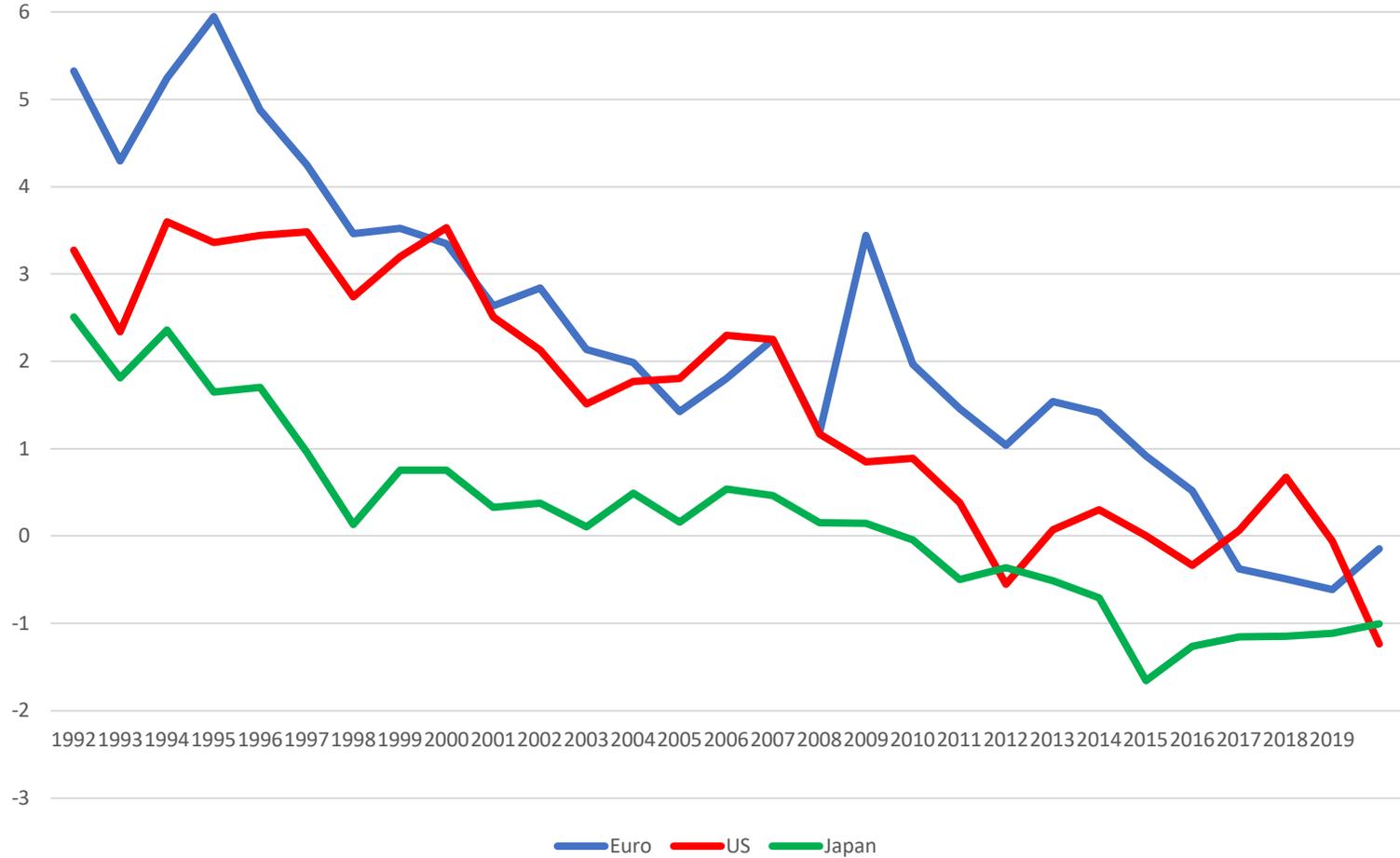


Fiscal policy under low rates.

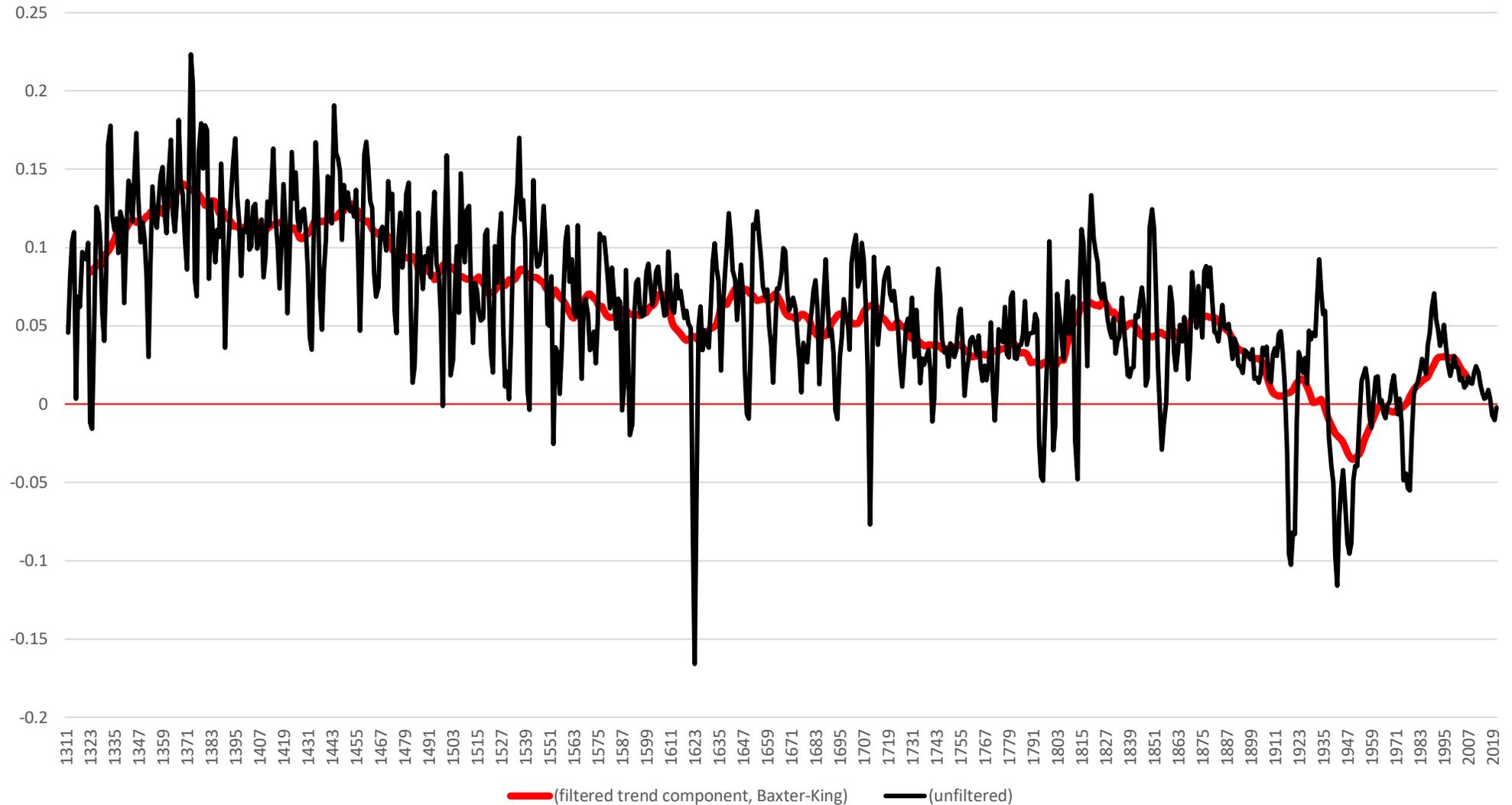
Olivier Blanchard

MIT Press book, January 2023.

What triggered the book: US, Euro, Japan 10-year real rates, 1992-2020



And this: (ex post) safe real rate from 1325 to 2021 (Schmelzing)



But real safe rates have increased since 2021...

Is the book a history book or a book about the post-inflation-fight future ?

I believe the second...

What investors believe:

US 10-year rate nominal rate: 3.5%. US 10-year forecast inflation rate (CBO): 2.4%. Real rate: 1.1%

US 10-year forecast growth rate (CBO): 1.7%, so $(r-g) = -0.6\%$.

Even more negative in euro zone (-1.3%) and Japan (-1.2%)

(1-year real rate 10-years out (from OIS and inflation swaps) minus CBO growth forecast: -1.2%)

Investors can be wrong...

Need to look at fundamentals:

What factors explain the decrease in r and $r-g$ in the past 30 years,

And do we have any reason to expect them to turnaround?

Fundamentals, past and future.

Equilibrium safe rate, r^* (“neutral rate” in the jargon) depends on saving, investment, and the demand for safety.

High saving, low investment, lead to low equilibrium marginal product of capital.

High demand for safety leads to low (safe) r relative to the (risky) marginal product of capital

All three have likely be at play pre-covid.

Saving. Demographics (increase life expectancy, increased retirement period). Income.

Investment. TFP growth has been weak, so has investment.

Demand for safety: Regulation, more uncertainty in general

Looking forward

Saving. Life expectancy and income will continue to increase

Higher public debt? Yes, but surprisingly small: In AEs, 2019-2022; 7% increase in D/Y

Demand for safety. Regulation will stay. If anything, uncertainty higher.

Investment. Where the uncertainty might be. Green investment, higher r^* , lower g .

Indeed, one conclusion from book. Increasing r^* this way would be desirable

Bottom line: $r-g$ likely to remain negative on average, with high probability.

The basic argument of the book.

There has been a steady decrease in safe real neutral rates over the past 35 years

There might well be bumps (the current fight against inflation as an example)

In the medium run , the trend may flatten but is unlikely to reverse. So return to low real rates

Low real rates imply:

- Lower fiscal costs of deficits and debt
- Lower welfare costs of deficits and debt
- Combined with ELB, less room for monetary policy, more need for fiscal policy

Together, these imply:

Smaller costs and larger benefits of deficits and debt

The need for a more active role for fiscal policy

Caveat: Focus on AEs. Careful about translation for EMs and LICs.

The structure of the book

Chapter 1. Basic concepts: neutral rate, safe and risky rate, effective lower bound.

The importance of the two thresholds, $(r^*-g) < 0$, and $r^* < r$ ($=-\pi$) (binding ELB)

Why central banks should not be blamed for low r .

Chapter 2. The evolution of rates.

Saving, investment, safety.

Chapter 3. Debt sustainability.

The surprising debt dynamics when $(r^*-g) < 0$

The design of rules. SDSAs.

Chapter 4. Welfare costs and benefits of debt and deficits

Dynamic inefficiency. Debt and welfare under certainty and uncertainty.

DE and ELB: Potential role of fiscal policy.

Chapter 5. Fiscal policy in action

Too little (euro crisis), too much (Biden ARP), just right ? (Japan)

1. Fiscal costs of debt.

Current levels of debt are very high. Reasons to worry?

Start with the basic dynamics of the debt to GDP ratio:

$$d - d(-1) = (r-g) d(-1) - s$$

Debt to GDP ratio stabilization implies:

$$d = d(-1) \Rightarrow s = (r-g) d < 0 \text{ if } r-g < 0$$

Three ways of stating the implications of sustained $r < g$:

- Can issue additional debt once, and never raise taxes to pay for it...
- Can run any primary deficit, debt will increase, but not explode (primary deficit=3%, $r-g=-2\%$ then $d=150\%$).
- Can run a primary deficit and keep debt ratio constant ($d=100\%$, $r-g=-2\%$, primary deficit=2%)

Infinite fiscal space? No:

- Endogeneity. As d increases, r^* and by implication r will increase
- Uncertainty.

Assessing debt sustainability more generally.

Debt sustainability: Probabilistic statement. Uncertainty of the essence

About s , about g , and especially about r

Right tool: Stochastic debt sustainability analysis.

Not sure that there are satisfactory shortcuts. Happy with EU commission proposal.

Looking for actual rules? Large topic, just one remark:

Tempting to focus on **debt service ratio**, defined as $(r-g) d$ rather than debt ratio d

Need to look at first and second moment.

Much larger relative movement in $(r-g) d$ than in d .

If $(r-g) d$ increases, can government generate the required surplus s ?

Depends on maturity, investor base, currency denomination, access to liquidity, etc

[Other issues: Treatment of public investment. Sudden stops, and the role of central banks.]

2. Welfare costs of debt.

Traditional view: Public debt mortgages the future.

Crowds out capital accumulation and decreases future output and consumption.

Requires an increase in future taxes. Distribution effects and tax distortions.

The golden rule result. Phelps and Diamond

Phelps: $r < g$ is an indication of overaccumulation of capital.

Can decrease investment and increase consumption, now and later

Diamond. If $r < g$, public debt increases welfare.

The signal: low r is an indication of a deep underlying weakness of the economy.

Too much saving/too little investment. Equivalently: Insufficient private demand.

The practical issue. What r ? The safe rate, or, for example, the average MPK? Evidence.

The argument for the safe rate: It is the risk (liquidity) adjusted rate of return on capital

Complications. Overaccumulation: Really?

Bottom line: Reasonable position: **Welfare costs of debt, positive but small.**

3. Welfare benefits of deficits. Fiscal stabilization

If the ELB constraint binds (strictly), then $r^* < r_{\min}$, so $r > r^*$:

Monetary policy cannot be used by itself to keep output at potential

Even if $r^* > r_{\min}$ but close, limited room.

Then fiscal policy must be used: need for deficit (more generally, combination spending, taxes)

Does it work? What have we learned about multipliers? (A lot, thanks to the last 15 years)

- Effect depends a lot on expectations, on type of spending/tax.
- Case for expansionary fiscal austerity is weak in current context (no spreads to start)
- Recent work on multipliers. Wide dispersion, but typically right sign:
Surprisingly: Multiplier from tax cuts $>$ Multiplier from spending

Putting things together. 1.

The lower r^* , the smaller the fiscal and welfare costs, the larger the benefits of debt and deficits. But r^* itself is endogenous, depends on fiscal policy...

Optimal fiscal policy? A sketch

Start with the **pure public finance (PPF) view**. Ignore stabilization role of fiscal policy.

Think of the deficits justified on PPF grounds, given r^* :

Tax smoothing if temporary spending.

Protection during Covid, refugees from the war, bump in defense spending

Intergenerational redistribution

Green investment. Passing on some of the costs to future generations

Initial level of debt. Too high/too low to start?

Note: In each of these cases, debt more attractive/less unattractive the lower $(r^* - g)$.

Solve for resulting r^* (r^* affects fiscal decisions, fiscal decisions affect r^*).

If result is that the neutral rate is such that neutral rate $r^* \geq r_{\min} + x$.

Then, enough room for monetary policy to act to maintain output

Putting things together. 2

If $r^* < r_{\min} + x$,

Run larger deficits than under the PPF, so $r^* \geq r_{\min} + x$.

Use fiscal policy to maintain output at potential at a rate that gives enough room to monetary policy in case it is needed. (so, for example, limit speed of debt reduction)

(name Focus of fiscal policy to affect output is known as the **pure functional finance (PFF)** view from Abba Lerner)

Can think of as a fiscal put: On average, use fiscal policy to keep $r^* \geq r_{\min} + x$

Many other dimensions of fiscal and monetary policy left out.

Monetary policy: The ELB is in part a self-inflicted wound. Target inflation rate?

Application to public investment spending, and debt/tax finance.

Automatic stabilizers dominate monetary policy, even if ELB not relevant

Distributional effects of fiscal versus monetary policies. Current policies in Europe

Fiscal policy in action. Three applications

Too little? Fiscal austerity in Europe in the wake of the financial crisis
Obsession with debt consolidation while at the ELB.
Large output cost. Little gain of fiscal space

Too much? The Biden bet. Large fiscal expansion. Increase r^* . Keep $r < r^*$ to increase inflation.
Right policy, in the wrong proportion. (Overshoot. Now must keep $r > r^*$ for some time)

Just right? The Japanese experience. Sustained low r^* . High deficits and increasing debt/GDP: 172%

What if r^* increases? Depends on the source:
Sudden stop. Can the BOJ avoid it? Probably.
Stronger domestic private demand. Self solving
World r^* : Depreciation?

What if r^* remains low, less than r_{\min} ?
Alternatives to deficits to sustain private demand?
Social insurance to reduce precautionary saving ?
Public green investment, with large private spillovers?