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What Determines the Price Level?

Jae Won Lee*

Department of Economics, Rutgers University, USA

What determines the price level and inflation rate of an economy? This has been a central question because the nature of the price level determination is fundamental to understanding other important issues such as the business cycle, stock market fluctuations, monetary and fiscal policy design and exchange rate determination.

The standard answer to the question is that the price level and inflation is purely a monetary phenomenon: they are primarily or exclusively determined by the central bank through its ability to control the money supply. Accordingly, many economists view that fiscal factors are unimportant for the price level determination. Due to the conventional view, macroeconomic models that are currently estimated and used for the analysis of monetary policy and business cycles typically abstract from fiscal policy, as best exemplified by the medium scale dynamic stochastic general equilibrium models in Christiano, Eichenbaum and Evans [1] and Smets and Wouters [2]. However, this conventional approach is not without critics.

There is an alternative theory, often called the "fiscal theory of the price level" (FTPL) ([3-6]; the excellent review by Canzoneri et al. [7] and references they list). The theory emphasizes that either monetary or fiscal policy may pin-down the equilibrium price level, depending on the particular monetary and fiscal policy regime in place. In particular, how the government finances its debt most of which is denominated in nominal terms plays a critical role. Proponents of the FTPL argue that the price level will be determined by monetary conditions only if fiscal authorities behave in a "Ricardian" fashion, that is, they adjust systematically government primary surplus in response to changes in outstanding government debt, satisfying the government's intertemporal budget constraint. In contrast, when fiscal policy is unconstrained by the state of government indebtedness, the price level should adjust to stabilize the real value of government debt and thus satisfy the budget constraint. Therefore, in this case, the price level and inflation rate are determined by fiscal conditions.

Investigating whether the FTPL is empirically relevant is an open and active area of research. It is difficult to imagine that fiscal authorities always behave in a non-Ricardian way in all circumstances. Nevertheless, the FTPL might provide a useful characterization of actual policies in some contexts. We should then ask if there are historical episodes in which the FTPL was operative and how important the theory is empirically. These are important, yet still open, questions. Answering the questions will be the first step in understanding many central issues in economics, including the effects of monetary and fiscal policies, the sources of business cycles, the effects of macroeconomic factors on stock markets and exchange rate determination.

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***Corresponding author:** Jae Won Lee, Assistant Professor, Department of Economics, Rutgers University, New Brunswick, NJ, USA, E-mail: jwlee@economics.rutgers.edu

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