Fiscal policy under low rates.

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Book coming out at MIT Press, end of 2022.
Intermediate draft available on open site: https://fiscal-policy-under-low-interest-rates.pubpub.org/

The basic argument

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

There might well be bumps (implications of 2021 US fiscal expansion for example); the trend may flatten but is unlikely to reverse.

It implies:

- Lower fiscal costs of deficits and debt
- Lower welfare costs of deficits and debt
- Less room for monetary policy, more need for fiscal policy

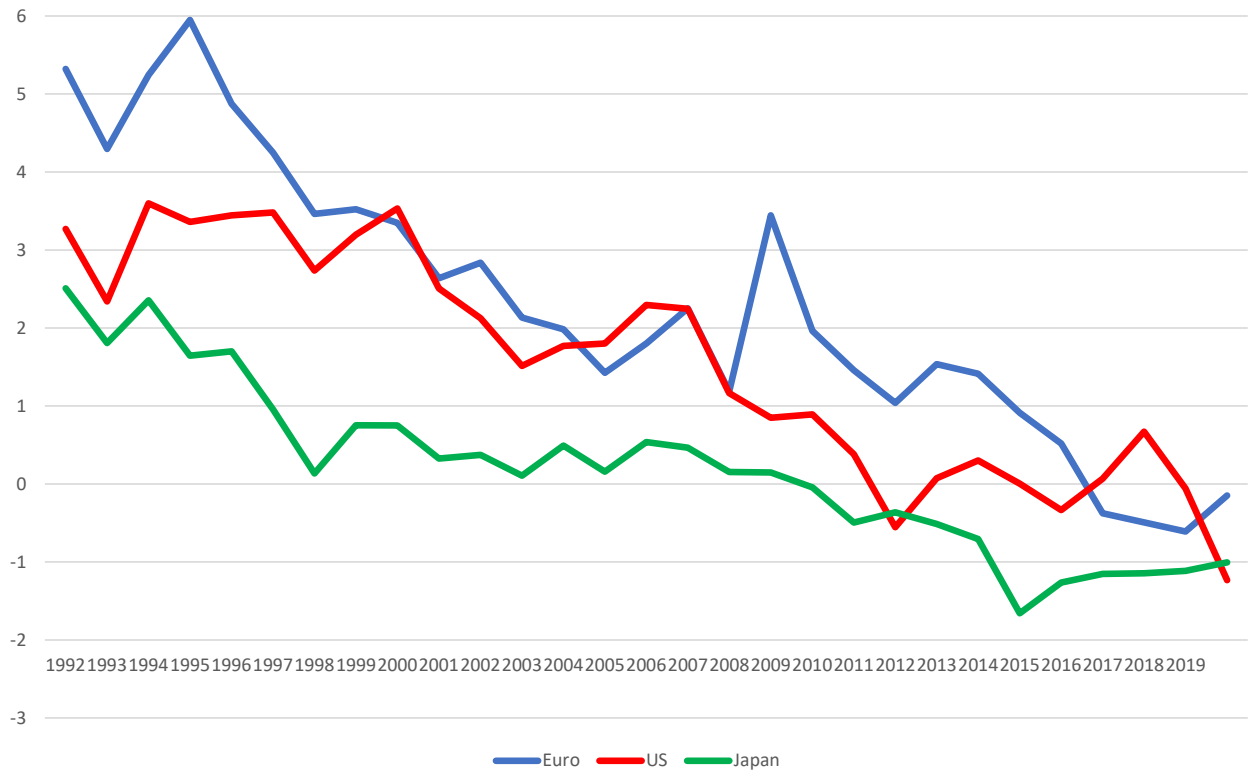
Together, these imply:

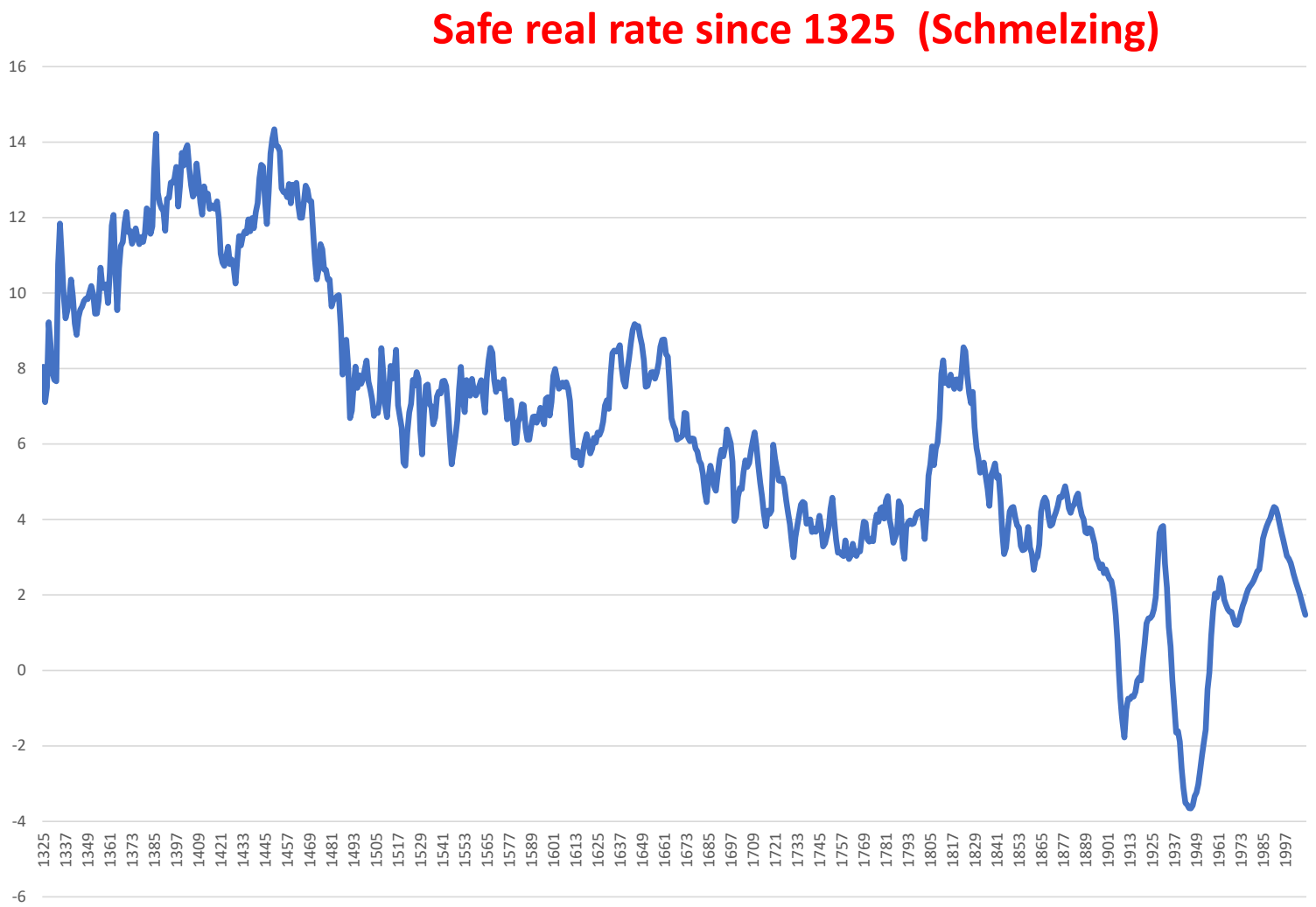
Smaller costs and larger benefits of deficits and debt

A more active role for fiscal policy

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

US, Euro, Japan 10-year real rates, 1992-2020




Safe real rate since 1325 (Schmelzing)
16
14
12
10
8
6
4
2
0
-2
-4
-6
1325
1337
1349
1361
1373
1385
1397
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1817
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1841
1853
1865
1877
1889
1901
1913
1925
1937
1949
1961
1973
1985
1997

What is behind the decrease of the last 30 years?

The (real safe) neutral rate can be defined in two (equivalent) ways

Rate such that saving=investment at potential output.

Rate such that aggregate demand = potential output.

What we have seen is a decrease in the **neutral rate**. Two potential sets of factors:

- Decrease in marginal product of capital. Strong saving/weak investment
- Decrease in safe rate given MPK. Increased demand for safe assets

Evidence: Many suspects, no indictment. My own take: Both sets of factors at work

- Saving. Demographics (longevity)/income level (individuals, countries).
- Equity premium/safety discount (regulation, probably more)

Will low rates last? Most of the factors unlikely to change sign. But two caveats:

- A green investment boom?
- Expansionary fiscal policy: Example: SR: The Biden/Powell bump. Or LR: major green plans

The two crucial thresholds

Call r the safe rate, r* the neutral rate.

On the way down, r has crossed two thresholds:

First threshold: r<g

Holds by a substantial margin. Currently US, 10 year: r-g = 0%-2%=-2%

Clear fiscal implications. Debt dynamics

Clear (and more profound) welfare implications. Welfare costs of debt

Second threshold, sometimes crossed. Effective lower bound:

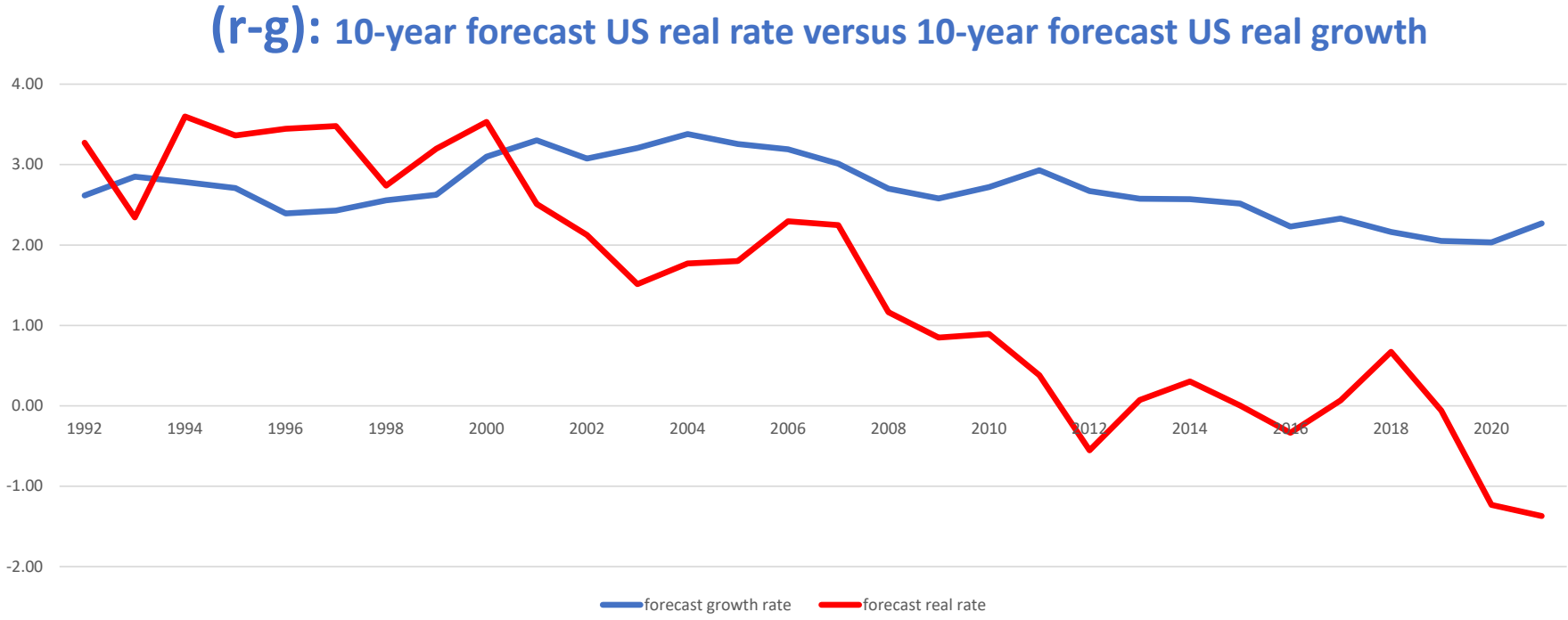
$i \geq 0$ (or $\geq -\varepsilon$) , or $r \geq -\pi^e - \varepsilon = r_{min}$

if $r^* \leq r_{min}$, then $r>r^*$ Monetary policy cannot achieve the neutral rate.

Even if not strictly binding, still constraining.

Essential role of fiscal policy to sustain demand and output.

Room between the two thresholds: g=2%; with 2% inflation, $r_{min} = -2\%$


(r-g): 10-year forecast US real rate versus 10-year forecast US real growth
4.00
3.00
2.00
1.00
0.00
-1.00
-2.00
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
forecast growth rate
forecast real rate

1. Fiscal costs of debt.

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

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

$$d = (1+r)/(1+g)\, d(-1) - s$$

Debt to GDP ratio stabilization implies:

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

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

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

Infinite fiscal space? No:

- Endogeneity. As d increases, r* and thus r will increase
- Uncertainty.

Assessing debt sustainability.

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.

Looking for rules (current discussion in EU). 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

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.

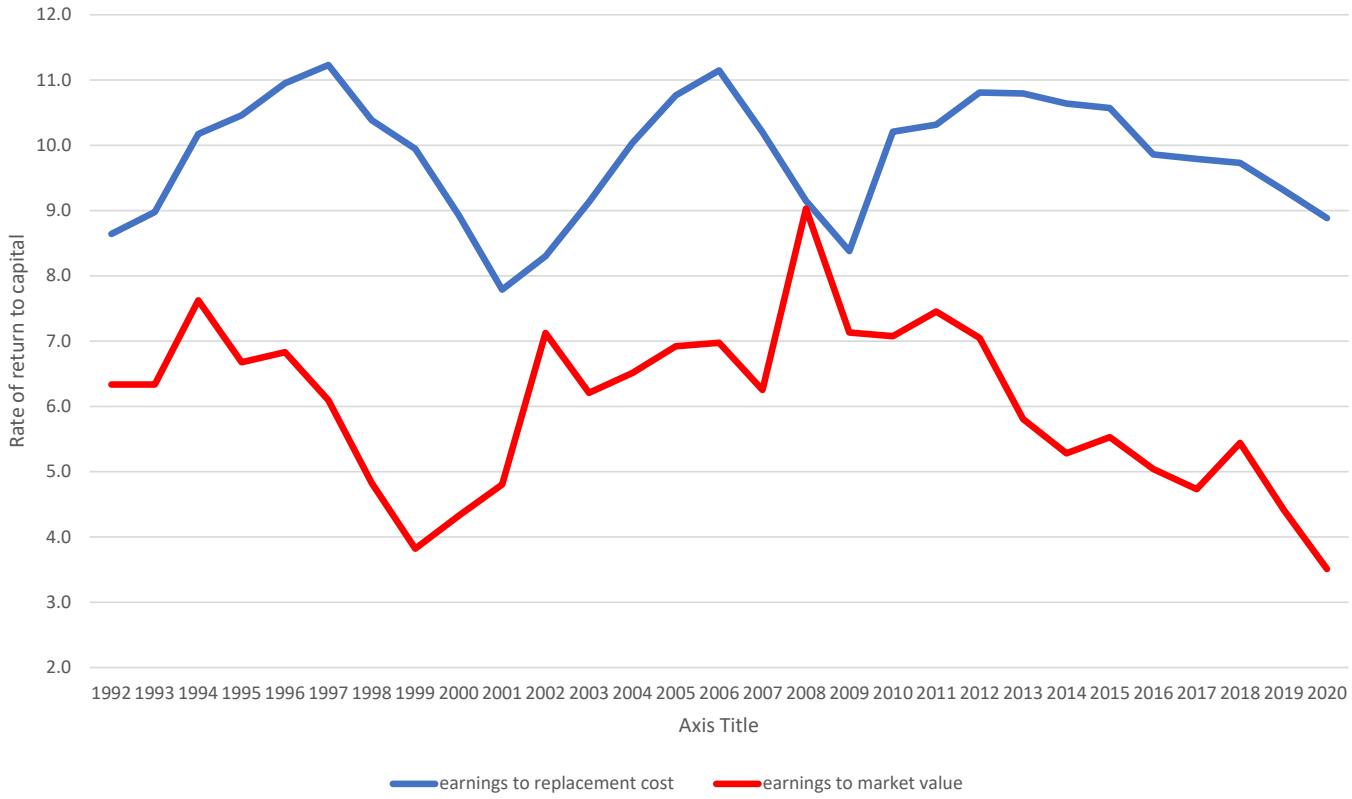
The practical issue. What r? The safe rate, or, for example, the average MPK? Evidence.

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.**

Two proxy measures of the US net MPK.



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)

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)

Focus of fiscal policy on output is known as the **pure functional finance (PFF)** view (name 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.

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.

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

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

Just right? The Japanese experience. Sustained low r*. High deficits and increasing debt (Figure)

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 demand?
Social insurance.
Public green investment, with large private spillovers?