Relaxing fiscal discipline: A response to Blanchard and Ubide

Charles Wyplosz
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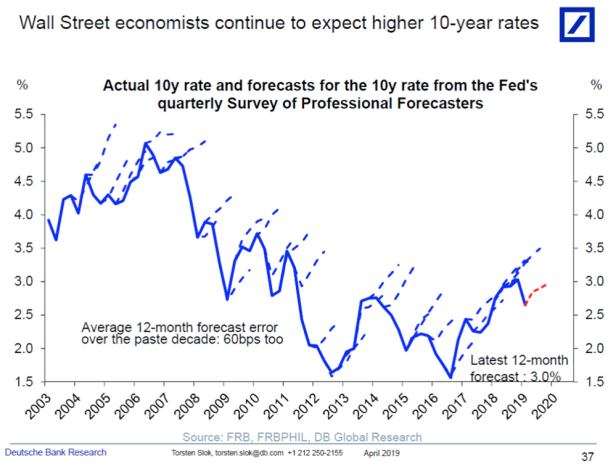
I have previously criticized Blanchard's arguments in favor of "a more relaxed attitude on public debts". In a response, Blanchard and Ubide (2019) claim that their critics are wrong. (I did not criticize Ubide's VoxEU column, in fact I totally agree with him.) They offer two arguments.

The first one is that the interest rates will remain low, in the US and other developed countries. The basis for this assertion is implicitly the secular stagnation hypothesis and explicitly current long-run expectations. They heavily rely on market expectations. Unfortunately, the track record of market expectations is poor, especially for long-run interest rates, as illustrated in the figure below from DB Research. That in the past, the markets have overestimated future interest rates by a wide margin, does not imply that they cannot underestimate them in the different data used by Blanchard. It certainly means that information about long-term expectations extracted from market prices is unreliable. In addition, what matters is the difference between the interest rate and the growth rate. Growth forecasters usually focus on the real GDP, so we need to assess how good are the markets at predicting inflation. The same market-based methods to infer expected long-run interest rates can be used to obtain inflation estimates. In a recent comparison of various estimates, Coibion et al. (2018, p.1475) conclude that "professional forecasters, financial markets, and the staff of the Federal Reserve had larger absolute mean forecast errors and under-predicted inflation" than consumers survey. It is surprising that Blanchard and Ubide put so much confidence in market-based forecasts, implicitly accepting that their argument rests on such a week reef.



Nor is history on their side. As many proponents of the secular stagnation hypothesis, they focus on the evolution of interest rates after the early 1980s a period when indeed nominal interest rates exhibit a declining trend. Unfortunately, the early 1980s is when interest rates peaked after having risen for about one decade, in the US and in many other countries. This evolution reflects the evolution of inflation and the monetary policy adoption of interest

targeting. A study of secular trends require a much longer observation period. Hamilton et al. (2016) have produced careful historical estimates of the real interest rates, going back one century and more. Their conclusion: "we are skeptical of the secular stagnation view that the equilibrium rate will remain near zero for many years to come".

Presumably, they have in mind the evolution of the equilibrium (or natural) real interest rate (r^*) that drives the Taylor rule. Estimates of r^* are highly imprecise, however, so much so that Laubach and Williams (2016), the lead players in this line of research, write: "uncertainty about the natural rate of interest argues in favor of policy approaches that deemphasize the role of the natural rate in policy decisions and therefore make these decisions more robust to potentially mismeasured natural rates". I agree. We need a warning.

In fact, the other argument of Blanchard and Ubide deals with the way policy should address uncertainty about the future course of interest rates. They write: "if we turn out to be wrong and interest rates sharply increase without a simultaneous increase in growth, then the strategy should, of course, be reassessed again, just as we argue for a reassessment today". In other words, it is worth taking a risk to avoid fiscal policy austerity that hurts growth (permanently?). The risk is that fiscal policies become too lax. In the best case, this will leave future generations with a heavy burden, in the worst case it will result in highly disruptive debt crises. The critics who argue that fiscal policy should be used countercyclically but carefully are not necessarily wrong, as asserted, they weigh risks differently. They call for being careful because they worry that governments are biased towards running unwarranted deficits, a well-documented tendency. Blanchard and Ubide admit that much when they write that "we are indeed giving governments arguments to be more relaxed about debt, and, yes, we might encourage some to go too far, which would be bad.". Too bad indeed.

References

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