

The Fiscal Theory of the Price Level in a World of Low Interest Rates

Marco Bassetto

Federal Reserve Bank of Chicago, University College London, and IFS

Wei Cui

University College London and Centre for Macroeconomics

January 2018

Summary

Models of monetary economies are plagued by the presence of multiple equilibria, which weakens the ability to make tight predictions. An alternative approach to price-level determinacy follows “active fiscal policies,” in which the requirement that government debt follows a stable trajectory is used to select an equilibrium. This is known as the “fiscal theory of the price level” (FTPL). A central equation for FTPL is the government budget constraint (or “government valuation equation”), which equates the real value of government debt to the present value of fiscal surpluses. Government debt is a promise to deliver “dollars” (either purely a unit of account, or the underlying currency which by assumption can be freely printed by the government), and the value of a dollar adjusts in equilibrium so that the present value of surpluses and the real value of debt match.

In the past decade, the governments of most developed economies have paid very low interest rates, and there are many other periods in the past in which this has been the case. In this paper, we revisit the implications of the FTPL in a world where the rate of return on

government debt may be below the growth rate of the economy, considering different sources for the low returns: dynamic inefficiency, the liquidity premium of government debt, or its favorable risk profile.

We show that when the rate of return on government debt is below the growth rate, the government runs deficit most of the time. There is an issue of computing the present value of fiscal surpluses when the interest rate is low. We also learned three lessons.

Dynamic inefficiency and liquidity premium can pose a challenge for the theory of FTPL. The ability of the FTPL to select a unique equilibrium when interest rates are low is not robust across specifications; appealing to fiscal policy to achieve a price level target is thus fraught with even greater difficulties than those that arise in economies where returns are such that computing present values is always possible.

It is difficult to blame an excessively conservative fiscal policy for the recent experience of low inflation, because, over extended periods of time, low interest rates and stable (or increasing) government debt levels coexist only when fiscal policy entails primary deficits on average. Moreover, the presence of multiple equilibria makes it problematic to use comparative statics to study the effects of fiscal expansions.

While unsuccessful at uniquely pinning down the price level, the FTPL still provides a lower bound on prices across all the environments that we consider here, which implies that it is not completely devoid of content.