HARVARD UNIVERSITY

A Reconsideration of Fiscal Policy in the Era of Low Interest Rates

Jason Furman & Lawrence Summers

Presentation to the Hutchins Center on Fiscal & Monetary Policy and Peterson Institute for International Economics

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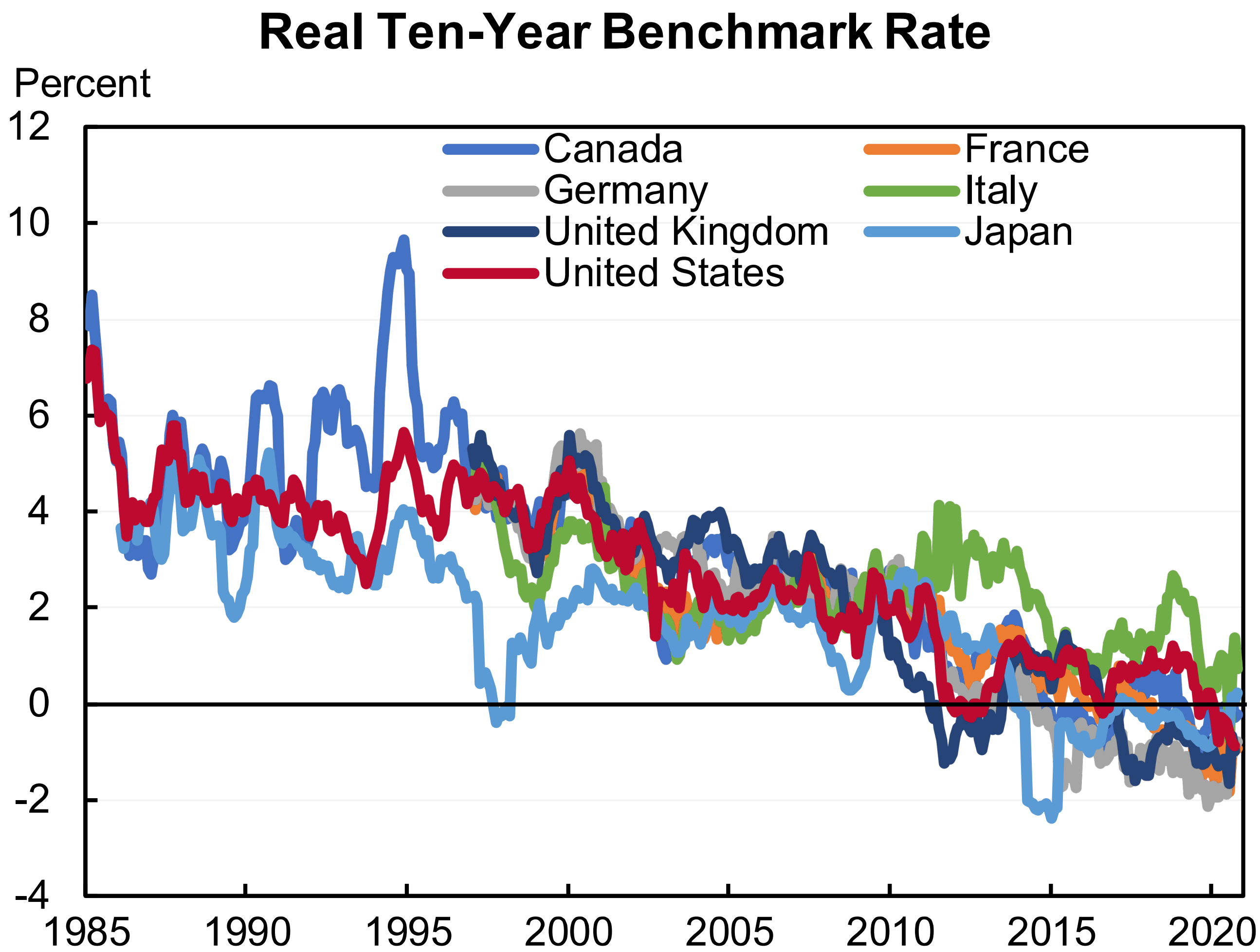
Interest rates are low despite debt being high

U.S. Debt is Much Higher
But Interest Rates Are Much Lower

	2000	2020
Debt-to-GDP (10-year ahead forecast)	6%	109%
Real Interest Rates	4.3%	-0.1%

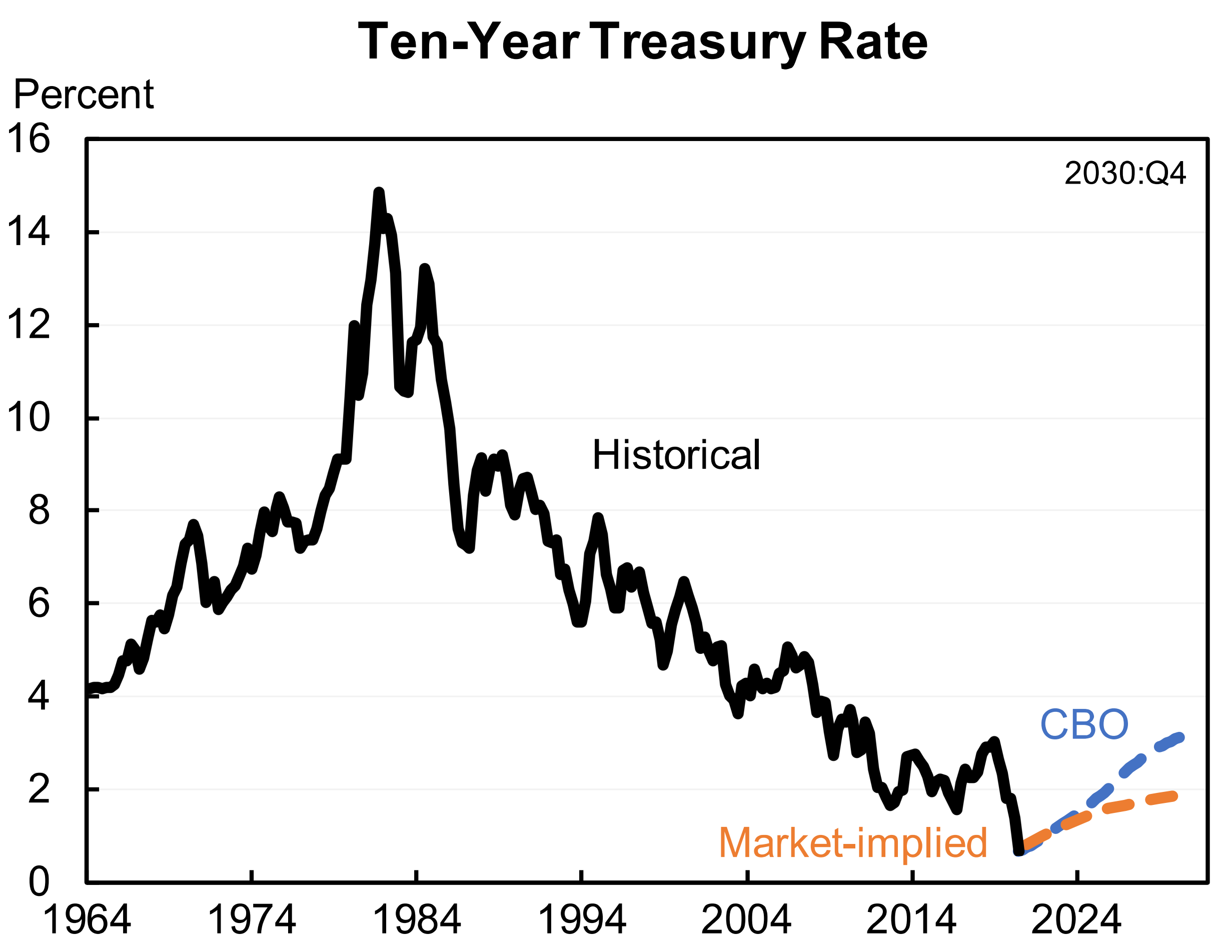
Note: Debt-to-GDP forecast is the CBO 10-year ahead forecast (2030 from June 2019 Alternative Fiscal Scenario for 2020). Real interest rates are based on 10-year Treasury Inflation Protected Securities (TIPS) from January 2000 and February 2020.
Source: Congressional Budget Office; U.S. Department of the Treasury; authors' calculations.

Interest rates have fallen everywhere, starting before the financial crisis and continuing after it



Note: Inflation measured by one-year changes in the core consumer price index (core personal consumption expenditures for United States).
Source: Bank of Canada; Statistics Canada; Eurostat; Japanese Statistics Bureau; U.S. Bureau of Economic Analysis; Macrobond; authors' calculations.

Interest rates are expected to stay low



Note: Dashed lines are projections. Market-implied rates as of November 27, 2020.
Source: Congressional Budget Office; Bloomberg.

Market expectations:

72% probability FFR < 0.25 five years from now

1.4% FFR a decade from now

-0.9% real FFR a decade from now

2% nominal 10-year rate a decade from now

Three challenges posed by low interest rates

1. **Less scope for monetary policy in recessions**
   - Average 630 basis point cut in past recessions

2. **Increased financial stability risks**
   - Increased risk taking
   - Increased fragility for banks

3. **Possibility of demand shortfalls in normal times**
   - Monetary and fiscal policy in 2018-19 looked like the response to a medium-sized recession with the fed funds rate cut to 1.15 percentage point and a 2.6 percent of GDP fiscal expansion.
   - If Bowles-Simpson had passed after 2010 would have been hard to have reasonable growth over the following decade.

Three implications of low interest rates and the opportunities they afford

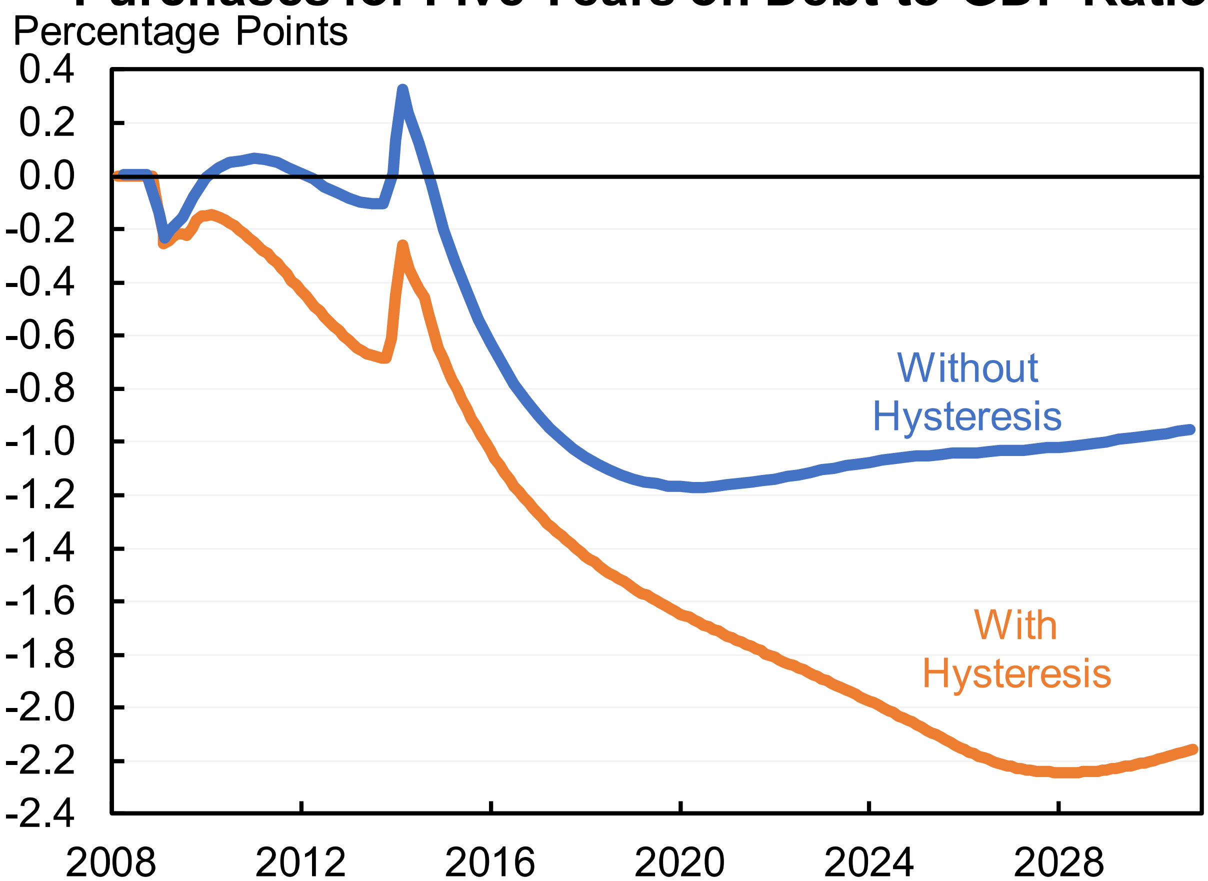
1. Active use of fiscal policy is essential in order to maximize employment and maintain financial stability in the current low interest rate world

2. Lower interest rates necessitate new measures of a country’s fiscal situation

3. The scope and need for public investment has greatly expanded

Implication 1: Countries cannot afford <u>not</u> to undertake fiscal expansions in recessions

Effects of a 1 Percent of GDP Increase in Federal Purchases for Five Years on Debt-to-GDP Ratio



Similar findings in:

IMF modelling (Gaspar, Obstfeld and Sahay 2016)

OECD modelling (2016)

Auerbach and Gorodnichenko (2017)

Works the same way or even more in countries with high debt levels.

Source: Reifschneider and Summers as reported in Ball, DeLong, and Summers (2017).

Other steps that should be taken

1. **Automatic recession insurance**
   - U.S. automatic stabilizers relatively weak
   - Triggers for state assistance, unemployment insurance, nutritional assistance, etc.

2. **Further demand increases in a budget neutral manner**
   - Balanced budget multiplier
   - More progressive fiscal policy
   - Expanded social insurance

Implication 2: Lower interest rates necessitate new measures of a country's fiscal situation

$$\frac{\text{Debt}}{\text{GDP}}$$

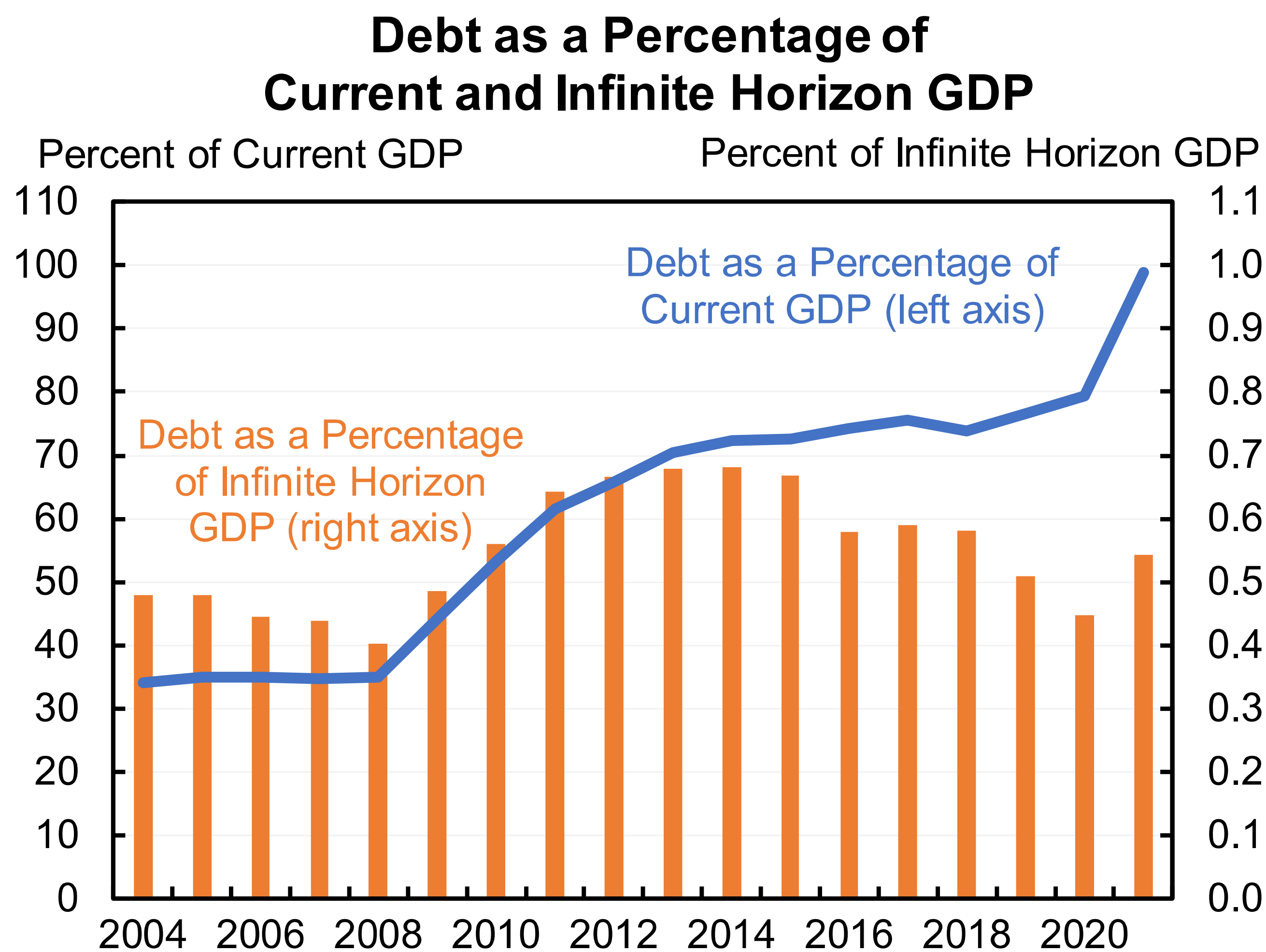
Stock

Backward looking

Flow

NPV of U.S. GDP is \$3.9 quadrillion (SS Trustees) or ∞ (if $r<g$).

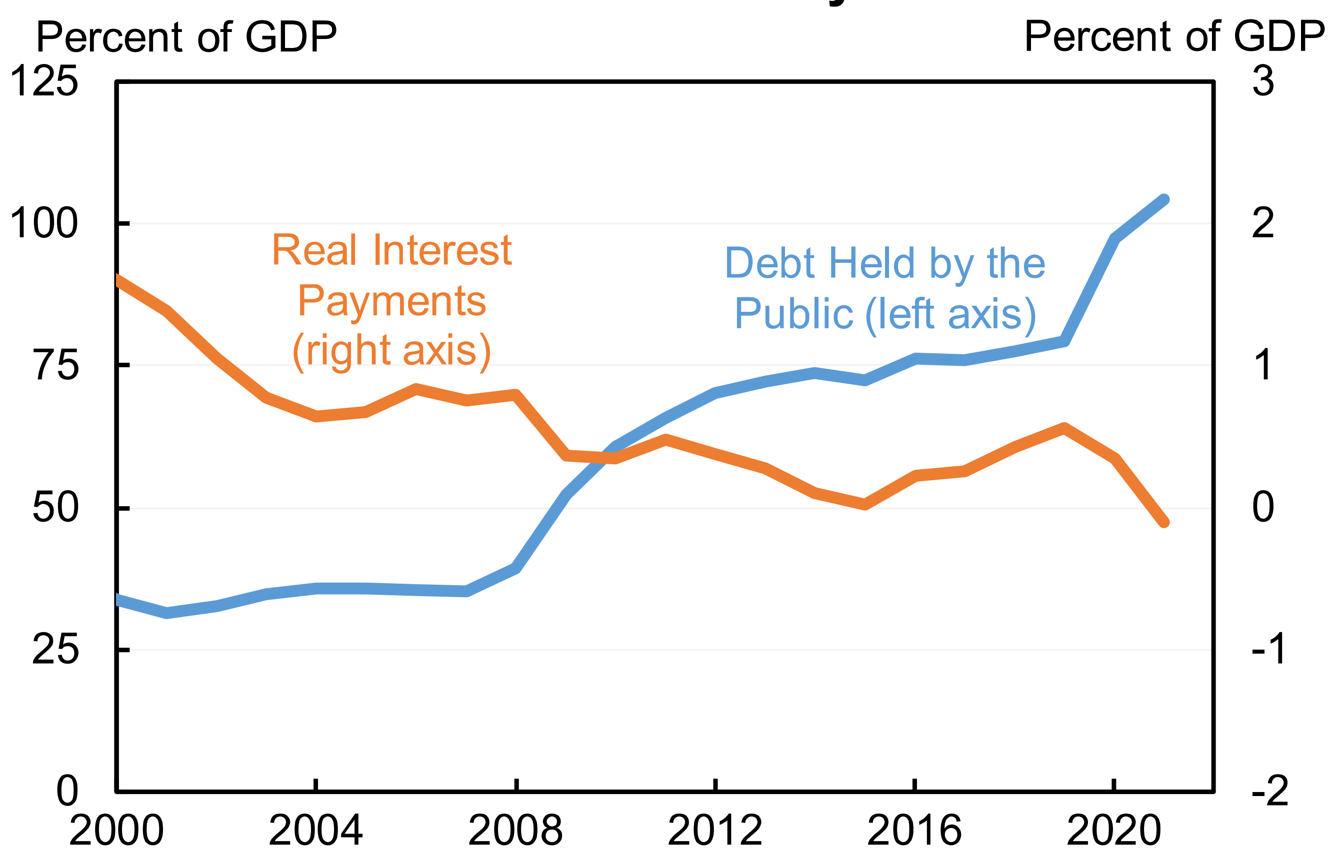
Stock-stock: debt stable relative to future GDP even while tripling relative to present GDP



Note: 2021 value is based on debt as of November 19, 2020.
Source: The Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds; Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters; Department of the Treasury; Macrobond; authors' calculations.

Flow-flow: real debt service has fallen even while debt has increased

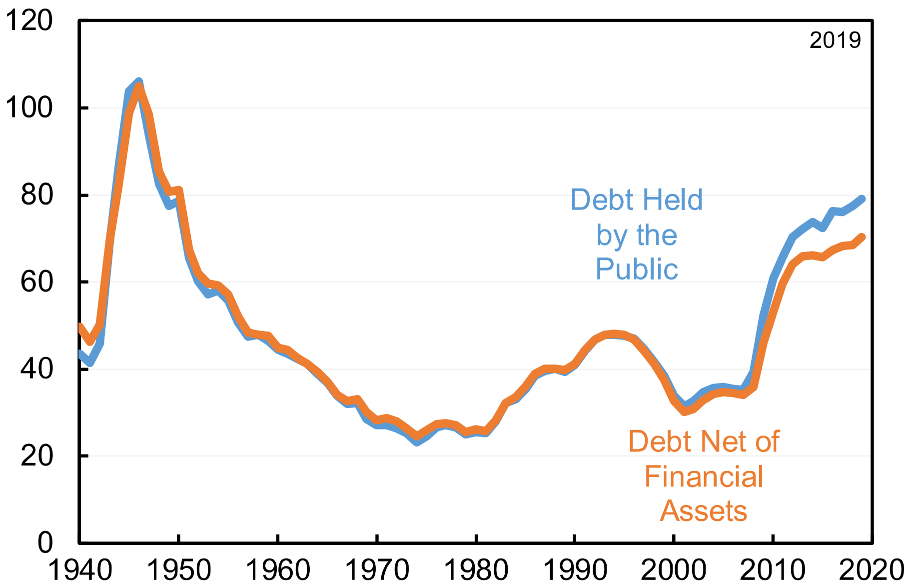
U.S. Federal Debt Held by the Public and Real Net Interest Payments



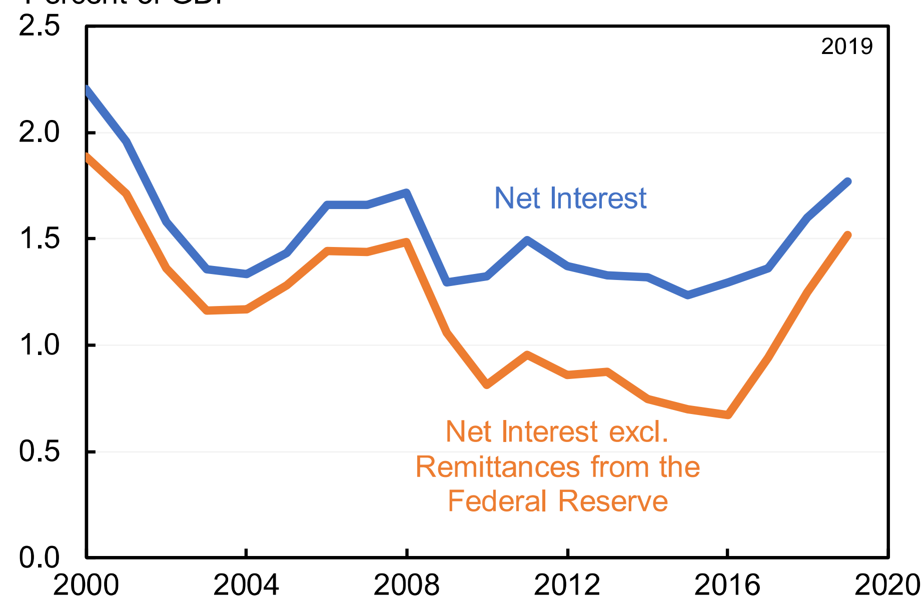
Note: 2021 values are projections.
Source: Office of Management and Budget; Congressional Budget Office; Macrobond; authors' calculations.

Technical aside: should exclude financial assets from debt & Federal Reserve remittances from interest

Debt Held by the Public and
Debt Net of Financial Assets

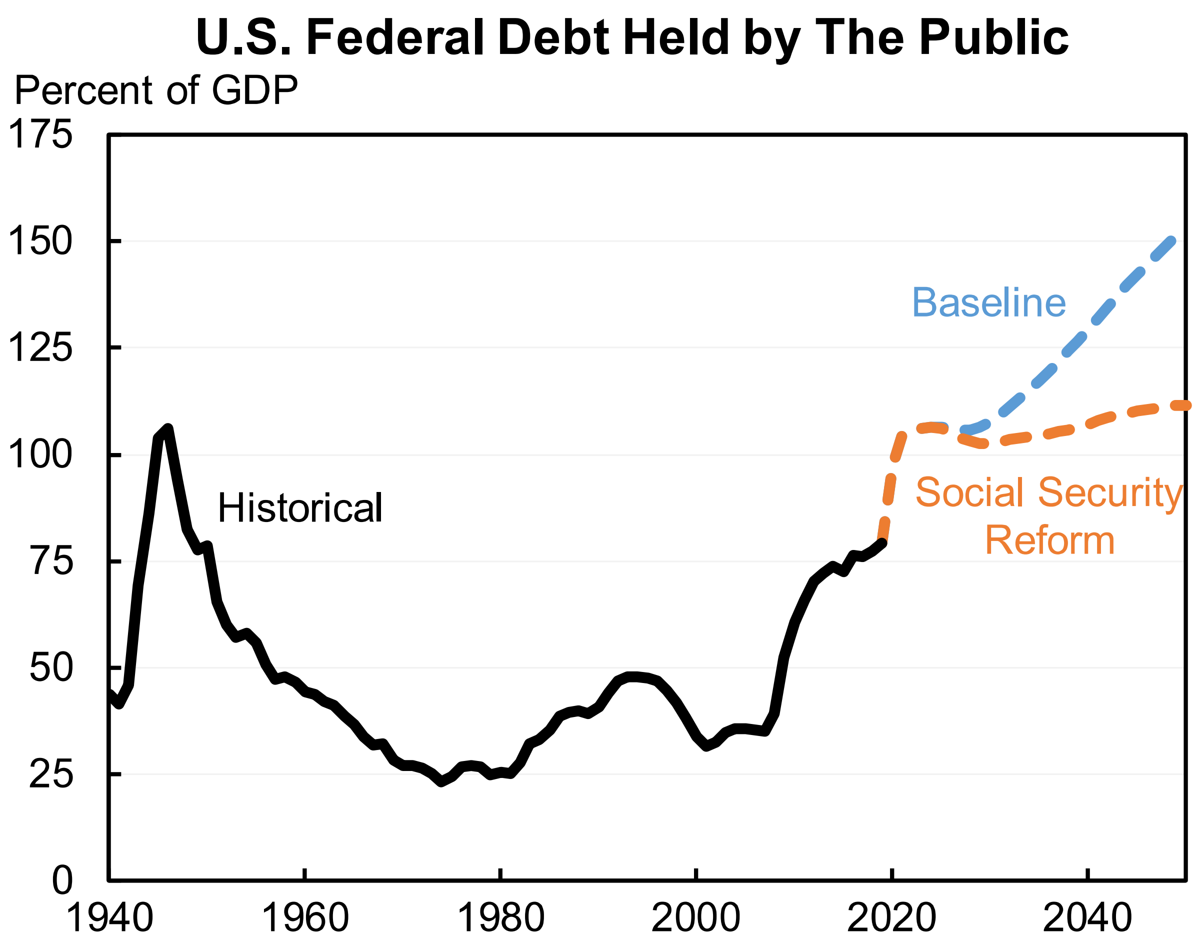


Net Interest Payments as a Percentage of GDP



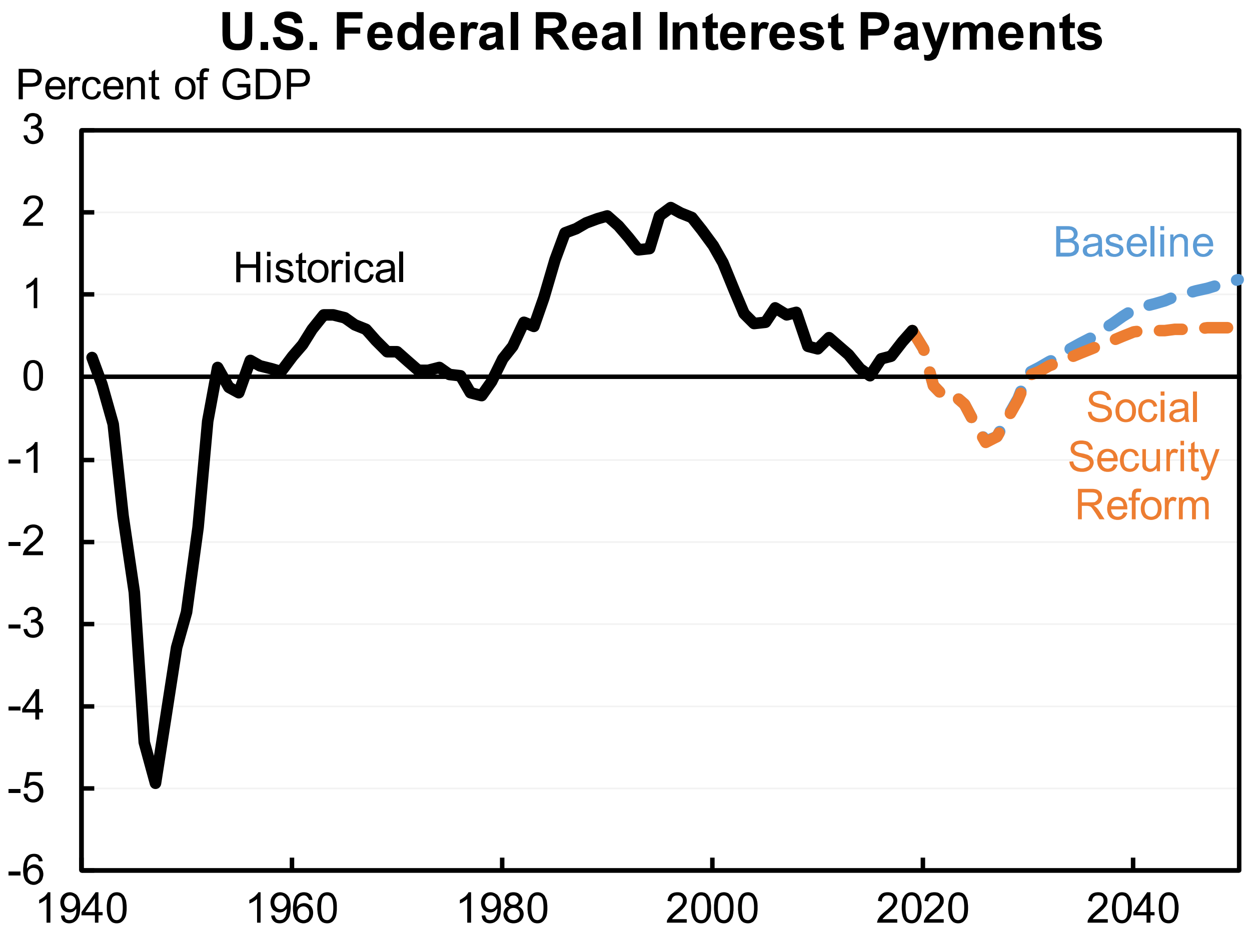
Source: Office of Management and Budget; Richard Kogan's calculations; authors' calculations.

Looking forward: debt projected to be stable over the next decade & beyond if Social Security reformed



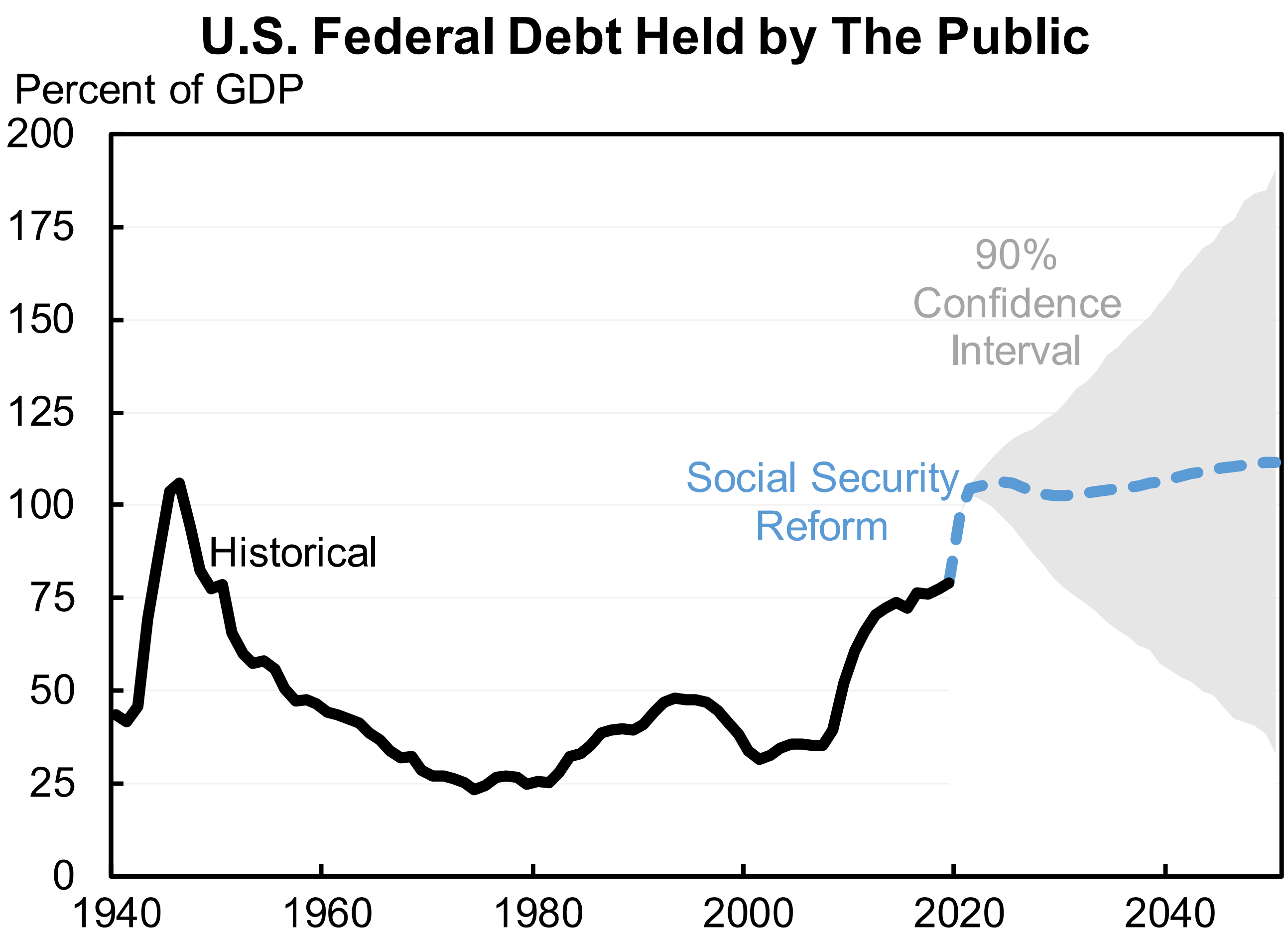
Note: Social Security reform phased in linearly from 0.5% of GDP to 1.7% of GDP over 10 years beginning in 2025.
Source: Office of Management and Budget; Congressional Budget Office; Macrobond; authors' calculations.

The more relevant metric of real debt service expected to stay low relative to the economy



Note: Social Security reform phased in linearly from 0.5% of GDP to 1.7% of GDP over 10 years beginning in 2025.
Source: Office of Management and Budget; Congressional Budget Office; Macrobond; authors' calculations.

Thirty-year ahead budget forecasts are incredibly uncertain



Note: Social Security reform phased in linearly from 0.5% of GDP to 1.7% of GDP over 10 years beginning in 2025
Source: Office of Management and Budget; Congressional Budget Office; Macrobond; authors' calculations.

Implication 3: The scope and need for public investment has greatly expanded

Blanchard (2019) argues that $r - g$ being negative should change how we think about intergenerational fiscal policy.

- **Demand perspective:** Fiscal expansions in recessions may improve debt-to-GDP ratio

- **Supply perspective:** At low interest rates more public investments pay for themselves:
  - Children (Hendren and Sprung-Keyser 2020)
  - Infrastructure
  - Research and development

Going forward we need a fiscal framework that is a combination of:

- Optimal
- Understandable
- Achievable

New objectives, guideposts and guidelines

Context: Interest rates are dangerously low, debt is projected to be stable, real debt service is projected to be low. More fiscal expansion needed.

Objective: Growth and financial stability including the avoidance of recessions and stronger long-term growth.

New guidepost: Real interest payments should not be rising sharply or projected to exceed around 2 percent of GDP over the next decade.

Guidelines:
1. Temporary emergencies should not be paid for, broad definition
2. Long-term programs should be paid for, broad exceptions
3. Improve composition of government to support demand and efficiency

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