Abstract

The paper provides a formalisation of the monetary folk proposition that fiat (base) money is an asset of the holder (the private sector) but not a liability of the issuer (the monetary authority, as agent of the state). The issuance of irredeemable fiat base money can have pure fiscal effects on private demand. With irredeemable fiat base money, weak restrictions on the monetary policy rule suffice to rule out liquidity trap equilibria, that is, equilibria in which all current and future short nominal interest rates are at their lower bounds. In a model with flexible prices, liquidity trap equilibria cannot occur as long as the private sector does not expect the monetary authority to reduce the nominal money stock to zero in the long run. In a New-Keynesian model, liquidity trap equilibria are ruled out provided the private sector expects the authorities not to reduce the nominal stock of base money below a certain finite level in the long run.