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It is time for governments to borrow more money

By Lawrence H. Summers,

With the past week's dismal jobs data in the United States, signs of increasing financial strain in Europe and discouraging news from China, the proposition that the global economy is returning to a path of healthy growth looks highly implausible.

It is more likely that negative feedback loops are again taking over as falling incomes lead to falling confidence, which leads to reduced spending and yet further declines in income. Financial strains hurt the real economy, especially in Europe, and reinforce existing strains. And export-dependent emerging markets suffer as the economies of the industrialized world weaken.

The question is not whether the current policy path is acceptable. The question is, what should be done? To come up with a viable solution, consider the remarkable level of interest rates in much of the industrialized world. The U.S. government can borrow in nominal terms at about 0.5 percent for five years, 1.5 percent for 10 years and 2.5 percent for 30 years. Rates are considerably lower in Germany and still lower in Japan.

Even more remarkable are the interest rates on inflation-protected bonds. In real terms, the world is prepared to pay the United States more than 100 basis points to store its money for five years and more than 50 basis points for 10 years. Maturities would have to reach more than 20 years before the interest rates on indexed bonds becomes positive. Again, real rates are even lower in Germany and Japan. Remarkably, the United Kingdom borrowed money last week for 50 years at a real rate of 4 basis points.

These low rates on even long maturities mean that markets are offering the opportunity to lock in low long-term borrowing costs. In the United States, for example, the government could commit to borrowing five-year money in five years at a nominal cost of about 2.5 percent and at a real cost very close to zero.

What does all this say about macroeconomic policy? Many in the United States and Europe are arguing for further quantitative easing to bring down longer-term interest rates.

This may be appropriate, given that there is a much greater danger from policy inaction to current economic weakness than to overreacting.

However, one has to wonder how much investment businesses are unwilling to undertake at extraordinarily low interest rates that they would be willing to undertake with rates reduced by yet another 25 or 50 basis points. It is also worth querying the quality of projects that businesses judge unprofitable at a -60 basis point real interest rate but choose to undertake at a still more negative rate. There is also the question of whether extremely low, safe, real interest rates promote bubbles of various kinds.

The renewed emphasis on quantitative easing is also an oddity. The essential aim of such policies is to shorten the debt held by the public or issued by the consolidated public sector, comprising both the government and central bank. Any rational chief financial officer in the private sector would see this as a moment to extend debt maturities and lock in low rates — the opposite of what central banks are doing. In the U.S. Treasury, for example, discussions of debt-management policy have had this emphasis. But the Treasury does not alone control the maturity of debt when the central bank is active in all debt markets.

So, what is to be done? Rather than focusing on lowering already epically low rates, governments that enjoy such low borrowing costs can improve their creditworthiness by borrowing more, not less, and investing in improving their future fiscal position, even assuming no positive demand stimulus effects of a kind likely to materialize with negative real rates. They should accelerate any necessary maintenance projects — issuing debt leaves the state richer not poorer, assuming that maintenance costs rise at or above the general inflation rate.

As my colleague Martin Feldstein has pointed out, this is a principle that applies to accelerating replacement cycles for military supplies. Similarly, government decisions to issue debt, and then buy space that is currently being leased, will improve the government's financial position as long as the interest rate on debt is less than the ratio of rents to building values — a condition almost certain to be met in a world with government borrowing rates below 2 percent.

These examples are the place to begin because they involve what is in effect an arbitrage, whereby the government uses its credit to deliver essentially the same bundle of services at a lower cost. It would be amazing if there were not many public investment projects with certain equivalent real returns well above zero. Consider a $1 project that yielded even a permanent 4 cents a year in real terms increment to GDP by expanding the economy's capacity or its ability to innovate. Depending on where it was undertaken, this project would yield at least an extra 1 cent a year in government revenue for each dollar spent. At any real interest rate below 1 percent, the project pays for itself even before taking into account any Keynesian effects.

This logic suggests that countries regarded as havens that can borrow long term at a very low cost should be rushing to take advantage of the opportunity. This is a view that should be shared by those most alarmed about looming debt crises, because the greater your concern about the ability to borrow in the future, the stronger the case for borrowing for the long term today.

There is, of course, still the question of whether more borrowing will increase anxiety about a government's creditworthiness. It should not, as long as the proceeds of borrowing are used either to reduce future spending or raise future incomes.

Any rational business leader would use a moment like this to term out the firm's debt. Governments in the industrialized world should do so too.