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Low Interest Rates and Public Borrowing

The fiscal rules of the euro area are being questioned with renewed force. The desirability of limits on deficits and debt has always been discussed, but remained for a long time 'academic' in that it was generally recognised that high debt were dangerous. With ultra-low interest rates in almost all euro area countries, this argument no longer seems valid.

The 2019 presidential address to the American Economic Association by Olivier Blanchard has given the debate about the desirability of higher public debt a thorough framework.[1] His message, that public debt can improve welfare, results mainly from standard vintage 1960 models with so-called 'overlapping generations' (OLG). One key message of these models is that under certain conditions, the working-age generation could accumulate too much capital to maintain their consumption in retirement. Too much is defined as a situation in which the return on capital falls below the growth rate. In this case, the government can make everyone better off by issuing more debt. Whether or not public debt improves welfare thus hinges on the difference between the rate of return on capital versus the growth rate.

Blanchard shows that the interest rate cost on public debt has usually been below the growth rate of nominal GDP. From this observation, he concludes that higher debt might be desirable, even, or rather particularly, because it crowds out investment. The key issue of this approach is that the private sector is saving too much. The purpose of deficits is not to increase employment, but rather to induce households to save less for their retirement. Public sector deficits constitute one way to reduce savings. But there are other ways to achieve this goal, for example, by simply offering the elderly a higher pension. The standard OLG model implies that if the public sector guarantees the retired an income that is equal to what they have while working, investment would not go beyond the point at which the return to capital falls below the growth rate.

1 O. Blanchard: Public Debt and Low Interest Rates, Presidential Address at the American Economic Association annual meeting, 4 January 2019, available at https://www.aeaweb.org/webcasts/2019/aea-presidential-address-public-debt-and-low-interest-rates.

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In reality, there exists an implicit 'pension guarantee' in most advanced countries as public pensions systems have contributed to consumption levels among the elderly which are at least comparable to that of the younger generations. Increasing public debt under these circumstances would reduce, not increase, welfare. Whether or not higher public debt is warranted remains thus very much an empirical question.

The contribution by Carl Christian von Weizsäcker attempts to provide an answer by looking at a different variable, namely the private wealth accumulated by the private sector.[2] He observes that the 'waiting period', which separates the working period to the time of retirement, increases with ageing. The private sector needs to accumulate wealth to be able to bridge this waiting period and thus finance the retirement period. When this waiting period increases due to ageing, the private sector needs more assets. These assets could be either public debt or real capital. However, it becomes more and more inefficient to bridge a longer waiting period with capital. This implies that ageing might induce over-investment unless the government steps in and provides the private sector with another asset, namely public debt. Von Weizsäcker observes that already today, with massive amounts of public debt in the hands of the private sector, the real interest rate is zero. This suggests that there must already be too much investment.

He then goes on to argue that countries in which the government does not provide enough public debt (e.g. Germany) are likely to run a persistent current account surplus, whereas those with high public debt are likely to run deficits. These persistent current account imbalances can lead to tensions and protectionism.

Another approach arguing for higher deficits starts with the observation that inflation remains very subdued globally, in particular in the euro area and Japan. This persistence of low inflation can lead to a key conclusion: Most economists concur that there is a reliable relation-

2 C.C. von Weizsäcker: Capital Abundance and Its Consequenes for Trade Policy, in: Intereconomics, Vol. 54, No. 5, 2019, pp. 275-279, available at https://archive.intereconomics.eu/year/2019/5/capital-abundance-and-its-consequences-for-trade-policy/.

ship between inflation and unemployment, or in general, under-employment of resources, which is also called the Phillips curve.

If this Phillips curve works, one can take the endurance of low inflation as a sign of a persistent output gap. In this view, emphasised by Ángel Ubide in his contribution,[3] fiscal policy should be expansionary as long as interest rates are at zero and inflation is below the generally accepted target of two percent. Monetary policy should of course also remain accommodative, but it is increasingly limited in its effectiveness as the policy rates set by central banks have reached a lower bound and further asset purchases lose much of their impact as even longer-term interest rates have little room to go down further.

These two strands of the argument for deficit spending have thus very different roots. In the OLG models, there is no unemployment or other economic slack. The only purpose of deficits is to reduce private savings. By contrast, in the 'low inflation means economic slack' approach, the problem is not private savings but rather the existence of unemployment. Public sector deficits still serve to encourage households to spend more, but the key aim is to increase overall demand, not to reduce savings. Many of those who argue for higher deficits along these lines stress that deficits should finance additional public investment rather than current expenditure. This seems to go in the opposite direction to the OLG models, in which the purpose of deficits is to reduce saving and investment. The only way to reconcile these two approaches is to focus on public sector investment, especially infrastructure, as different from private investment. The argument is usually that infrastructure investment has been neglected in the past and that additional infrastructure would increase the productivity of private investment, thereby helping to solve the over-investment problem. This is the line taken by Ubide, who argues for the introduction of a so called 'Golden Rule', under which deficits would be permitted to finance investment (presumably net investment).

One of the key arguments against continuing fiscal deficits is that the accumulation of high debt levels can lead to re-financing problems for the government. The contribution by Paul De Grauwe and Yuemei Ji investigates the sustainability of the government debt using a behavioural macroeconomic model which incorporates 'animal spirits'.[4] They find that with interest rates much below the growth rate of the economy, concerns about sustainability should be strongly reduced. They thus conclude that an active use of fiscal policy should under most circumstances lead to a more stable growth rate and that "a significant number of eurozone countries...could engage in a fiscal stimulus of three percent or more of their GDP".[5]

The experience of Japan provides an important example of the proposition that fiscal policy should be used more actively at low inflation. Japan is usually seen in a situation to be avoided because it has supposedly lost two decades. This is also done in the contribution by Yoshiyasu Ono entitled "Japanese Economy: Two Lost Decades and How Many More?".[6] The argument that these decades were lost is based on the observation that full employment has only been reached because non-regular employees constitute a growing proportion of the workforce.

The Japanese government has run a large fiscal deficit for over two decades, including years with very high infrastructure spending. However, these decades are still considered lost. How can these two sides of the Japanese experience be reconciled? Apparently even massive infrastructure spending during the 1990s did not do much to increase the trend growth rate. It is, of course, possible that without this massive deficit spending the economic performance of the country would have been even worse. But this is a hypothesis that is nearly impossible to prove, or disprove. The Japanese experience thus remains difficult to interpret.

The contributions to this Forum summarise different strands of arguments for higher deficits or debt under current circumstances. None of these contributions argues that higher deficits and debt are always desirable – the message is usually narrower, namely that today's conditions of ultra-low interest rates and the absence of inflation might create the conditions under which higher deficits should be acceptable. This is an important contribution to a debate that is far from being over.

3 Á. Ubide: Fiscal Policy at the Zero Lower Bound, in: Intereconomics, Vol. 54, No. 5, 2019, pp. 279-285, available at https://archive.intereconomics.eu/year/2019/5/fiscal-policy-at-the-zero-lower-bound/.

4 P. De Grauwe, Y. Ji: Time to Change Budgetary Priorities in the Eurozone, in: Intereconomics, Vol. 54, No. 5, 2019, pp. 285-290, available at https://archive.intereconomics.eu/year/2019/5/time-to-change-budgetary-priorities-in-the-eurozone/.

5 Ibid., p. 290.

6 Y. Ono: Japanese Economy: Two Lost Decades and How Many More?, in: Intereconomics, Vol. 54, No. 5, 2019, pp. 291-296, available at https://archive.intereconomics.eu/year/2019/5/japanese-economy-two-lost-decades-and-how-many-more/.