(\mathbf{C} - \mathbf{D} [\mathbf{E}_f \mathbf{Q}^{-1} \mathbf{A}^{-1} \mathbf{D}]^{-1} \mathbf{E}_f \mathbf{Q}^{-1} \mathbf{A}^{-1} \mathbf{C} \right).$$

A.10 Additional figures

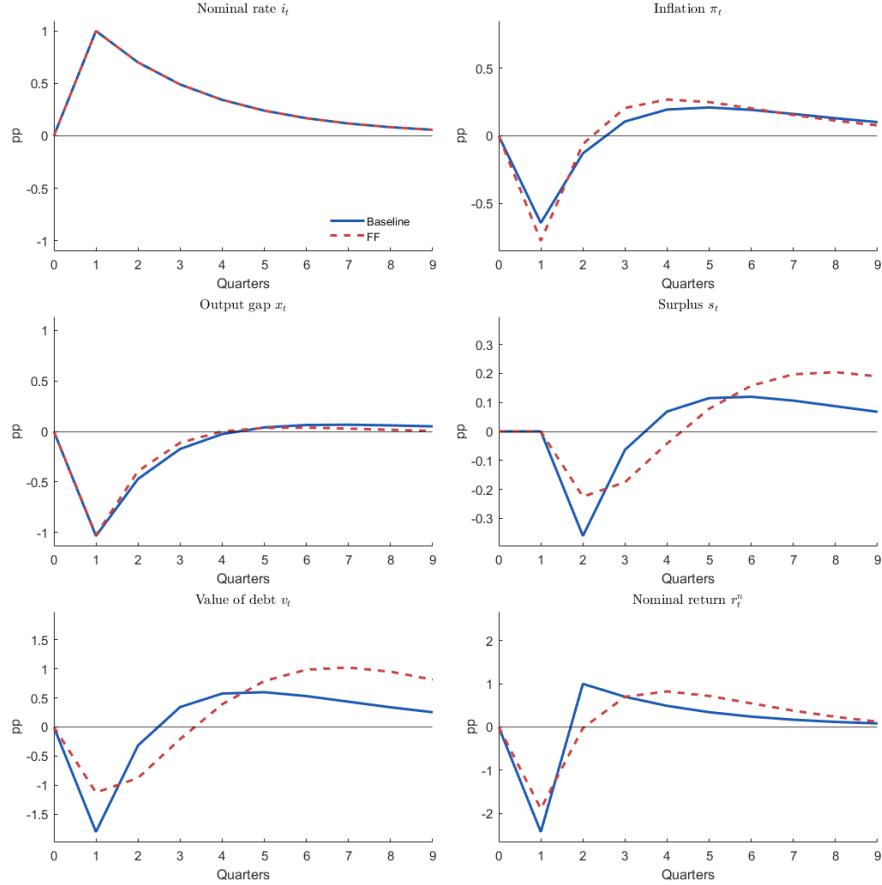


Figure 7: MP Shock - No Rules

Figure 7 shows the responses of the variables to a monetary policy shock with policy rules shut off, meaning $\vec{\theta} = \mathbf{0}$. Note that this includes the policy responses in the Taylor rule as well as the surplus equation. Therefore, surpluses purely respond to changes in debt (partially). The intuition for the dynamics of the variables in this model resembles that of Figure 4 in section 4.

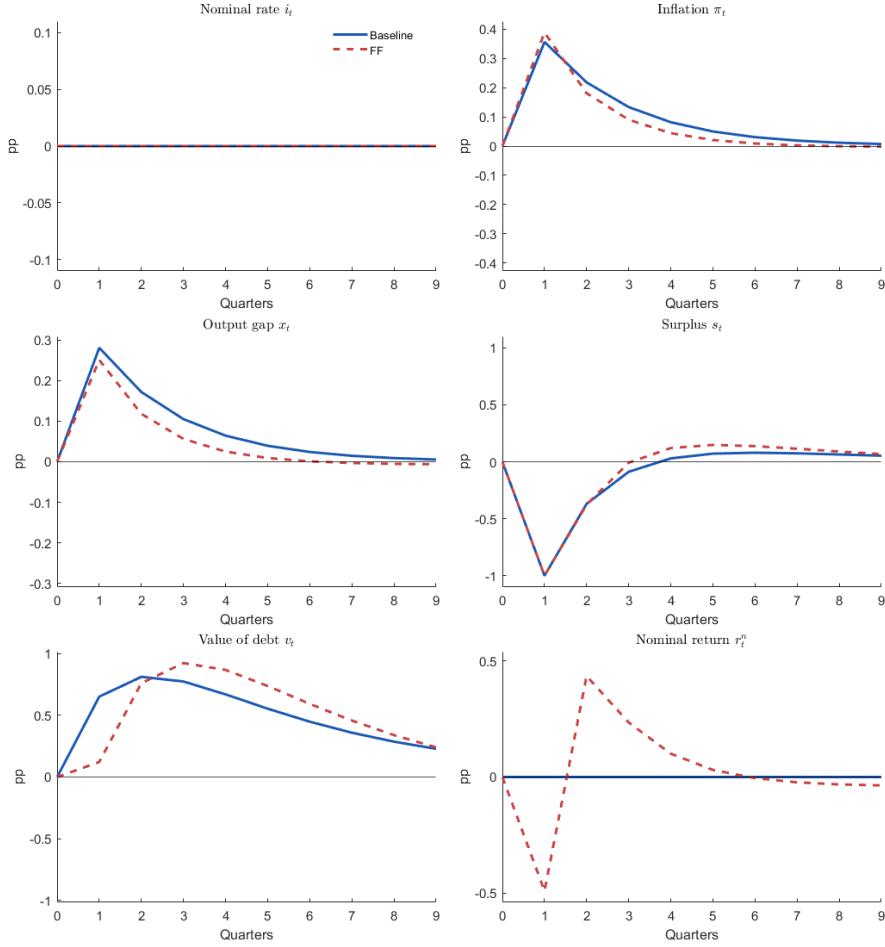


Figure 8: FP Shock - No Rules

[Figure 8](#) is the response of the core variables to a fiscal shock (negative shock to surpluses) where policy rules are shut off. The fundamental intuition of the difference in dynamics is similar to what we encounter in [Figure 5](#) in section 4. However, there are a few important differences. For one, the response of debt is pushed forward relative to the baseline model. This is entirely driven by the fall in r^n at early horizons - whereas in the baseline, r^n doesn't respond to the surplus shock. This is owing to the fact that, in the baseline, discount rates are largely driven by the policy rate. Under FF, the policy rate is an element, but financial frictions are also relevant.

This plot makes it plain that bank leverage and net worth are relevant to discount rate determination, since the policy rate doesn't even move. Going from the baseline to FF, the

financial frictions are entirely responsible for the determination of the discount rate in this scenario.

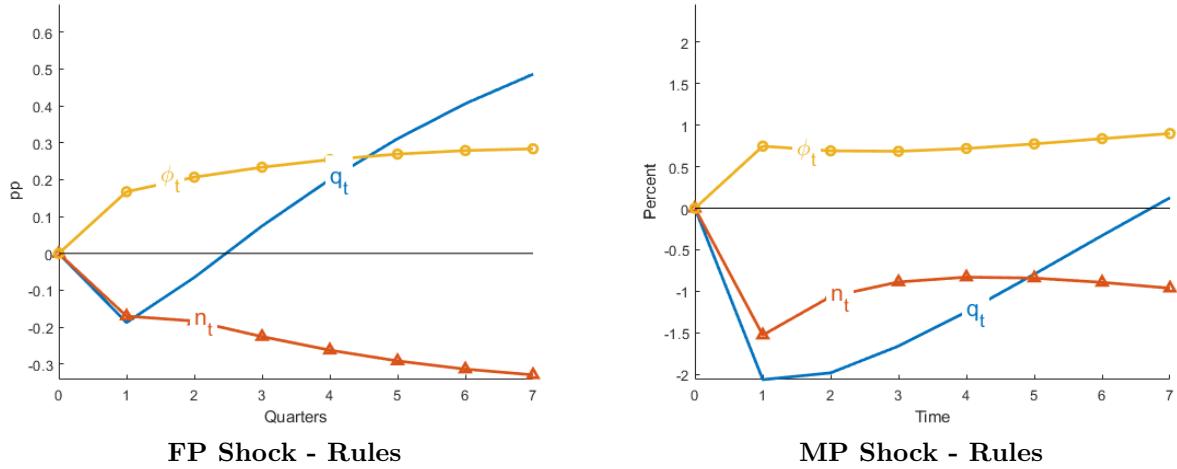


Figure 9: Response of Financial Variables to Shocks with Rules

Figure 9 plots the responses of key financial variables to the shocks discussed in section four (shocks with policy rules turned on). The left panel shows the responses of bond prices q_t , bank leverage ϕ_t , and bank net worth n_t to a fiscal policy shock (negative surplus shock). The right panel shows the same variables as they respond to a contractionary monetary policy shock.