Fiscal policy in the era of low interest rates

Discussion by Cristina Arellano and Manuel Amador

Outline

- Active recent discussion on US fiscal policy and debt sustainability.
- Summarize arguments for expansion of government debt.
  - Smooth expenditures, taxes, redistribution.
- Highlight potential problems for expansion of fiscal policy.
  - Debt is high and expected to grow more.
  - Highlight uncertainty of future paths of interest rates.

Summary of Furman and Summers 2020

1. Fiscal policy for stabilization given constraints of monetary policy.
    a. Automatic recession insurance: unemployment benefits, transfers to states, cash, nutrition assistance.

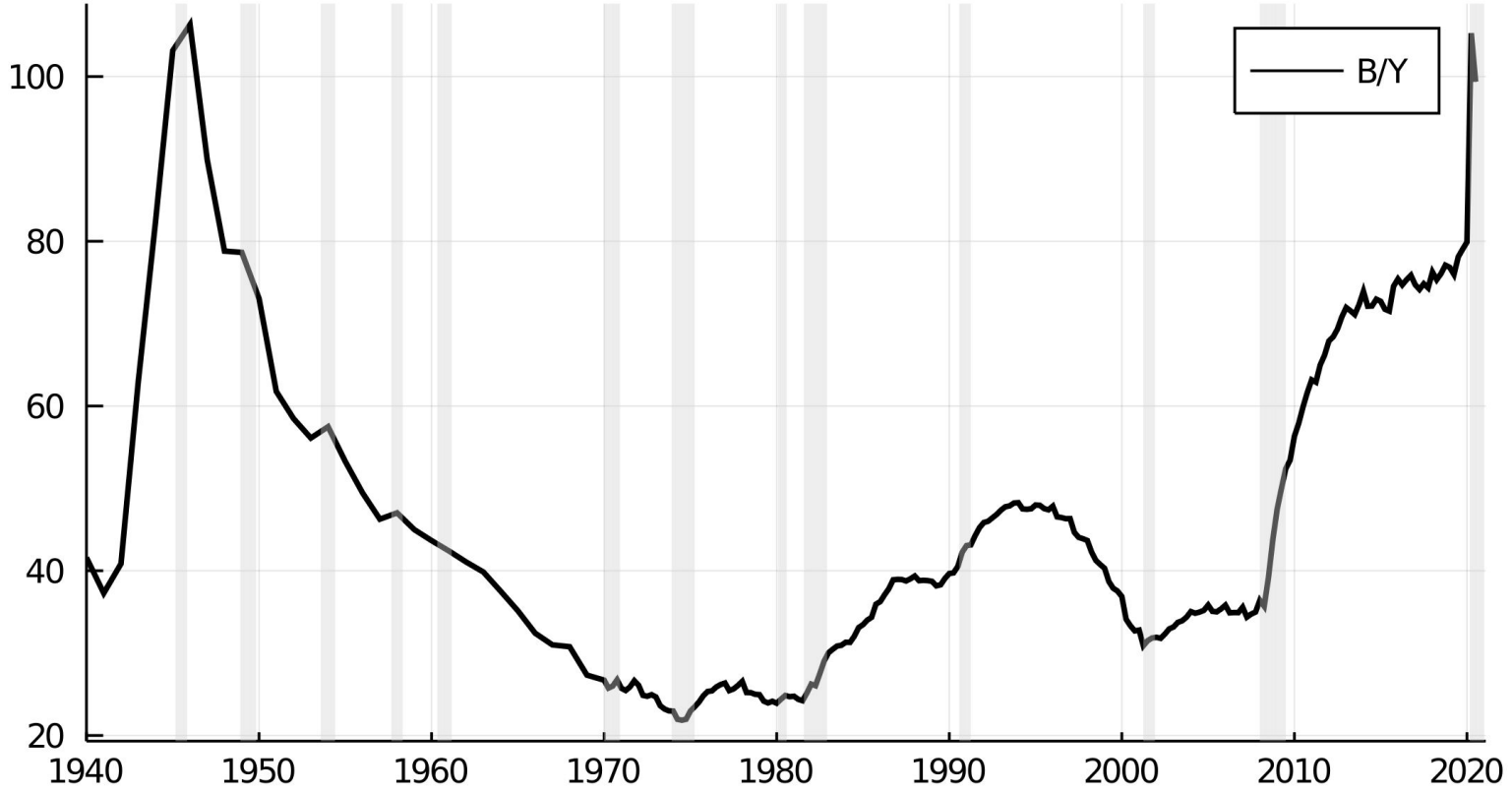
2. Useful borrowing for long-term projects.
    a. Invest in public projects with high ROR. Infrastructure, healthcare, education, basic research.

3. Debt to output ratios not as useful metrics for sustainability.
    a. Important is repayment capacity: future tax revenues, interest payments.
    b. Also consider flow variable Debt Service / Output.

Starting point:
Decline in real rates

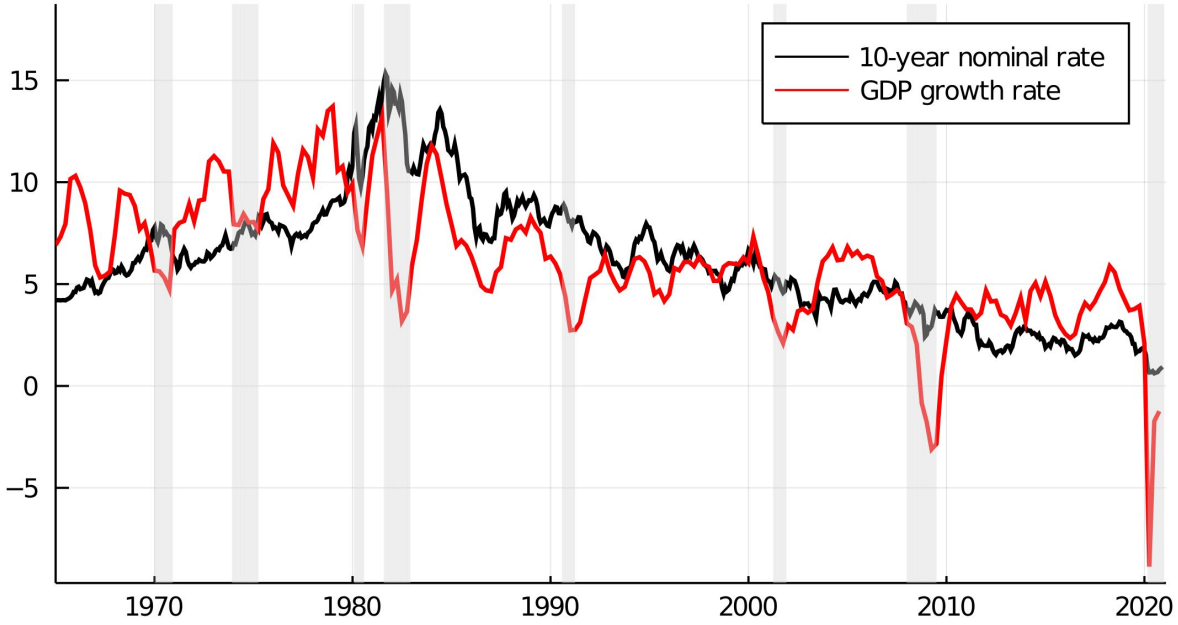
- Demographics
  - Aging population
- Global savings glut
    - Central Banks
    - Rising Asia
    - Safe-asset demand
- Low trend growth
- Increase inequality
- Decline in demand for investment

US Federal Debt Held by the Public



i B/Y

US nominal interest rates and nominal GDP growth



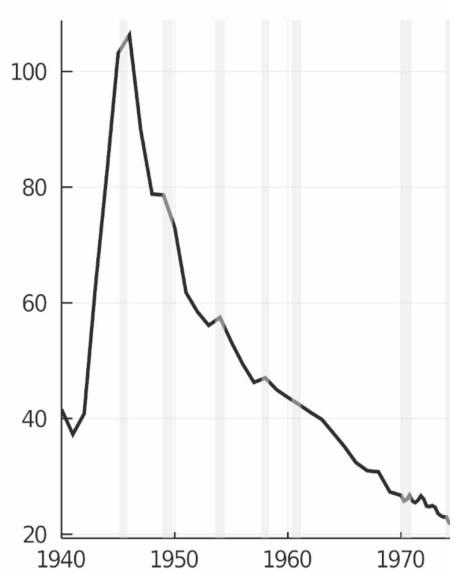
$$\frac{B}{Y}$$

- **i**
- **primary deficits**
- **g+π**

$$i < g + \pi$$

From 1945 - 1975: Decomposing post WWII reduction

B/Y Change 1945 to 1974	=	Interest	+	Inflation	+	Growth	+	Primary Surpluses
-80%		22%		-35%		-21%		-35%

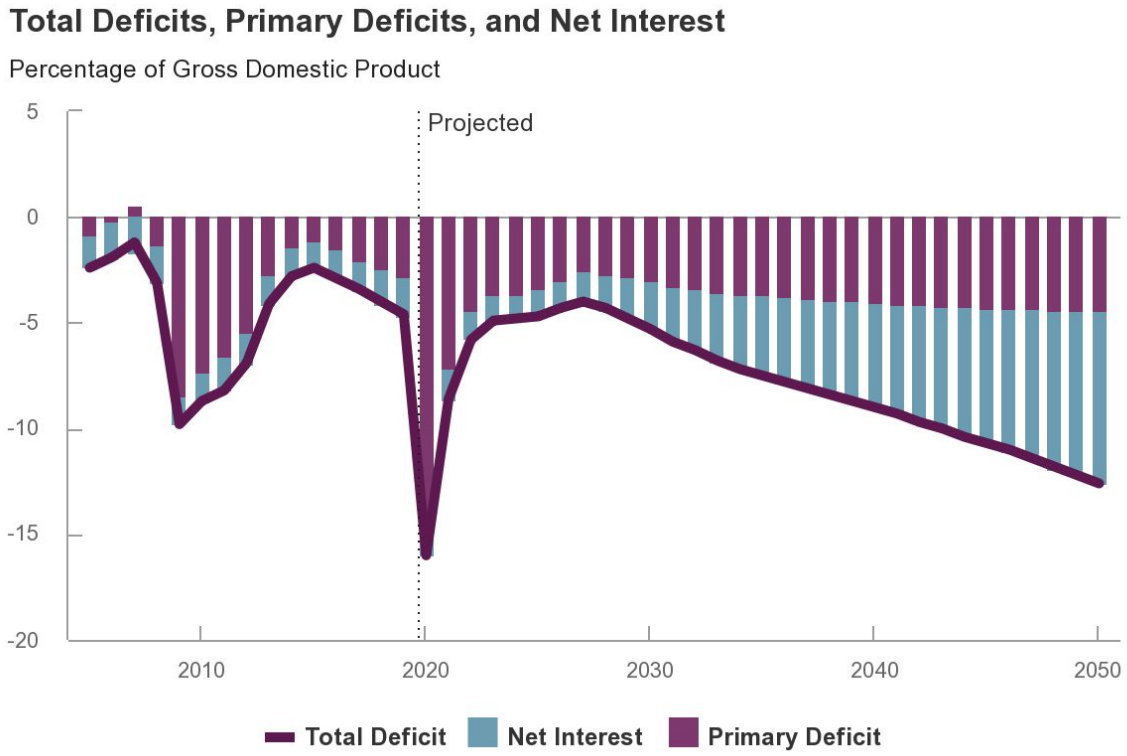


- WWII Debt was relatively long term.
  - Inflation hit those hard.
- Increase in G was temporary.
  - US ran primary surplus afterwards.
- Economic growth helped.

Source: Hall and Sargent 2011

Large deficit projections

Due to primary deficits and higher interest rates.

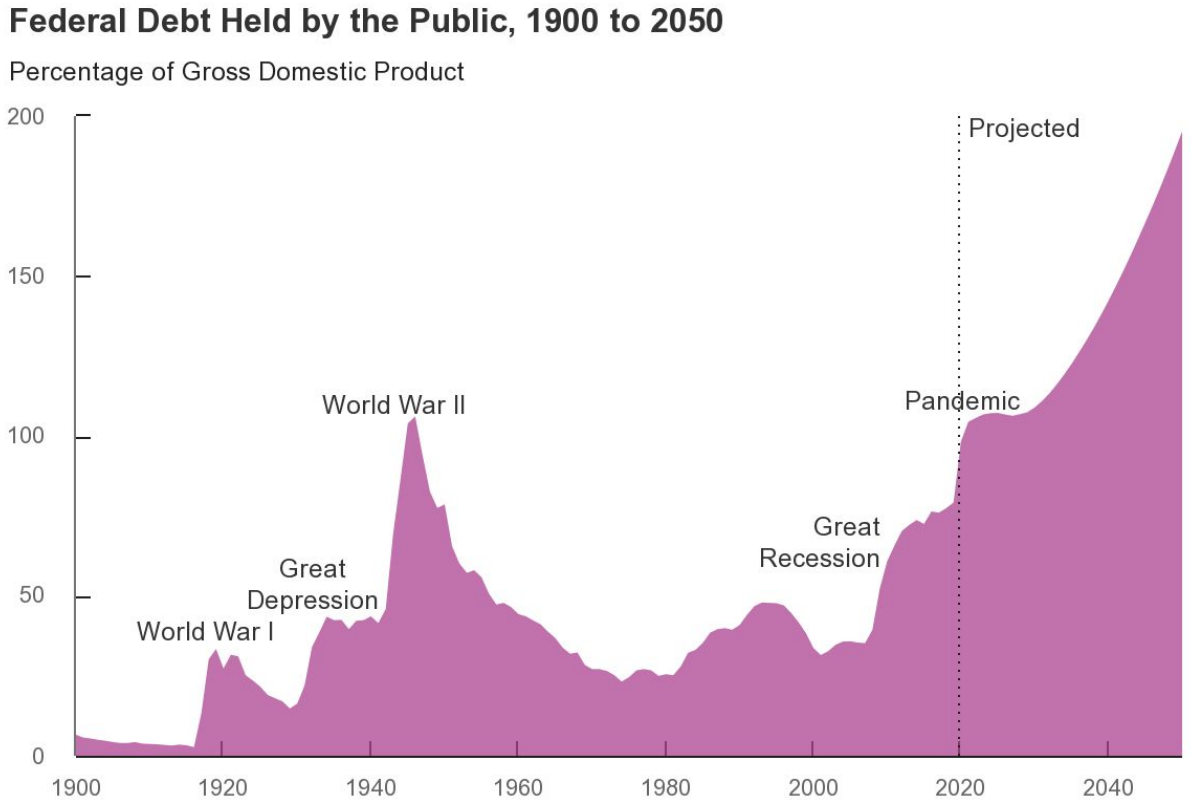


4.5% ⇦ Health, Social security

8% ⇦ 10 year nominal rate increases back to 5% (pre GFC)

Source: CBO 2020 long-term budget outlook

CBO baseline



Source: CBO 2020 long-term budget outlook

Benefits of borrowing in response to shocks

- In the face of temporary spending shocks.
  - Smooth tax rates.
  - Borrow in bad times -- repay in good.
- Redistribution/transfers for temporary shocks.
  - Covid shock: Borrow for transfers to the poor and smooth taxes on the rich.
- For stabilization when monetary policy is at the ELB.
  - Germany vs US. ⟹

Benefits of borrowing when interest rates are low

- Higher incentives for government investments/consumption at low rates.
- Financed with debt?
  - If external forces drive rates decline.
    - YES, country as a whole has higher borrowing incentives.

  - If domestic forces drive decline.
    - NOT CLEAR. Govt ***borrowing*** does not really help the country as a whole save.
  - If subgroups of domestic people only want to save, maybe yes.

Risks of current high debt levels

- Maturity is short.
  - 40% due within 1 year (55% incorporating Fed balance sheet).

Maturity

- Inflation.
  - Large history of reducing debt through inflation (or financial repression)
- Roll over risks.
  - Foreign shocks: Significant share held by foreigners (30%).
  - Fed response of high rates can exacerbate fiscal burden of debt.

Do countries default on local currency debt?

- Interest rate increases accumulate (exponentially).
- Large debt makes economy more vulnerable to shocks.

Debt to output is not useful

1. Debt to output ratios not useful metrics for sustainability.
    - True. We know this for emerging markets.
    - Better assessment by using previous history of defaults and spreads (hard to do for the US).
2. Proposed PV calculations may not be useful. Chile
3. Interest rate expenses / GDP is a valid suggestion. Italy
    - But may miss episodes.

Conclusion

- During bad shocks and persistently low interest rates:
  - Case for more borrowing (specially if external).
- Projection: unprecedented increase in debt
  - Not many episodes in US history to guide us. Present times different from WWII.
  - Uncertainty on where the danger zone is.
- Bad scenarios:
  - Increase in rates (specially given maturity structure).
  - Reduction in economic growth.

CBO

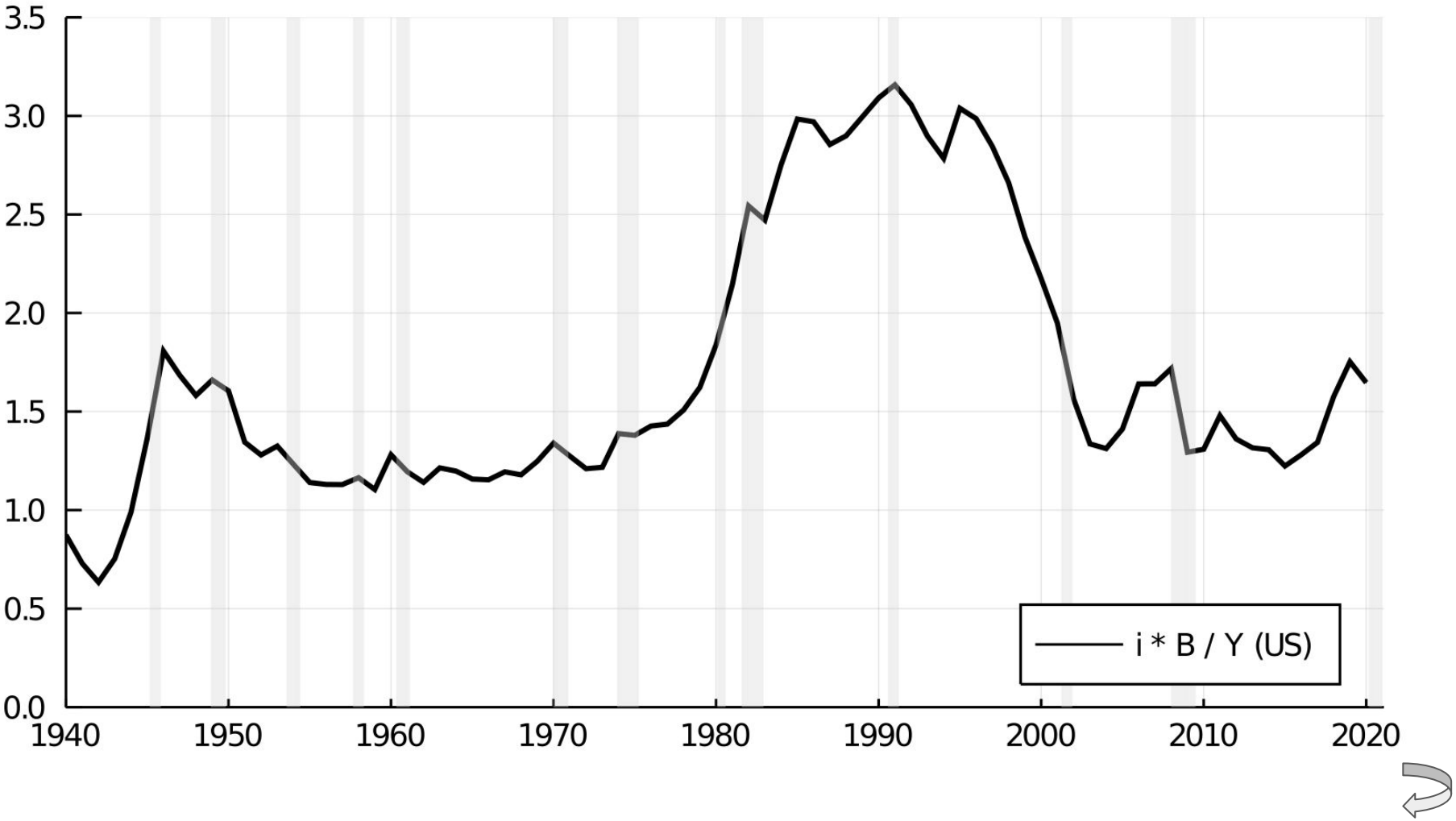
- One policy suggestion: extend the maturity of the debt in private hands.

Other

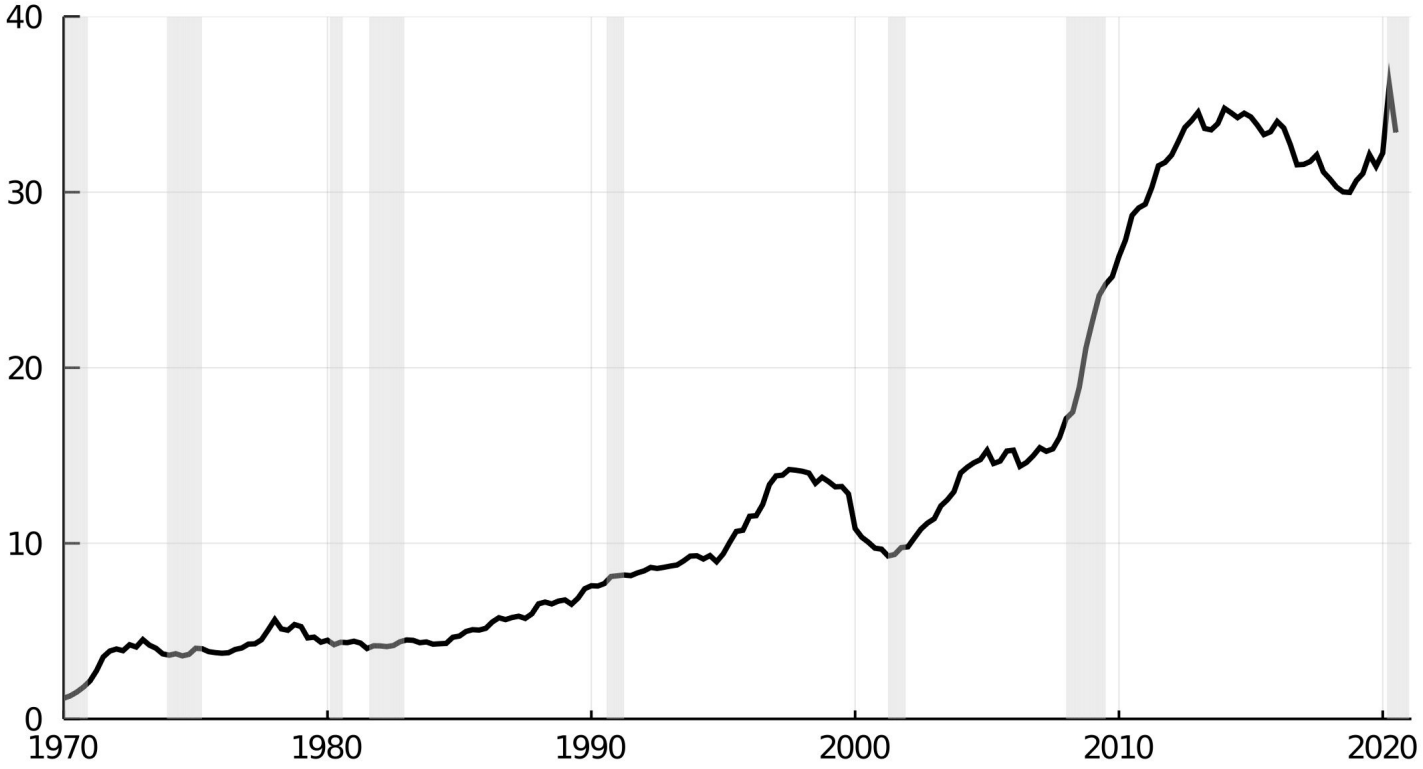
Risks of high debt

CBO:

High and rising federal debt makes the economy more vulnerable to rising interest rates and, depending on how that debt is financed, rising inflation. The growing debt burden also raises borrowing costs, slowing the growth of the economy and national income, and it increases the risk of a fiscal crisis or a gradual decline in the value of Treasury securities.


3.5
3.0
2.5
2.0
1.5
1.0
0.5
0.0
1940
1950
1960
1970
1980
1990
2000
2010
2020
i * B / Y (US)

Foreign holdings of US Debt / GDP



Do countries default on LC debts?

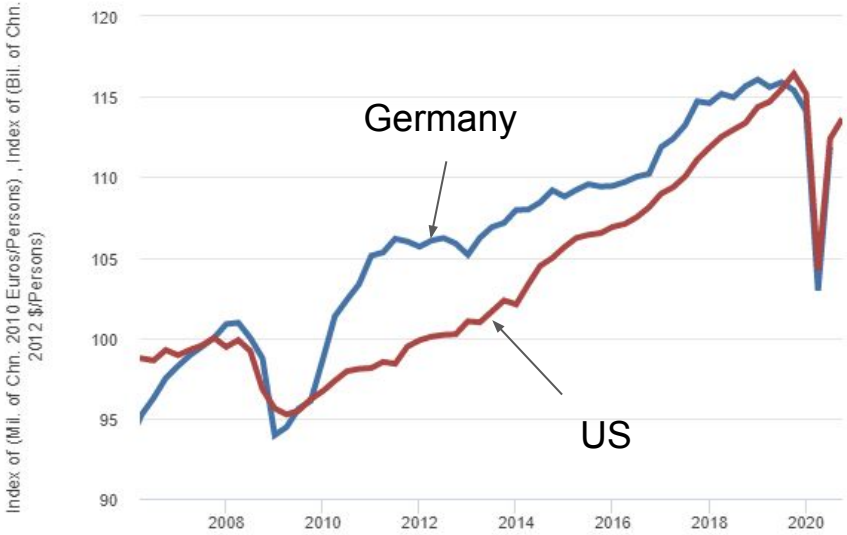
- Absolutely.
  - Many since 1960s (Russia, Turkey, Dominican Republic, Venezuela, ...)
  - Not counting inflation and financial repression episodes
  - No developed countries in this group (not counting Greece)

- In emerging markets, there is a measurable credit spread in LC govt debt.
  - 150 basis point from 2005-2012.

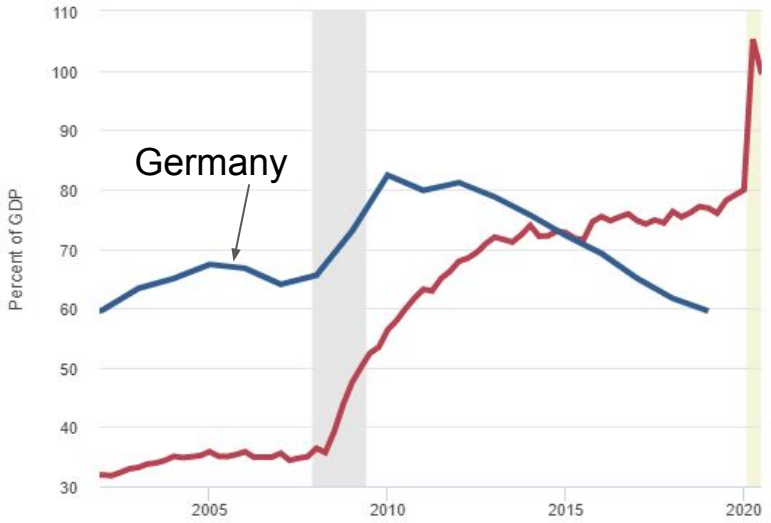
- England in 1976 required IMF assistance
  - Italy also. France in 1983 within EMS also require external assistance.

Great Recession: Germany and U.S.

Output per capita

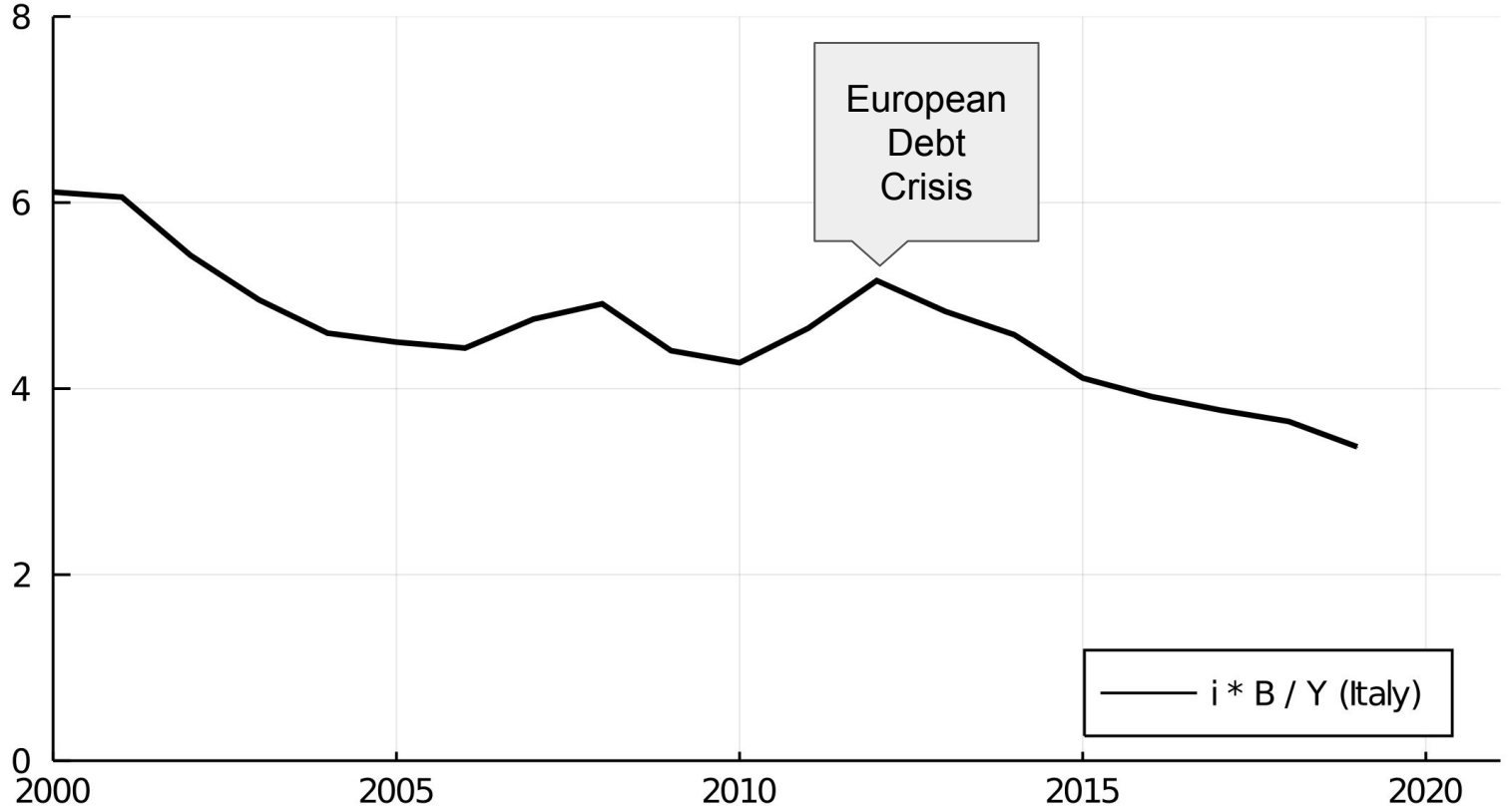


Debt to Output

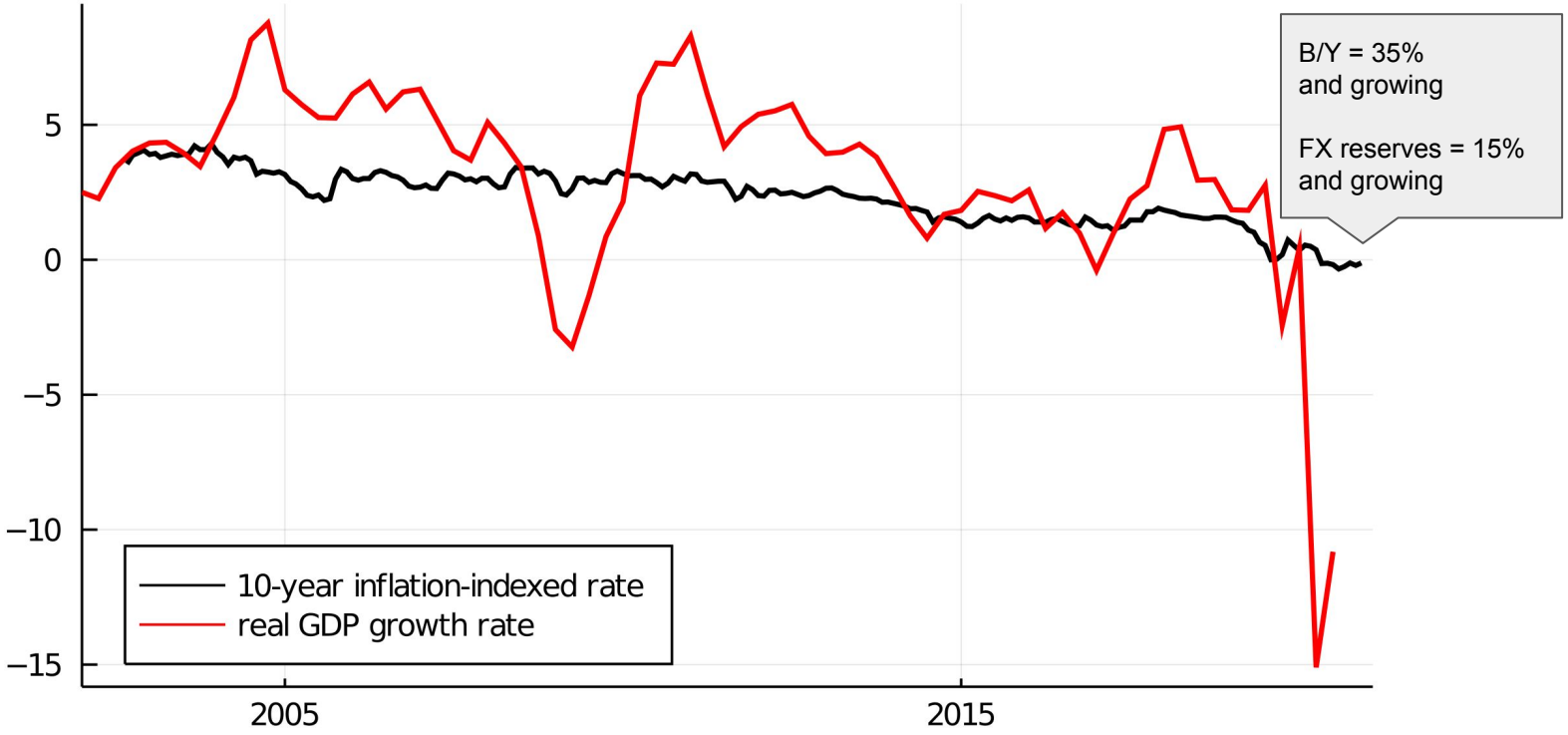


Both were constrained with monetary policy and experienced similar drop in output.

Italy: Interest rate expenses over GDP

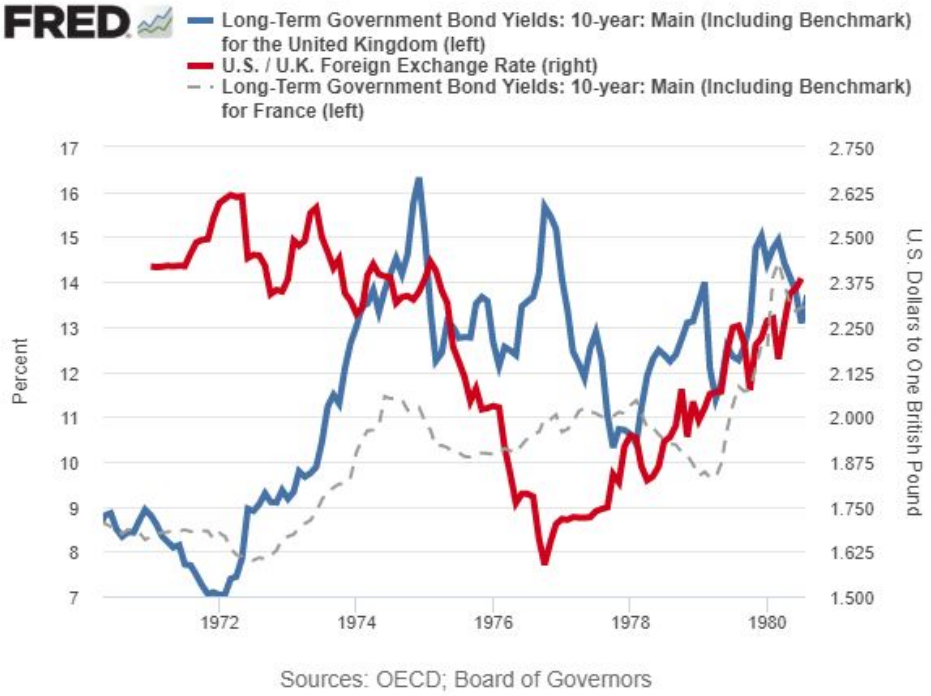


Chile: Real growth and real rates

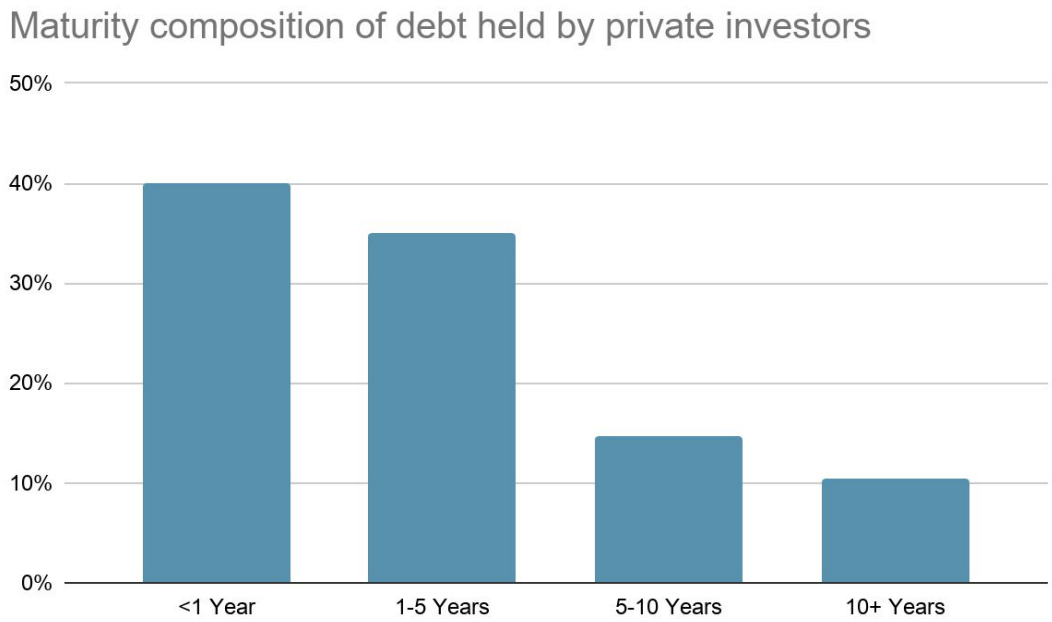


United Kingdom Crisis 1976

- Government debt around 100% of GDP (still elevated from wars)
- Had to borrow from IMF in 1976
- Large depreciation of the currency (40%)
- Hikes in borrowing rates of about 3%
- Double dip recession



US Maturity composition



Debt by held by Private investors: 80% of GDP

32% of GDP < 1 year

How do we think about the 20% of GDP held by Fed?

Transformed into very short term liabilities.

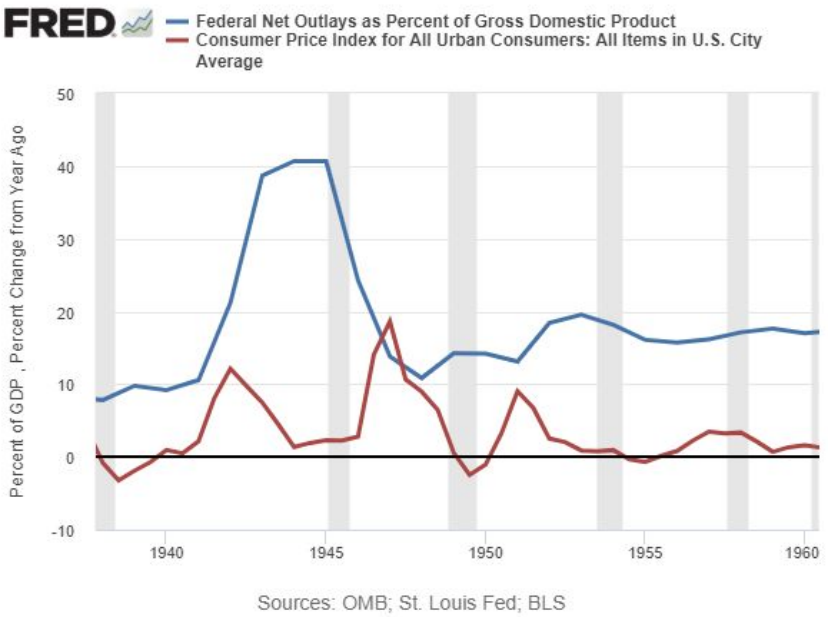
WW II Govt Spending and Debt

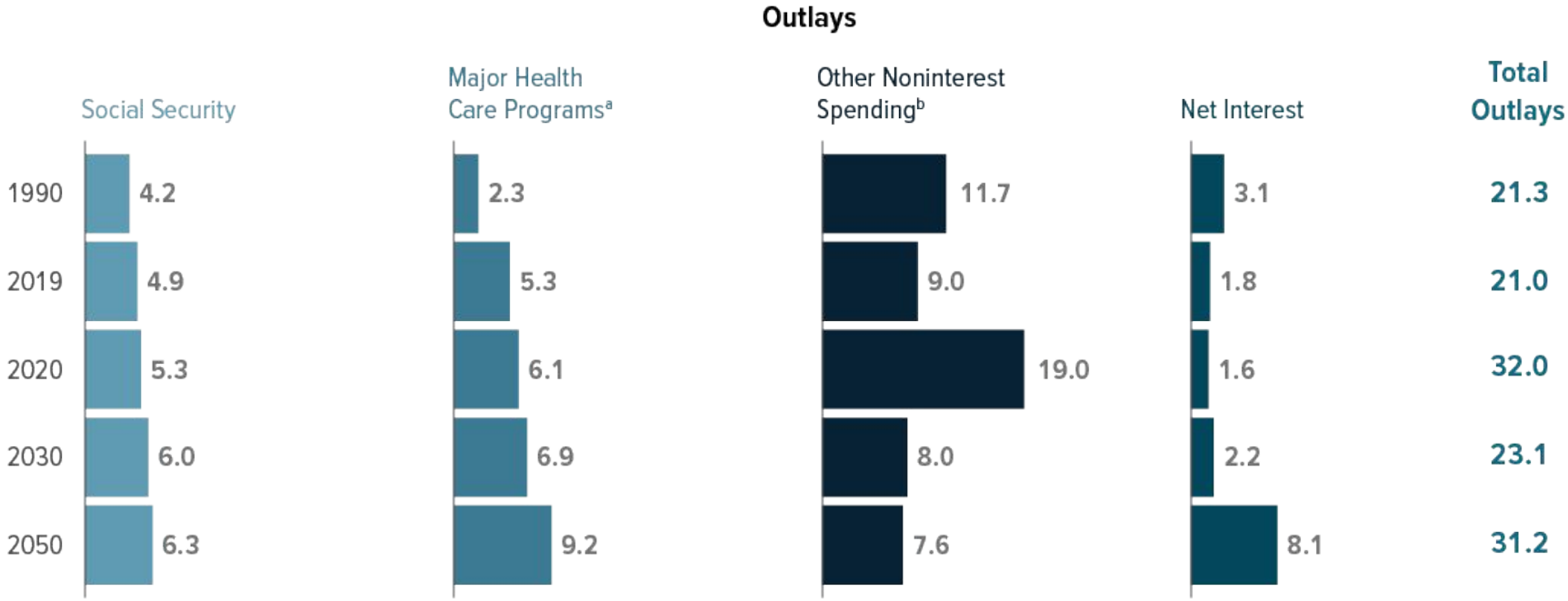
- Govt spending up by 130% (40-46)
    * Taxes 50%, debt 50%
    * Debt to output reached 90%

- Debt to output decreased to 35% in 15 years after war
    * 43% with inflation (negative real rates)
    * 28% growth
    * 22% surpluses

- Debt had real returns of -2%

- Today: If inflation is 2% for 15 years & govt borrows long at 1%
    debt to output could be reduced by 15%





- Government expenditures as % GDP
- Expansion for health care, social security
- Interest payments moderate in 2030, large in 2050, but **highly uncertain**