

Fiscal Policy and Budget Deficits Following the Pandemic

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The World Bank

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Reducing Debt: The Menu

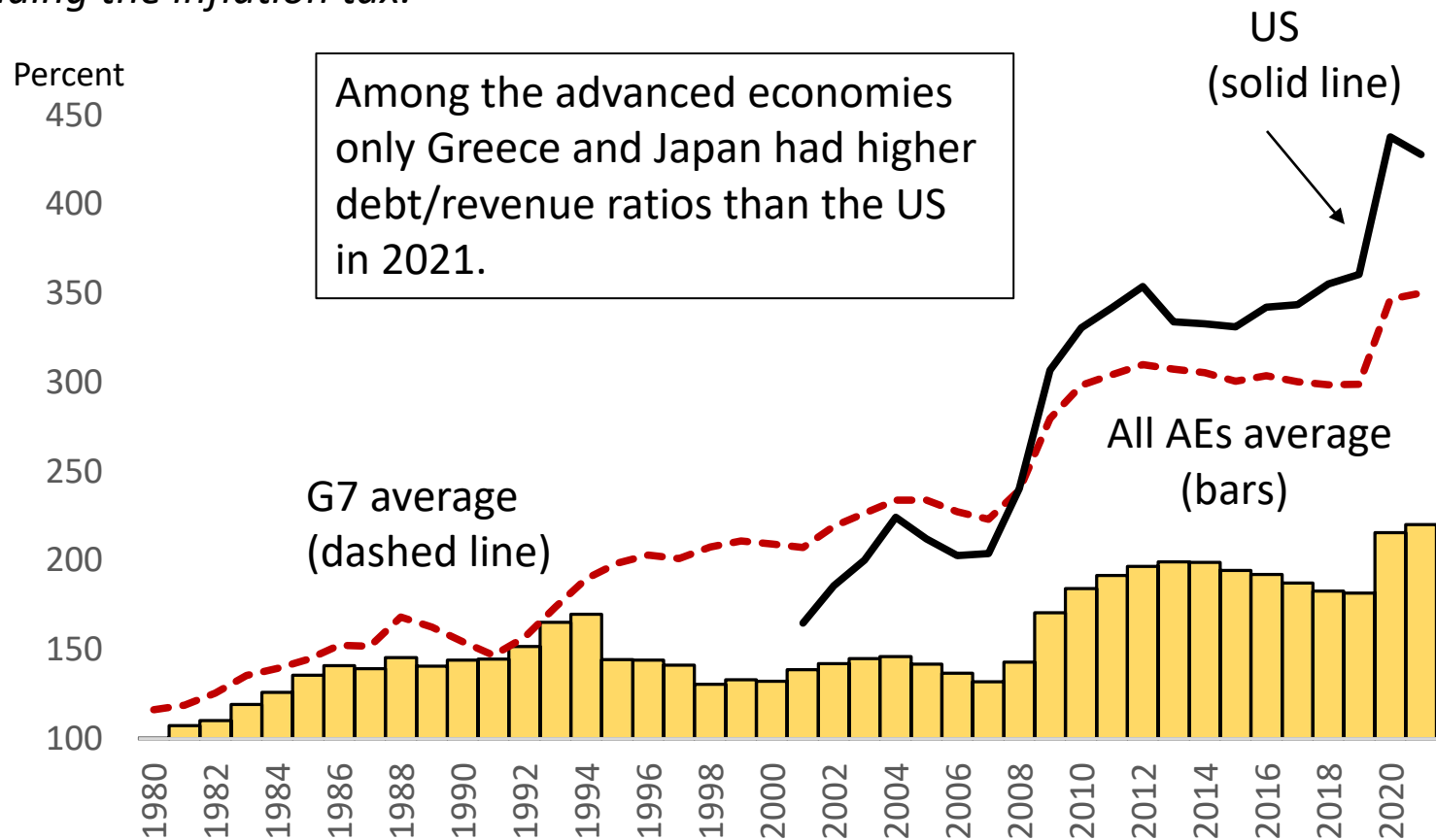
Debt/GDP ratios have been reduced by:

- (i) economic growth;
- (ii) fiscal adjustment/austerity;
- (iii) explicit default or restructuring;
- (iv) a sudden surprise burst in inflation; and
- (v) a steady dosage of financial repression that is accompanied by an equally steady dosage of inflation.

Note: *Options (iv) and (v) are only viable for domestic-currency debts.*

General government debt/revenue: Advanced economies, 1980-2021 (33 countries)

Given the downward rigidities of government spending in the US, it is difficult to envision scenarios that do not involve higher taxes, including the inflation tax.



Salient features of monetary since the Global Financial Crisis (GFC) of 2008-2009

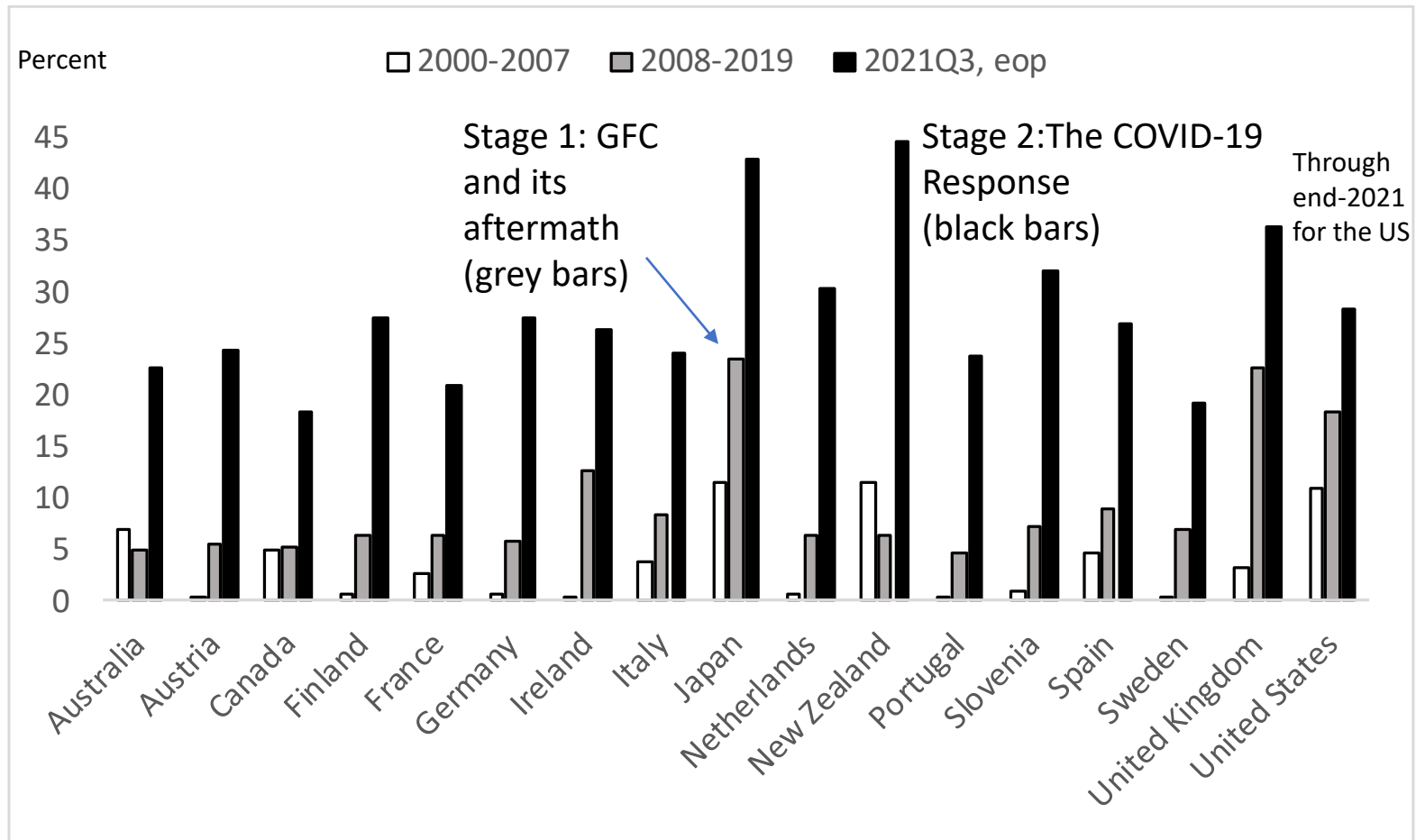
- The two instruments of monetary policy (the central bank balance sheet and the policy interest rate) have followed a **two-step ratchet** since the GFC (see next 3 figures and Reinhart, 2022).
- Under the umbrella of Quantitative Easing (QE), massive (a record, by peacetime standards during the GFC) purchases of government debt (or government-guaranteed) by the Fed and other advanced economy central banks. In the older literature, this is known as **monetization**.
- Central Bank balance sheets, began to shrink back to their pre-GFC levels. Then COVID-19 erupted, and central bank purchases of government debt skyrocketed from their already large base to levels only seen during major wars.

Salient features of monetary since the Global Financial Crisis (GFC) of 2008-2009

- Another prevalent feature during 2008-2021 is sustained negative short-term real interest rates (nominal interest rate minus inflation) in the United States and other advanced economies. In much of Europe and Japan, nominal interest rates have also been negative during this period.
- Policy interest rates, nominal and real, ratcheted to new lows also in two steps.
- In effect, 2008-2021 is the longest spell of negative real interest rates in a global financial center since the start of our data in 1790 (see table that follows next 3 figures).

The two-step ratchet and the expanding role of central banks in advanced economies, 2000-2021

Central bank holdings of government debt as a % of outstanding debt stock

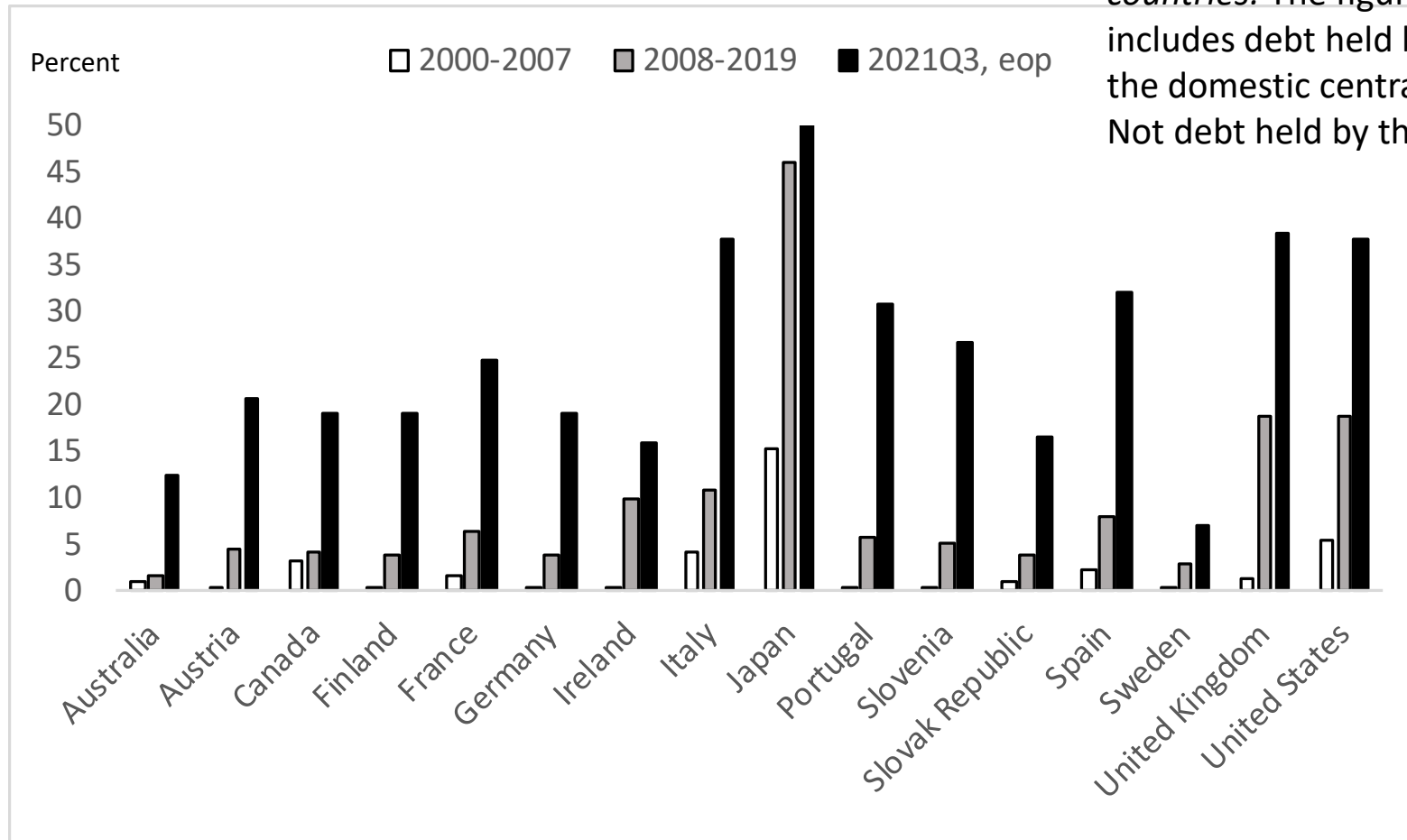


Note: GSE debt is included in the US totals.

Sources: Arslanalp and Tsuda (2014), Board of Governors of the Federal Reserve, and Reinhart (2022).

Central bank holdings of government debt as a % of GDP, 2000-2021 displays the same **two-step upward ratchet**.

Note on Eurozone countries: The figure only includes debt held by the domestic central banks Not debt held by the ECB.

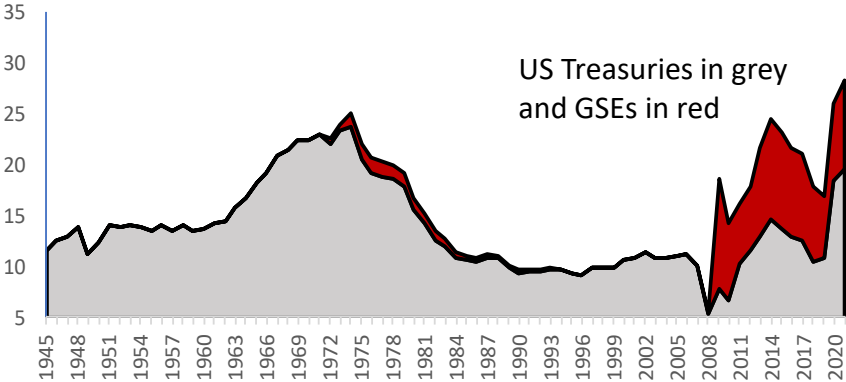


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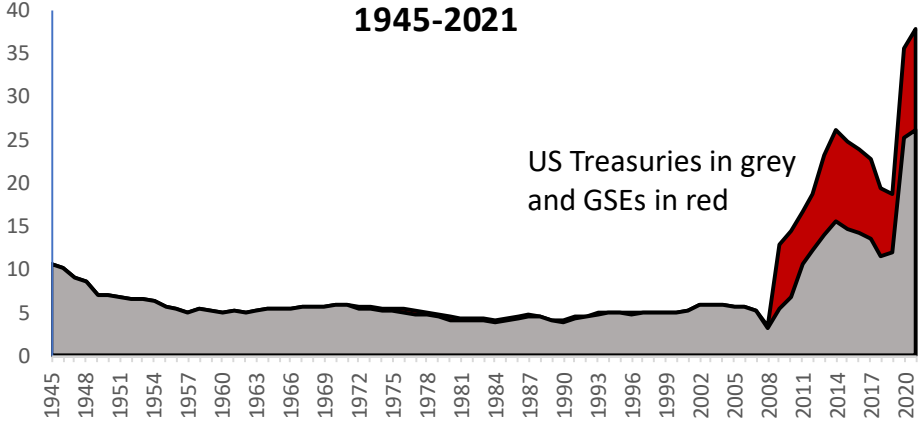
Sources: Arslanalp and Tsuda (2014), Board of Governors of the Federal Reserve, and Reinhart (2022).

While the list of explanations for the exceptionally low interest rates that have prevailed for more than a decade is long and varied, the obvious explanation that advanced economy central banks have gone to great lengths to keep them there remains underappreciated. A benign inflation outcome facilitated sustained monetary accommodation and deficit financing.

US Marketable Treasury Securities and GSEs held by the Federal Reserve as a % of outstanding: 1945-2021



US Marketable Treasury Securities and GSEs held by the Federal Reserve as a % of GDP: 1945-2021



Note: GSE debt is included in the US totals.

Sources: Arslanalp and Tsuda (2014), Board of Governors of the Federal Reserve, and Reinhart (2022).

Historical negative short-term real interest rate spells in global financial centers: UK, 1870-1918 and US, 1919-2021 (Real ex-post rates are at historical lows on a sustained basis)

Negative real rate spell	Average annual US inflation	Major shocks
1916-1920	14.7	WWI
1941-1948	7.1	WWII
1974-1980	9.3	OPEC oil shock
2008-2021	1.9	GFC and COVID-19

Exit from the previous negative interest rate spell called for a draconian policy from the Federal Reserve.
What will this exit look like?

Sources: Bank of England, Board of Governors of the Federal Reserve, FRED, and Nickols, Reinhart, Reinhart, and Trebesch (2016 and 2022).

Some of the consequences of protracted negative (or very low) real interest rates:

- Encourages over-borrowing by both the government and private sector. At a sufficiently negative real interest rate, the $r - g$ calculus is bound to raise the perceived debt carrying capacity.
- Fuels risk taking in the search for yield.
- While (other things equal) negative/low rates improves the government's balance sheet, it may create or aggravate existing off-balance sheet losses. Pension fund solvency (including those of local governments) benefit from high rates of return.
- Negative real rates are not a substitute for fiscal discipline or reforms if these are needed. In effect, it may facilitate delay.
- For very high debt cases (Italy and Greece), low/negative rates are not a substitute for debt restructuring, which can (at least in principle) deliver faster and larger debt reduction.

The exit from sustained negative real interest rates is complicated if central bank independence is eroded--not necessarily *de jure*, but very possibly *de facto*. It fuels *The Debt Loop*

If a protracted period of low (negative) interest rates encourages risk taking and leverage (public and private), do financial stability/balance sheet concerns tilt policy toward continued accommodation?

If a protracted period of low (negative) interest rates fuels asset price bubbles, do fears of a market crash tilt policy toward continued accommodation?

At high levels of government debt, are central banks under greater political pressure to maintain an accommodative stance, as was the case during the aftermath of WWII?

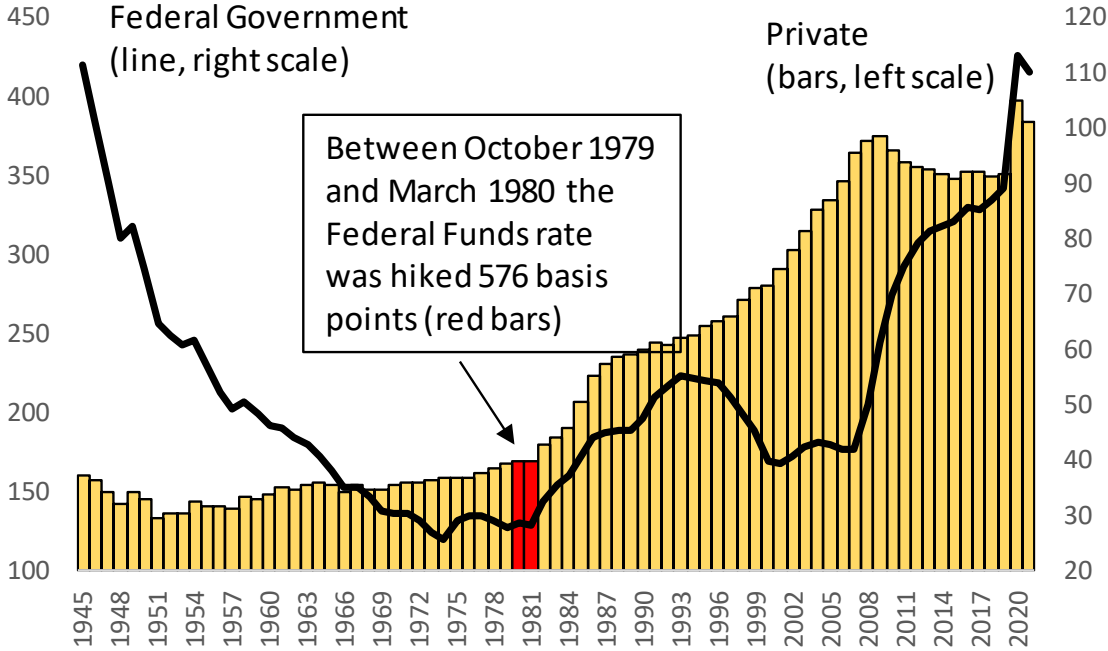
If there are concerns about potential sovereign insolvencies (an issue for the ECB) do such concerns tilt the bias of toward accommodation?

Does not some combination of the above introduce (reinforce) an asymmetry between easing and tightening?

During the past 15 years or so, it has been easier for the major central banks to ease than to exit. It took some years of sustained high inflation last episode in the 1970s.

The early 1980s marked a turning point for central bank independence among the advanced economies. Was it a coincidence that by then large WWII debts had been paid down or eroded by inflation? Was the increased focus on price stability facilitated by fewer concerns about financial stability, in light of the moderate levels of private debt?

Private and Federal Government Debt: United States, 1945-2021
(percent of GDP)



Sources: Board of Governors of the Federal Reserve, Flow of Funds and FRED.

Final thoughts

- While a modest tightening (by historical standards) is poised to unfold in 2022, at least in the US, it is unlikely that it will be sufficient to roll back inflation. As Reinhart and Rogoff (2013) highlight, much of the inflation persistence of the 1970s owed to the Federal Reserve's tendency to do too little too late until Paul Volcker's arrival.
- Delays in tackling inflation in the US during the 1970s ended up requiring draconian measures that ushered in one of the deepest postwar recessions in the US and the developing country debt crisis of the 1980s.
- Delays will stretch out ***The Debt Loop.***