

Fiscal policy after 2020

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Abstract

The pandemic packages, the inflation that followed, interest bills rising on high debt, and the questions the decade leaves open for r minus g , rules and central bank independence.

The pandemic produced the largest peacetime fiscal expansion in the advanced economies, followed within a year by the largest inflation in forty years and, within two, by the fastest tightening. Every lesson of this course was tested at once. This last lesson reads the episode through them and lists what remains open.

The expansion

Discretionary fiscal support in 2020 and 2021 reached roughly a quarter of GDP in the United States and between 10 and 20 percent in most of Europe, through transfers to households, wage subsidies, loan guarantees and grants to firms. Debt ratios rose by 15 to 25 points in a year. In the arithmetic of The government budget constraint and debt dynamics this was financed almost entirely at $r < g$: nominal rates near zero and, from 2021, nominal growth above 8 percent from the combination of recovery and inflation. By 2023 debt ratios in most countries were back near or below their 2020 peak despite continued primary deficits, the snowball effect running in reverse.

The inflation

The size of the US package relative to the output gap became the central dispute of 2021. The demand-side reading, argued by Summers and Blanchard before the fact, was that transfers of that size into an economy with constrained supply would produce inflation; the monetary-fiscal reading of Monetary and fiscal interaction adds that transfers perceived as unfunded raise the price level directly (Bianchi et al., 2023). The supply-side reading points to energy and shipping shocks that hit Europe, with smaller packages, at least as hard. The evidence supports a mixture with different weights across countries: the US inflation had a larger demand component, the European one a larger energy component, and the persistence in both had a fiscal element that the multipliers of Fiscal multipliers at the lower bound would have predicted.

The interest bill

The tightening of 2022 and 2023 ended the free lunch. With policy rates at 4 to 5 percent, net interest payments in the United States rose above 3 percent of GDP in 2024, exceeding defence spending, and the Congressional Budget Office projects them to keep rising. Two features of the previous decade made the bill respond quickly: the shortening of effective maturity by central bank purchases, discussed in the previous course, and the reliance of some treasuries on short bills. Blanchard's 2023 reassessment keeps the conclusion that debt is not the emergency it was made out to be, but drops the assumption that $r < g$ is permanent: the safe rate is a variable, and a fiscal plan must be robust to its rising (Blanchard, 2023).

Definition 1 (Gross financing need). The amount a government must borrow in a year: the deficit plus the debt maturing that year. It measures exposure to a change in market conditions better than the debt ratio does, since a country with long maturities can wait out a high-rate episode and a country with short ones cannot.

Rules and independence

The escape clauses of Fiscal rules and the Swiss debt brake were used everywhere and, in Switzerland and the European Union, the return paths were followed or renegotiated rather than abandoned. The harder question is the one Sargent and Wallace asked: when debt is high and the central bank raises rates, does the public believe that the treasury will adjust? The 2022 gilt episode in the United Kingdom, in which an unfunded tax cut announcement produced a bond sell-off severe enough to require central bank intervention within days, showed that the answer can change within a week, and that the market enforces fiscal backing faster than any rule.

Open questions

- Is $r < g$ the normal state of a safe-asset economy, or a thirty-year episode that ended in 2022? The answer sets the required primary balance for every country.
- Should fiscal rules exempt public investment, as the debates on the Swiss debt brake and the EU expenditure paths propose, and can “investment” be defined tightly enough to prevent relabelling?
- How should the consolidated government manage the maturity of its debt when the central bank’s balance sheet is part of it?
- Can a monetary union have a lender of last resort for governments without a fiscal union, or is the conditionality of OMT and TPI the permanent compromise?

None of these is settled. The tools to think about them are the identity of the first lesson, the reaction functions of the second, the multipliers of the third, and the regime question of the fifth.

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Blanchard, O. (2023). *Fiscal policy under low interest rates*. MIT Press.