Journal of Economics (2023) 139:89–91
https://doi.org/10.1007/s00712-023-00823-0

BOOK REVIEW

Blanchard, O.: Fiscal policy under low interest rates,

xiii, 162 pp., the MIT Press, Cambridge, Mass., 2022. Paperback, USD 40.00

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Published online: 21 March 2023
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In this agile little book Olivier Blanchard offers a masterfully guided tour across the currently prevailing view in the profession about the role of fiscal policy in advanced economies. The employed theoretical toolkit is quite minimalist, which makes the book highly accessible for a broad readership: basically, Blanchard's analysis rests on the good old IS-LM keynesian framework when he discusses the short run, and on the OLG model à la Diamond when long-term perspectives are dealt with.

Blanchard's line of thought may be summarized as follows. Powerful structural factors over the last three decades have driven down the neutral interest rate – defined as the real safe rate such that output is at potential. Apart from temporary accidents, these structural factors are not going to reverse for a while, so that low safe interest rates are here to stay. In particular, life expectancy will keep rising faster than retirement age, entailing an increase of savings and a protracted downward pressure on the safe interest rate. From a policy perspective, the relevance of this long-lasting reduction of the interest rate especially matters if it crosses two thresholds: the growth rate of GDP and the rate at which monetary policy hits the effective lower bound constraint.

Assume that the actual real safe rate r is equal to the neutral interest rate (the main goal of monetary policy is to achieve that equality so as to ensure price stability). The first crossing (meaning that the situation becomes one of $r<g$, where g is the real growth rate) matters for two prominent issues: debt sustainability and dynamic inefficiency. The link with debt sustainability is an immediate consequence of the government's intertemporal budget constraint. If the interest rate is exogenous and there is no uncertainty, the government's fiscal space is infinite and debt sustainability is not an issue. Blanchard stresses that in reality the interest rate responds to the evolution of public debt and it may be affected by major uncertain developments in the

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future – both of an extrinsic and an intrinsic nature. Even if the mean forecast is $r<g$, governments should engage in an assessment of sustainability known as stochastic debt sustainability analysis. Admittedly, this is "… as much art as it is science", p.62. However, it would be the best tool to assess the effective size of fiscal space.

Even if the fiscal space is comfortable, this does not imply that the government should use it, especially because public debt will likely crowd out private investment. According to Blanchard, the welfare assessment of debt policy chiefly depends on its relationship to dynamic (in)efficiency. In a standard deterministic model without land, its equilibrium path displays dynamic inefficiency precisely if $r<g$. In this case, public debt is welfare improving at the margin and should be increased up to the point where $r=g$ so as to get rid of the excess capital. In richer models the welfare implications of public debt usually depend on a weighted average of the safe rate and the, much higher, risky rate. Blanchard believes that in the current situation in which the safe rate is likely to remain somewhat below the growth rate, the welfare costs of additional public debt are likely to be second order.

The second crossing occurs if the neutral rate becomes lower than the minimum rate implied by the effective lower bound of monetary policy. In such a situation, monetary policy loses much of its power to stabilize the economy, which provides a strong reason for using fiscal policy as "functional finance". Blanchard's recommendation is simple: if also this second threshold has been crossed, use expansionary fiscal policy to raise the neutral interest rate (e.g. by means of deficit-financed green investments) so that we cross the threshold again - but now from below - and to such an extent as to give enough room for monetary policy to achieve again macroeconomic stabilization.

Along with this general survey of fiscal policy, this book touches upon a number of fiercely debated issues, both in theory and in the policy arena. One of those issues concerns the fiscal rules in the European Union. These rules are blamed upon by Blanchard for being opaque and having produced a prolonged fiscal austerity. Rather than aiming at a reduction of the debt ratio, it is better to develop credible contingent plans for the case that $r>>g$. He advises the EU to skip fiscal rules and replace them with stochastic debt sustainability analysis. If a rule must be, then the best one is to make the primary surplus depend on the debt service (the Bohn rule).

Two further issues concern the interaction between fiscal policy and central banks. The first one is whether central banks are actually bailing out governments and causing inflation. Blanchard argues that, despite QE, central banks are not bailing out their governments. They have purchased bonds by means of central bank reserves that pay roughly the same interest rate as bonds. Thus, there is almost no effect on the budget of the consolidated government. According to him, QE has been just an operation of financial intermediation, quite different from printing money and generating inflation. The second one is whether central banks, especially the ECB, should write off their holdings of government bonds. Blanchard's answer is a clear "No". First, such an operation would have no effect on the budget constraint of the government because it is entitled to the profits and losses of the central bank. Second, because such a write-off would be interpreted as a signal of loss of political independence of the central bank. Finally, Blanchard devotes a chapter to three case studies of fiscal

policy: EU and the global financial crisis (too little); Japan during the last 30 years (almost right); the Biden stimulus (too much).

In sum, Blanchard's book provides an authoritative rationale for a pragmatic use of fiscal policy. He acknowledges that public debt has distinctive costs and benefits, the relative weight of which depends on time and place and can be investigated using a variety of analytic tools. Similar views on public debt and fiscal policy have been advanced over the last years by other distinguished economists like Lawrence Summers and Carl Christian von Weizsäcker. Blanchard's book will be especially welcomed by practitioners; it will also stimulate further research by theory-oriented scholars. Among the various questions that remain to be explored, one concerns the politico-economic implications of generous fiscal space, i.e. how governments may use it for rent-seeking purposes, possibly generating a misallocation of resources at the microeconomic level that more than offsets the macroeconomic benefits from additional public debt when $r<g$.

Funding Open Access funding enabled and organized by Projekt DEAL.

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