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# Introduction

WHAT DETERMINES the overall level of prices? What causes inflation, deflation, or currency appreciation and devaluation? Why do we work so hard for pieces of paper? A \$20 bill costs 10 cents to produce, yet you can trade it for \$20 worth of goods or services. And now, \$20 is really just a few bits in a computer, for which we work just as hard. What determines the value of a dollar? What is a dollar, really?

As one simple story, the fiscal theory of the price level answers: Money is valued because the government accepts money for tax payments. If on April 15 you have to come up with these specific pieces of paper, or these specific bits in a computer, and no others, then you will work hard through the year to get them. You will sell things to others in return for these pieces of paper. If you have more of these pieces of paper than you need, others will give you valuable things in return. Money gains value in exchange because it is valuable on tax day. This idea seems pretty simple and obvious, but as you will see it leads to surprising conclusions.

The fiscal theory is additionally interesting by contrast with more common current theories of inflation, and how its simple insight solves the problems of those theories. Briefly, there are three main alternative theories of the price level. First, money may be valued because it is explicitly backed: The government promises 1/32 of an ounce of gold in return for each dollar. This theory no longer applies to our economies. We will also see that it is really an interesting instance of the fiscal theory, as the government must have or obtain gold to back dollars.

Second, intrinsically worthless money may be valued if people need to hold some money to make transactions and if the supply of that money is restricted. This is the most classic view of fiat money. (“Fiat” means money with no intrinsic value, redemption promise, or other backing.) But current facts challenge it: Transactions require people and business to hold less and less money. More importantly, our governments and central banks do not control internal or external money supplies. Governments allow all sorts of financial and payments innovation, money multipliers do not bind, and central banks follow interest rate targets, not money supply targets.

Third, starting in the late 1970s a novel theory emerged to describe that reality, and in response to the experience of the 1970s and 1980s. In this theory, inflation is controlled when the central bank follows an interest rate target, so long as the target varies more than one for one with inflation, following what became known as the Taylor principle. We will analyze the theoretical problems with this view in detail below. Empirically, the fact that

inflation remained stable and quiet even though interest rates did not move in long-lasting zero bound episodes contravenes this theory.

The fiscal theory is an alternative to these three great classic theories of inflation. The first two do not apply, and the third is falling apart. Other than the fiscal theory, then, I argue that there is no simple, coherent economic theory of inflation that is vaguely compatible with current institutions.

Macroeconomic models are built on these basic theories of the price level, plus descriptions of people's saving, consumption, production, and investment behavior, and potential frictions in product, labor, or financial markets. Such models are easily adapted to the fiscal theory instead of alternative theories of inflation, leaving the rest of the structure intact. Procedurally, changing this one ingredient is easy. But the results of economic models often change a lot if you change just one ingredient.

Let's jump in to see what the fiscal theory *is*, how it works, and then compare it to other theories.



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