Deficits and Inflation: Beyond the FTPL*

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Abstract

We ask how fiscal deficits affect inflation within the New Keynesian framework. According to the Fiscal Theory of the Price Level (FTPL), deficits drive output and inflation despite the fact that households are Ricardian in the sense of Barro (1974); we show that this is because the FTPL lets Ricardian Equivalence fail by force of equilibrium selection, reflecting self-fulfilling beliefs among households. We rule out this mechanism and, instead, focus on how deficits drive inflation when households are non-Ricardian due to finite horizons or liquidity constraints. The effect of deficits on inflation is now commensurate to the departure from the permanent-income hypothesis, and vanishes if households are Ricardian. If they are not, then inflation responds to deficits; compared to the FTPL, this inflation response is: *robust* to hard-to-test assumptions about which policy authority is "active" and which is "passive"; *front-loaded* and thus short-lived; and *smaller* by a margin that increases with the price rigidity and the pro-cyclicality of tax revenue. When applied to the post-covid episode, we find that the effect of stimulus checks on cumulative inflation is at most one half of that predicted by the FTPL, and plays out relatively quickly, over a couple of years.

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