Discussion of Rogoff’s
“Is Higher Debt an (almost) Free Lunch?”

Giancarlo Corsetti
(University of Cambridge and CEPR)

High Debt, Low Rates and Tail Events:

Rules-Based Fiscal Frameworks under Stress

Third Annual Conference organized by the European Fiscal Board

February 26 2021

Framing our thinking about ‘fiscal space’

- The paper carefully examines most consequential arguments
  - “r-g<<0 will be very persistent”
  - “Shocks can only reduce r-g”
  - “Larger, additional deficits not an issue—no adjustment required”

  in light of
  - Historical evidence on R* and r-g, growth and crises
  - Outstanding implicit, hidden, contingent (junior) debt (e.g., ageing)
- Mandatory reading.

Not a free lunch: a window (with policy footprint on it)

How should we interpret the current conditions?

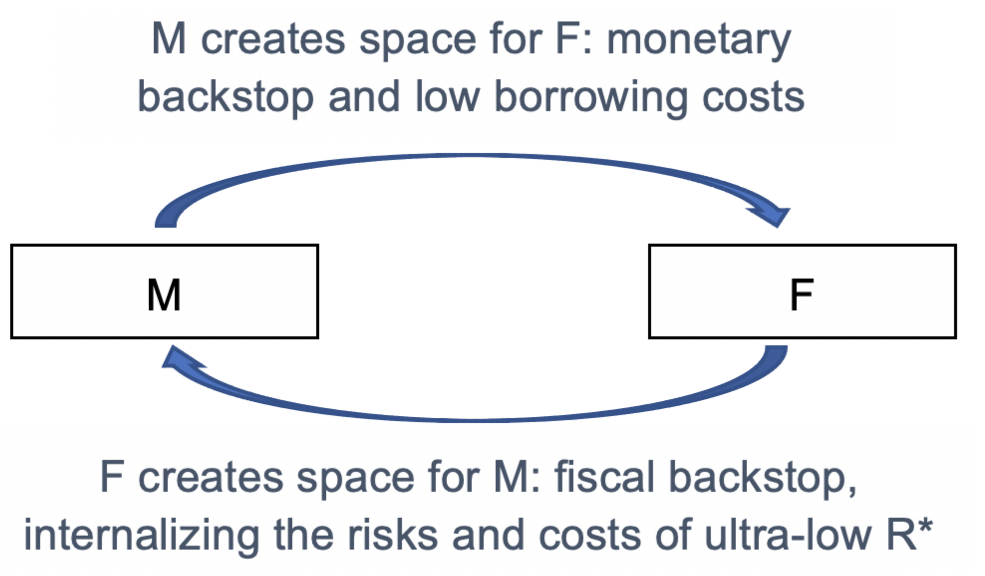
- Structural factors underlying downward trend on R*
  - Gently declining trend.
- Large drop following the Global Financial Crisis and COVID-19

- A key driver of super low rates is the policy mix in the 'tail events'--see Geneva Report 2020.

In a tail event, Monetary and Fiscal policies are <u>strategic complements</u>

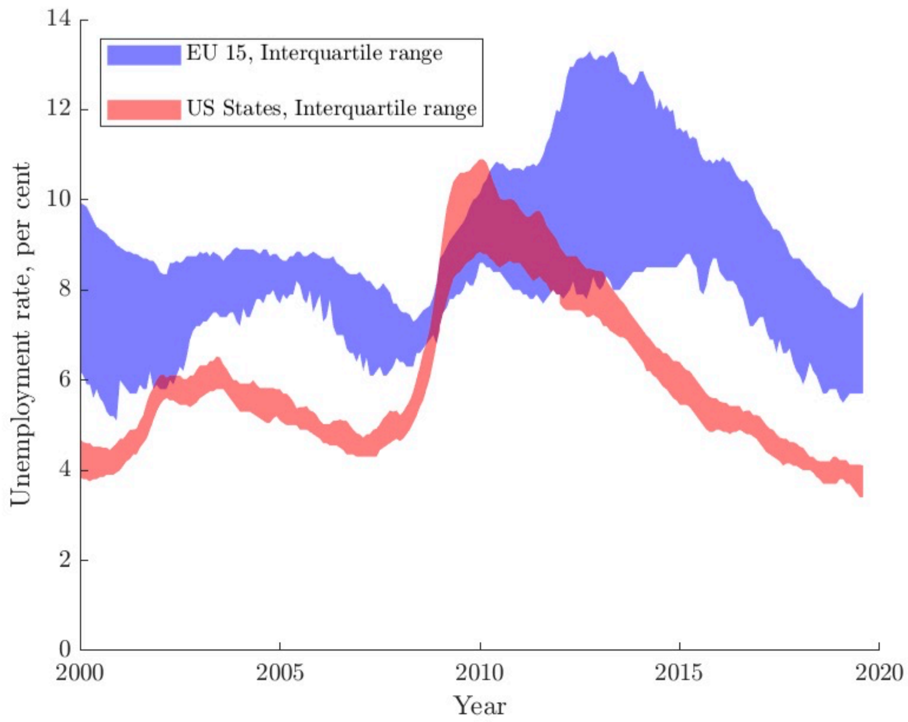
- Tail events stretch monetary M and fiscal F instruments to the limit
  - Not enough policy space for M and F to be **substitutable, both must be used**
  - Each influences the <u>space and credibility</u> of the other

<u>Geneva report 2020:</u>



Different regions have been able to exploit policy complementarities to a different degree

- Unemployment rate and dispersions across states pre-COVID: EU 15 vs US
- Comparable in 2010. Afterwards, both rose and long remained high in the euro area relative to the US.
- Hard to downplay the role of the overall & national macroeconomic stance



Address tail risk and build back resilience

In advanced economies, an even higher stock of debt may remain sustainable, but does entail loss of fiscal flexibility in responding to shocks

- Risks for growth
- Reduced resilience to tail shocks

"it was fortunate that advanced economies could use debt as aggressively as they did in the pandemic, but that capacity should not be taken for granted'' (p. 12)

A robust exit from tail risk requires moving **policies 'back to the middle of the road' (Okun).** Ken Rogoff reminds everybody that it may be good not move them further away from the middle.

The window r-g<0 can close abruptly for bad reasons and bad policies (accidents)

- Rising borrowing costs driven by inflation and default premia
  - Multiple equilibria: belief driven crises (slow moving, or rollover crises)
- Further drop in growth due to inefficient stabilization and spending.

Concrete risk that policy mix (a) fails to use instruments enough, or (b) fails to preserve their credibility---i.e. their independence and effectiveness.

Complementarity not an argument against independence.

Ideally, the window should be kept open for some time, and closed for good reasons with good policies/policy regimes

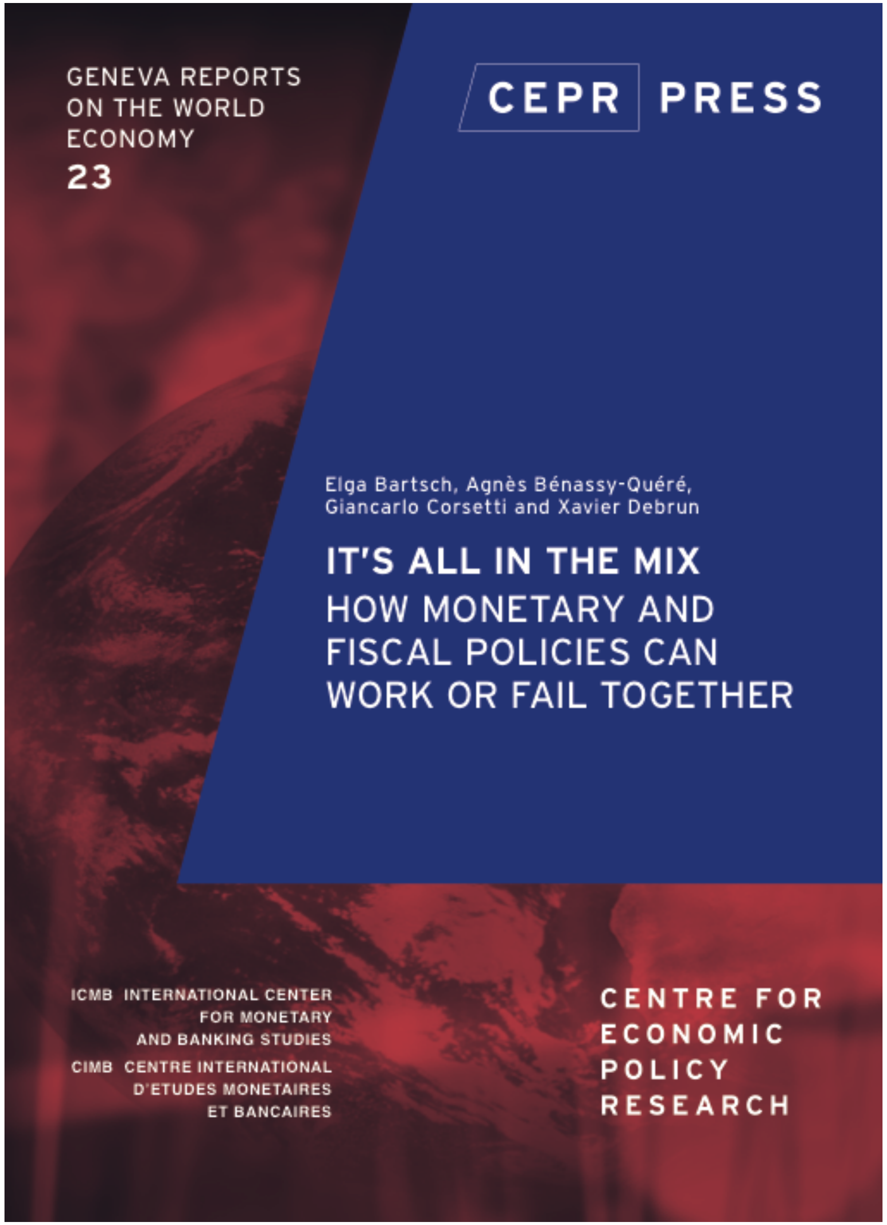
- Short term support to activity and bridge to post-COVID-19 economies
  - Extent of needed re-allocation and adjustment still uncertain
- Spending leading to higher potential growth
  - ‘still high return projects the government can undertake’ p.10
- Maintain robust backstop of government debt
  - But no monetary subordination

Ideally, the window should be kept open for some time, and closed for good reasons with good policies/policy regimes

- Higher supply of safe assets

- Rogoff quotes Fahri & Maggiori, who argue that a currency and financial hegemon (the US) may retain its status even if it pushes its borrowing beyond the ‘safe zone’ of no default---the Triffin space of vulnerability to confidence crisis.
- Hard to think of the international role of a (European safe asset denominated in) euro independently of these considerations

Thank you!



Chapters

Theory

The classics

Evidence

The mix in OECD countries

Tail risk challenges

GFC, EA sovereign risk crisis, COVID-19

A great normalization

R* as a global compass