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The Fiscal Theory of Money as an Unorthodox Financial Theory of the Firm

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1 Introduction

There are three issues in which everyday macroeconomic life and economic theory seem to be quite apart. The first is the zeal with which governments in Europe and elsewhere pursue fiscal discipline as almost a precondition for price stability. One would think that governments were trying to implement a well-established theorem in monetary theory, but while the need to co-ordinate fiscal and monetary policies is a well-understood principle,[1] such a theorem has been missing.

The second issue is the fact that, in many rational expectations monetary equilibrium models, the price level is indeterminate: a fact that the quantity theory had long ago unveiled. In contrast, everyday discussions regarding exchange rate (or other asset prices) movements seem to take prices as being determined.

The third issue is that, while in order to avoid indeterminacy problems, many economists, notably Friedman (1959), have advocated monetary policies that target the supply of money, increasingly central banks have been following endogenous monetary policies – for example, by targeting nominal interest rates, raising again the problem of price determinacy.

In this context, the fiscal theory of money (Sims (1994, 1995); Woodford (1995, 1996)) seems to be the missing theory for which many

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had been looking. It is a theory that provides a rationale to the above three 'common views'. The main elements of the theory are not new. For example, real balance effects had already been accounted for by Fisher (1911) and Wicksell (1936) and, in particular, in Patinkin's seminal work (Patinkin, 1965). Similarly, properly specified models have always taken into account the government's budget, although Christ (1979) had to insist on the importance of taking into account the consolidated budget of the government. What is new in the fiscal theory of money is that the implications of a government's budget accounting and of possible wealth effects are fully worked out in the context of rational expectations models with no special distortions. That is, in models where one would have expected that Ricardian equivalence results would have washed out real balance effects. The results on price determination are in striking contrast to standard quantity theory prescriptions.

The fiscal theory of money is based on an important feature that makes governments different from other agents – say, for example, households: namely, the government's monopoly of a nominal asset: that is, money. But, in this important respect, governments are not different from other agents that issue nominal assets – and in particular, firms. As a way to expose, and assess, the central elements of the fiscal theory, I develop it and present it in the context of an equilibrium model with firms that use a mix of debt and equity as outside financing. The corresponding fiscal financial theory of the firm also appears in marked contrast with standard asset price theory. In the context of the firm, however, it appears to be very transparent how the theory, as a theory of price determination, relies on letting agents (firms, in our case) make plans that violate their 'no default' constraints. This allows for real balance effects (real financial assets effects) based on a peculiar failure of the Modigliani–Miller theorem: fully rational and unconstrained agents do not take debt and equity financing as being equivalent, since (unless prices adjust) they may fail to satisfy standard – 'no default' – transversality constraints.

I present the model in Section 2. In Section 3, I develop some of the implications of the theory and discuss its relationship with asset price theory. In Section 4 I discuss in what sense the fiscal theory determines prices when firms' policies are endogenous. In particular, I show how the indeterminacy problem is related to a problem of policy misspecification. Section 5 concludes.

2 A model with representative agents and firms

In this section I develop a modified version of the Lucas's (1978) model of asset prices. There is a representative firm and a representative consumer.