The Fiscal Theory of the Price Level - A Short Introduction

Livio Maya

Precursors and Intellectual Landscape

Notes based on Cochrane (2022b): you should read yourself!

- Old-Keynesian Models (adaptive expectations, little economics)
  - Interest peg is unstable
  - Taylor rule $i_t = \phi \pi_t$ with $\phi > 1$ recovers stability by "adjusting aggregate demand"
- New-Keynesian Models (rational expectations, micro-founded)
  - Interest peg stable but indeterminate
  - Rule $i_t = i_t^* + \phi(\pi_t - \pi_t^*)$ with $\phi > 1$ threats spiral, selects π_t^*
- Theoretical issues: How to rule out spirals? Where does $\Delta E_t \pi_t^*$ come from? Forward guidance puzzle?
- Empirical issues: Why rule out spirals? Do CBs threat spirals? Zero Lower Bound?

FTPL in a One-Period Model

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- Household budget contraint: $B_0 + P_1 y_1 = P_1 c_1 + P_1 s_1 + M_1$
- Equilibrium conditions $y_1 = c_1$ and $M_1 = 0$ imply:

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  - "Too much money chasing too few goods" ✓
  - "Strong aggregate demand" ✓

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  - "Too much money chasing too few goods" ✓
  - "Strong aggregate demand" ✓
- *"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"* - Wealth of Nation, Adam Smith

FTPL in a Two-Period Model

Now, let's consider decisions in period zero.

- Households inherit B_{-1} bonds, government charges s_0 in taxes and sells B_0 new bonds at discount Q_0
- Given equilibrium conditions $y_0 = c_0$ and $M_0 = 0$:

$$B_{-1} = P_0 s_0 + Q_0 B_0 \implies \frac{B_{-1}}{P_0} = s_0 + \frac{Q_0 B_0}{P_0}$$

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- Fisher equation $Q_0 = \frac{1}{1+i_0} = \frac{1}{R} E_0 \left(\frac{P_0}{P_1} \right)$ and $\beta R = 1$:

$$\text{Real Bond Sales Revenue} = \frac{Q_0 B_0}{P_0} = \beta E_0 \left[\frac{B_0}{P_1} \right] = \beta E_0 \left[s_1 \right]$$

- The valuation equation becomes

$$\frac{B_{-1}}{P_0} = s_0 + \beta E_0 \left[s_1 \right]$$

and the price level P_0 is again determined.

FTPL in a Two-Period Model: Fiscal and Monetary Policy

Monetary Policy sets Q_0 by changing B_0

Fiscal Policy sets s_0 and s_1

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- What if $B_0 \uparrow$?
  - Real bond sales revenue unchanged at $\beta E_0[s_1] \implies P_0$ constant
  - Since $Q_0 B_0$ is constant, $Q_0 \downarrow$ (the government raises nominal interest)
  - By the Fisher equation, monetary policy controls **expected** inflation

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  - Therefore $P_0 \uparrow$ (**unexpected** inflation)
- What if $s_1 \downarrow$?
  - In $t = 1$: Lower surpluses soak up less $B_0 \implies P_1 \uparrow$ (**unexpected** inflation)
  - In $t = 0$: Real bond sales revenue $\beta E_0[s_1]$ declines $\implies P_0 \uparrow$ (**unexpected** inflation)
  - If monetary policy fixes Q_0: expected inflation $E_0(P_0/P_1)$ constant

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FTPL: Infinite Periods

- Let $\beta_t = Q_t P_{t+1} / P_t$ be the *ex-post* real discount for public bonds, and $\beta_{t,t+k} \equiv \prod_{\tau=t}^{t+k} \beta_\tau$
- As long as $\lim_{k \to \infty} \beta_{t,t+k} \frac{B_{t+k}}{P_{t+k+1}} = 0$ at every t (No-Ponzi, optimality)

$$\frac{B_{t-1}}{P_t} = \sum_{k=0}^{\infty} E_t \left[\beta_{t,t+k-1} \, s_{t+k} \right]$$

- This is a valuation equation, not a budget constraint. It holds in all micro-founded models!
  - **Standard NK**: causality from left to right, $PDV(\{s, \beta\})$ adjusts to P_t
  - **FTPL**: causality from right to left, P_t adjusts to $PDV(\{s, \beta\})$
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- Which theory asks more from the government? What about Japan? Reading of 2021/22 inflation?
- Let v_t be *end-of-period* real debt. Linearize law of motion of public debt (around $v = 1$):

$$v_t + s_t = \underbrace{\frac{1}{\beta}\left(v_{t-1} + i_{t-1} - \pi_t\right)}_{\text{Beginning-of-period } V_{t-1}/P_t}$$

Frictionless Model

- Flexible prices, constant output, interest peg i^*
- From valuation equation:

$$\frac{B_{t-1}}{P_{t-1}} \Delta E_t \left[\Pi^{-1}\right] = \Delta E_t \left[\sum_{k=0}^{\infty} \beta_{t,t+k-1} s_{t+k}\right]$$

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$$E_t \pi_{t+1} = i_t^*$$
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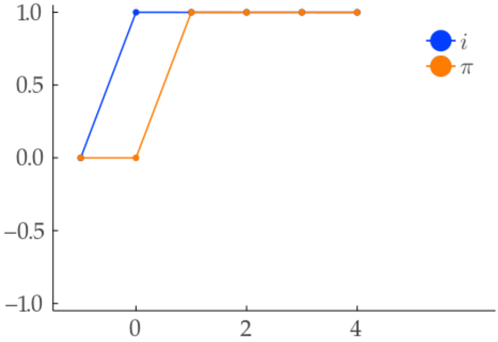

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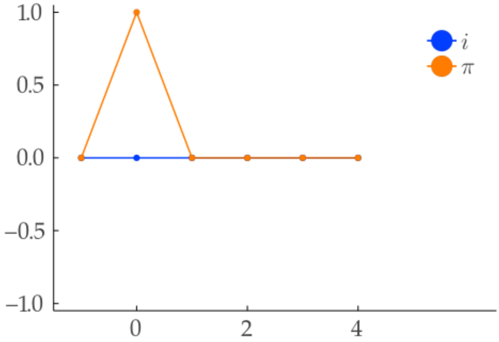

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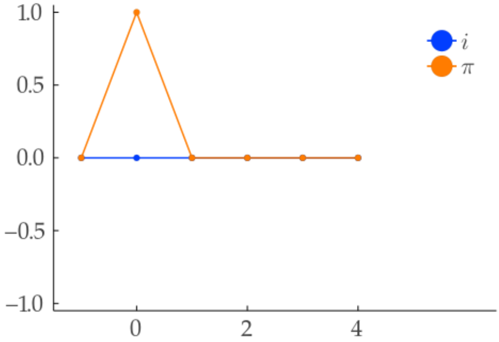
- Spiral threat model:

$$i_t = i_t^* + \phi(\pi_t - \pi_t^*) \qquad \phi > 1$$
$$\pi_t^* = i_{t-1}^* + \Delta E_t \pi_t^*$$

generates same equilibrium



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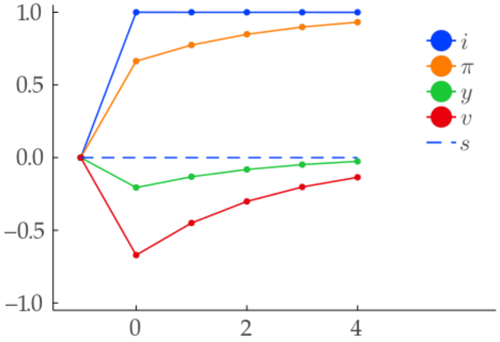

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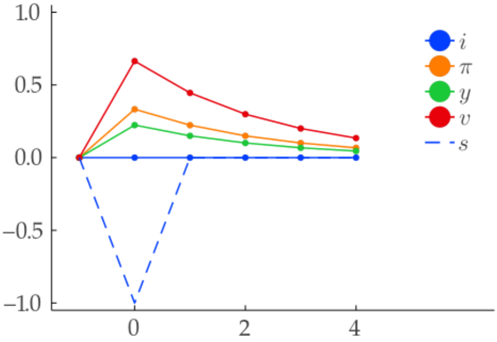

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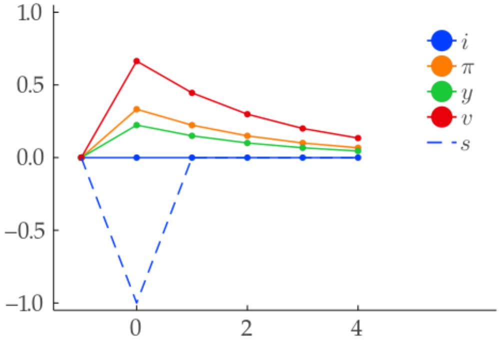
- Spiral threat:

$$i_t = i_t^* + \phi(\pi_t - \pi_t^*) \qquad \phi > 1$$
$$s_t = \alpha v_t - \varepsilon_{s,t}$$

- Empirically, $\alpha > 0$. Is that a problem for the FTPL? Cochrane (2022a)



Long-Term Debt

- In practice, governments finance themselves through long-term debt
- This is important because, with long-term bonds, higher interest rate can reduce the market value of debt
- Multiple maturities $n = 1, 2, 3, \dots$ (until now, we only had $n = 1$)

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\implies R^N_t V_{t-1} &= P_t s_t + V_t
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where $R^N_t = \sum Q^{n-1}_t B^n_{t-1} / \sum Q^n_{t-1} B^n_{t-1}$ is the *ex-post* nominal return on the public debt portfolio.

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- $v_t = V_t / P_t =$ real end-of-period market value of public debt

$$\frac{R_t^N}{\Pi_t} v_{t-1} = s_t + v_t \quad \implies \quad \frac{R_t^N}{\Pi_t} v_{t-1} = \sum_{k=0}^{\infty} E_t\left[\beta_{t,t+k-1}\, s_{t+k}\right]$$

Now: market value of debt = discounted surpluses

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- Let $Q_t = \sum_{n=1}^{\infty} \omega^{n-1} Q_t^n$. Therefore: $V_t = Q_t B_t^1$.

$$R_t^N = \frac{\sum_{n=1}^{\infty} Q_t^{n-1} B_{t-1}^n}{V_{t-1}} = \frac{B_{t-1}^1 + \sum_{n=2}^{\infty} Q_t^{n-1} B_{t-1}^n}{Q_{t-1} B_{t-1}^1} = \frac{1 + \omega \sum_{n=1}^{\infty} \omega^{n-1} Q_t^n}{Q_{t-1}} = \frac{1 + \omega Q_t}{Q_{t-1}}$$

- Linearizing:

$$r_t^N = \omega q_t - q_{t-1} \tag{6}$$

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- Next, we need a pricing model. I assume a constant risk premium $E_t r_{t+1}^N = i_t$ (embeds expectations hypothesis)

$$q_t = \omega E_t q_{t+1} - i_t = -\sum_{k=0}^{\infty} E_t i_{t+k} \tag{7}$$

- Monetary tightening: $i \uparrow \implies q \downarrow \implies r^N \downarrow \implies$ Market Value of Debt $\downarrow$
  - We can get deflation even if discounted surpluses decline!

Basic NK Model with Long-Term Debt

- Private sector, debt and bonds:

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y_t &= E_t y_{t+1} - \gamma \left(i_t - E_t \pi_{t+1} \right) \\
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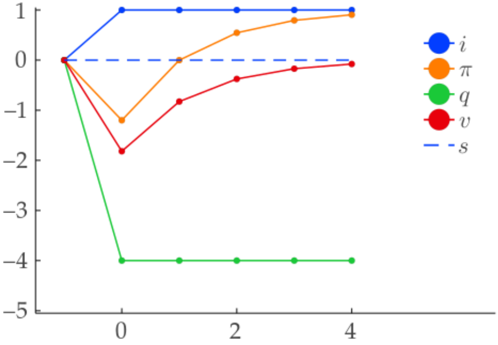
- Success! $i \uparrow$ reduces inflation (in the short-run)



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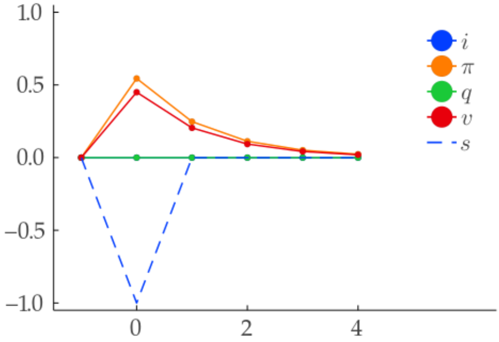
r_t^N &= \omega q_t - q_{t-1} \\
q_t &= \omega E_t q_{t+1} - i_t
\end{aligned}
$$

- Fiscal theory:

$$
\begin{aligned}
i_t &= i_t^* \\
s_t &= -\varepsilon_{s,t}
\end{aligned}
$$

- Success! $i \uparrow$ reduces inflation (in the short-run)



Basic NK Model with Long-Term Debt

- Private sector, debt and bonds:

$$
\begin{aligned}
y_t &= E_t y_{t+1} - \gamma\left(i_t - E_t \pi_{t+1}\right) \\
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v_t + s_t &= \beta^{-1}(v_{t-1} + r_t^N - \pi_t) \\
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i_t &= i_t^* \\
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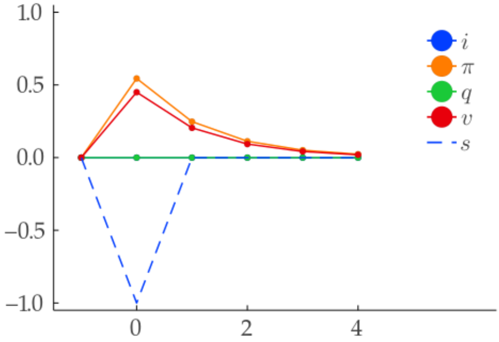
- Success! $i \uparrow$ reduces inflation (in the short-run)
- Spiral threat:

$$
\begin{aligned}
i_t &= i_t^* + \phi(\pi_t - \pi_t^*) \qquad \phi > 1 \\
s_t &= \alpha v_t - \varepsilon_{s,t}
\end{aligned}
$$



Fiscal Policy: Inflation and the Surplus Process

- Fiscal deficits left and right: where is inflation? Surpluses can have an S-shape!

$$s_t = \sum_{i=0}^{\infty} a_i \varepsilon_{t-i} = a(L)\varepsilon_t$$

with $a_0 = 1$ so that $\Delta E_t s_t = \varepsilon_t$

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- If $a(\beta) = 0$, then deficit $\Delta E_t s_t = \varepsilon_t < 0$ leads to no unexpected inflation.
- But $a(\beta) = 0$ and $a_0 = 1$ means that some higher terms of a need to be negative: surpluses follow deficits.

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- But $a(\beta) = 0$ and $a_0 = 1$ means that some higher terms of a need to be negative: surpluses follow deficits.
- Be careful with $s \sim$ AR(1)! In that case, deficits follow deficits: $a(\beta) = (1 - \beta\rho)^{-1} > 1$
  - In the AR(1) case, the government does *not* raise revenue by selling bonds to finance deficits...
  - ... and a deficit *reduces* the market value of debt (why?)

Concluding Remarks

- The FTPL:
  - determines the price level through the volume of surpluses backing nominal debt
  - determines unexpected inflation in rational expectations models (or provides the additional unstable root)
- Observational Equivalency: in equilibrium, FTPL = Spiral Threat; "regime" identification requires strong assumptions
- Why is the FTPL appealing?
  - Fully neoclassical. Money not necessary or "special". It works in the absence of frictions and under interest pegs.
  - FTPL brings fiscal policy back to the center stage
  - FTPL offers an opportunity cost for unexpected inflation (*"stable inflation or emergency COVID transfers?"*)
  - Compatible with policy experience. Central banks do not threat spirals. Fiscal policy does not (and cannot) accomodate arbitrary changes in the price level (*"spending cut promises in deflationary recessions?"*)
  - Story telling meets theory
  - No ZLB inconsistency: contrained zero interest is stable and determinate. Not vulnerable to Forward Guidance Puzzle

References

Cochrane, J. H. (2022a). A fiscal theory of monetary policy with partially-repaid long-term debt. *Review of Economic Dynamics*, 45:1–21.

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