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Stepping on a Rake: the Fiscal Theory of Monetary Policy

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Abstract

The fiscal theory of the price level can describe monetary policy. Governments can set interest rate targets and thereby affect inflation, with no change in fiscal surpluses. The same basic mechanism describes interest rate targets, forward guidance, open market operations, and quantitative easing. It does not require any monetary, pricing, or other frictions. In the presence of long-term debt, higher interest rates lead to temporarily lower inflation, a challenging sign. I derive and replicate the results of the Sims [17] "stepping on a rake" model, which first produced this negative sign, and produces realistic impulse-response functions. I show that Sims' result is robust to many model features, but essentially requires long-term debt.

Keywords: Monetary, Fiscal, Inflation

1. Introduction

The fiscal theory of the price level does not just describe inflation and deflation driven by fiscal events. The fiscal theory of the price level also offers a cogent and unified description of *monetary* policy: how governments can set interest rate targets; and how governments can affect inflation and the real economy, by interest rate targets, by forward guidance about interest rate targets, and by varying the quantity and maturity structure of government debt

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