Fiscal Policy in a low interest rate environment

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A world of low (safe) rates

- Safe real rate, r, has steadily come down, and is now below the growth rate g.
- Maybe not forever, but probably for a while.
- New world? Yes, relative to early 1980s. But not relative to earlier: $r - g = -3\%$ from 1950 to 1979.

- How should we rethink fiscal policy?
  - First, a theoretical detour. What does $r - g < 0$ imply for fiscal policy?
  - Second, how can we improve fiscal policy as a macro policy tool?

Implications of $r - g < 0$

Implications of $r - g < 0$? It depends very much on why (and how long).

- Could reflect dynamic inefficiency: $g > MPK > r$.

  If so, debt sustainable without later primary surplus, and desirable.
  Probably not the case: MPK still high (evidence on hurdle rates)

- Could reflect risk associated with MPK and risk aversion: $MPK > g > r$.

  If so, debt still not sustainable without later primary surplus, and displaces capital

- Could reflect more (and I think it does). Incomplete markets, and safe public debt can help. Or liquidity of public debt.

  If so, debt sustainable without later primary surpluses. But is it desirable?

Implications for fiscal policy. An example

- Suppose $MPK - r$ reflects liquidity premium(maybe size and depth of US T-bill market)
- Think fixed liquidity premium x. so $r = MPK - x < g$. No uncertainty.
- Then, debt is sustainable without later primary surpluses, but displaces private capital if output at potential.
- If no output gap. Clearly debt finance should be used to finance public investment, if public MPK higher than private MPK. (no need for higher taxation, so no tax distortions; but macro opportunity cost)
- If output gap. Clearly debt finance should be used (no distortion, no macro opportunity cost). Need not be public investment.
- Gross and net debt: Should the government be in the intermediation business? Or the central bank? Or both? if so division of labor?

The case for a more activist fiscal policy.

Three separate arguments:

1. Following up on above: Because $r - g < 0$.
   Continuity: Even if $r - g$ eventually turns positive, case weakens but does not disappear.

2. Low neutral r (and low inflation) mean low nominal rates and increase the risk of hitting the zero lower bound.
   This decreases the room for monetary policy.

3. When monetary policy is at the ZLB, fiscal multipliers are larger.
   One of the lessons of the last ten years: multipliers can be large, especially at the ZLB.

How to implement it? Automatic stabilizers

- Automatic stabilizers. Useful, but clearly not designed with that task in mind.
- Semi-automatic stabilizers? (i.e depending on some aggregate statistic). Surprisingly little/no progress.
  - Stabilizers relying primarily on intertemporal substitution: Taylor's Swedish variable investment tax.
  - Stabilizers relying primarily on relaxing liquidity constraints: Variable income tax
  - Stabilizers relying on a combination: Variable VAT rates
  - Some designed for short recessions, others for longer recessions. Depends on the nature of the shock.
  - The difficult issue: Stabilizers stabilize output whether the movement is in the output gap (good) or in potential output (not good).
- Having a list of shovel-ready projects? Lessons from ARRA?

Better institutions? DSAs, and the fiscal golden rule

How to avoid excesses? "Public investment", "costless deficits". Danger already creeping up.

- Stochastic debt sustainability analyses (DSA)

  Allows to assess effects of public investment, structural reforms

  All the pros and cons of dynamic scoring. Uncertainty essential.

  Probability of exceeding some debt or debt service threshold.

- Time to revisit the (fiscal) golden rule? Separating the current and the capital account.

  Balancing the current account over the cycle. Financing the capital account partly by debt.

  Main but major issue. (has failed in the past). How to avoid accounting cheating? Putting items below the line.

Overall conclusion. A new world. New rules, not enough work.