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The fiscal theory of the price level in an open economy[☆]

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Abstract

Recent work (Loyo, E., Going international with the fiscal theory of the price level. Manuscript, John F. Kennedy School of Government, Harvard University, 1998; Dupor, B., Exchange rates and the fiscal theory of the price level. *Journal of Monetary Economics* 45, 613–630) has shown that extension of the fiscal theory of the price level to an open economy yields indeterminate prices and exchange rates, calling into question the usefulness of the theory. This paper shows that by carefully tailoring policies in an independent fashion, governments can eliminate price and exchange rate indeterminacy. Specifically, governments are assumed to care about the welfare of their agents so that they never set policy to yield an intertemporal government budget surplus. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

The fiscal theory of the price level has generated considerable recent interest (Leeper, 1991; Woodford, 1994, 1995; Sims, 1994, 1997; Cochrane, 1998a, b).

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The theory states that the price level is determined to equate the real value of nominal government debt with the present value of primary government budget surpluses. It is interesting on several counts. It predicts price level determinacy, even in the absence of a monetary aggregate. More importantly for policy, it predicts price level stability in the presence of rapid and uneven financial innovation, and price level determinacy in the presence of monetary policy rules focused on interest rate pegging. However, several recent papers have shown that extending the fiscal theory to an open economy with multiple currencies results in price level indeterminacy (Loyo, 1998; Dupor, 2000). This calls into question the usefulness of the theory.

This paper shows that by carefully tailoring policy rules in an independent manner, governments can eliminate price and exchange rate indeterminacy. Specifically, when each government sets policy to avoid an intertemporal government budget surplus, price and exchange rate indeterminacy are eliminated. Moreover, we argue that any government concerned with the welfare of its residents would choose this type of “no-surplus” policy.¹ We show that when all governments follow a “no-surplus” policy, the open economy fiscal theory of the price level becomes the exact analogue to the closed-economy fiscal theory.

The paper is organized as follows. Section 2 presents a closed-economy model, in which the standard results of price level determinacy with non-Ricardian fiscal policy and indeterminacy with Ricardian policy, are derived. Section 3 contains the open-economy results on indeterminacy. Section 4 describes the model with open-economy determinacy, and Section 5 contains conclusions.

2. Closed economy

In this section, we present the fiscal theory of the price level in the context of a simple, representative-agent, money-in-the-utility-function model. The closed-economy model serves as a benchmark for the subsequent open-economy model. The behavior of the representative agent is presented first. This is followed by a description of government policy, and finally by a discussion of equilibrium and the fiscal theory. All models assume perfect foresight and are in continuous time.

¹It is important to note that we are assuming that governments avoid intertemporal budget surpluses, not flow budget surpluses at all points in time.

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