Twitter Thread by Jason Furman

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The argument for deficits & debt raising interest rates in the US is not increased credit risk, it is that interest rates are a function of economic fundamentals, flows & policy. Deficits/debt change those.

I can't tell if I'm agreeing or disagreeing with @jc_econ.

> There is no relationship b/w deficits & interest rates in the US & many other advanced economies. Centuries of dynamic institution building underpin our reserve currency status that allows rates to be a function of economic fundamentals, flows & policy not credit risk 1/3
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> — Dr. Julia Coronado (@jc_econ) January 26, 2021

Increasing government spending or reducing taxes increases demand (or reduces saving). This raises the price of loanable funds or the interest rate.

In a dynamic context, more demand means a stronger economy, the central bank raises interest rates sooner, and long rates rise.

(As an aside, we are not close to the United States needing to worry about credit risk and the risks are more overstated than understated in most other advanced economies too. But credit risk is not always & everywhere irrelevant, just look at the UK in 1976 or Canada in 1994.)

Interest rates have fallen over the last 20 yrs while debt has risen. This does not necessarily mean that debt rising causes interest rates to fall. It could also mean that other things have happened at he same time that pushed down interest rates more than debt pushed them up.

The suspects for these "other things" include slower productivity growth, slower popln growth, higher inequality, less investment, etc. All of which either increase the supply of saving or reduce the demand for investment, reducing the equilibrium interest rate.

When interest rates are at zero and expected to be there for a while then fiscal expansions will not raise interest rates very much if at all. And if it raise inflation/expected growth then fiscal expansions are more likely to crowd in investment instead of crowding them out.

Moreover, interest rates are likely to be low even after the economy recovers for all of the structural reasons that made them very low even before the pandemic crisis hit (the real 10-year rate rate was negative in February). If fiscal policy can raise rates that would be good.

Higher interest rates would create more scope for monetary policy to cut rates when it needs to, reduce risk taking in financial markets and help the soundness of the banking system.

We have much more fiscal space than many think but it is not infinite because if you raise debt way too much r - g won't stay negative.

We still need some prioritization. If I thought r - g would be negative forever regardless of debt then why raise the top rate from 37 to 39.6?

In sum: The argument for expansionary fiscal policy now is that it it is unlikely to drive up interest rates & could crowd in investment.

An argument for not pivoting to fiscal consolidation is that higher rates are more of a plus not a minus.

Do also need to prioritize.