Debt Supercycle vs. Secular Stagnation

By Kenneth Rogoff

Comments

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Secular Stagnation vs. Financial Crisis
Great Depression (1929)

- **1939: Hansen** saw high unemployment and low inflation even with big Keynesian/expansionary (government) policies.
  - ✓ Proposes **secular stagnation**: lack of demand for investment results in low equilibrium real rates.
  - ✓ Probable cause is demographics (old people need services, not capital)

- **1983: Bernanke** explains it as a **financial crisis**—a long but temporary phenomenon.
  - ✓ Debt resolution is slow, and price adjustment (housing) is slow.
  - ✓ **Why so long?** Wealth effects destroy demand, excessive regulation undermines bank lending; political economy loss distribution.
    - Eventually, it ends, and growth and interest rates pick up again.

Secular Stagnation vs. Financial Crisis
Global Financial Crisis

- **2013: Summers** sees low growth and raetes even with expansionary fiscal policy

✓ Attributes it to **secular stagnation**: lack of demand for investments (capital) and excess savings

  - Blanchard (2019) proposes r -g<0 is rule rather than exception→ can safely run expansionary fiscal policies

- **2024: Rogoff** explains it as a **financial crisis** — long (10 years) but temporary

✓ Attributes it to the End of debt Supercycle: collapse of house and equity prices: GFC → Europe Crisis → China – policies implemented to deal with GFC

✓ Resolution is Slow: Long recovery instead of V-shaped — Two years just for GDP to stop sinking, unemployment took 5 years

  - Why so long? Huge time for debt resolution, wealth effect from price collapse, paralysis of the banking system, regulation overshoot (financial repression: e.g. K requirements or nominal interest rates)

Why Does it Matter? Implications
Secular Stagnation

➔ Mediocre growth (lack of demand, investments),

- If the decline in interest rates is explained by secular stagnation: the neutral interest rate continues to fall slowly, forever.
  - Low growth, low neutral rates, low inflation.

- **Monetary policy:** lower bound problem.
  - Need for asymmetric frameworks, higher targets, or other creative solutions.

- **No fiscal problem:** $r - g < 0$
  - Fiscal policy should be expansionary to offset/stimulate the lack of demand and should not worry about debt sustainability since $r - g < 0$

Why Does it Matter? Implications
Financial Crisis

➔ **Debt Supercycle:** growth and rates pick up.

- If the decline in interest rates was due to the financial crisis of 2008/9: The neutral interest rate fell very quickly due to the lack of demand.
  - Phenomenon is temporary, even if it lasts 10 years (average life is 2-5 years).
  - Growth returns to normal, neutral interest rate increases (or at least returns to the initial trend).
- **Monetary Policy**: "Normal/Usual," increase R to fight inflation (symmetry)
  - ➢ If wrongly believe in secular stagnation (low neutral rates: results in excessively loose policy and high inflation.
  - Risk of low interest rates as a form of fiscal adjustment (via inflation surprise)
- **Fiscal problem**: r>g
  - ➢ Fiscal policy as usual: should worry about debt sustainability since.
  - If one chooses a very expansionary fiscal policy ends up with a high debt/ sustainability problem.

Comments

- As always, insightful paper based on centuries of research (Reinhart; Rossi and Shmelzing, Yang, etc.)
  - What academic research and debate should be:
    - **Rigorous data-theory arguments** to inform **first order** questions:
    - ✓ growth, unemployment; innovation (bias towards K), demographics; fiscal, monetary, financial policy, regulation; international financial architecture, etc.

Comments

1. Agree: Evidence is clear
   - Similar debate about Business Cycles EMEs:
     - Productivity versus financial frictions (default): need longer data series
     - Dynamics: lingering effects of debt crisis due to protracted debt resolution
2. Question Implications: Should interest rates now go up or down? Effects?
3. Thoughts about International Financial Architecture

I. Business Cycles in Emerging Markets
Debate: Technology vs. Financial Frictions

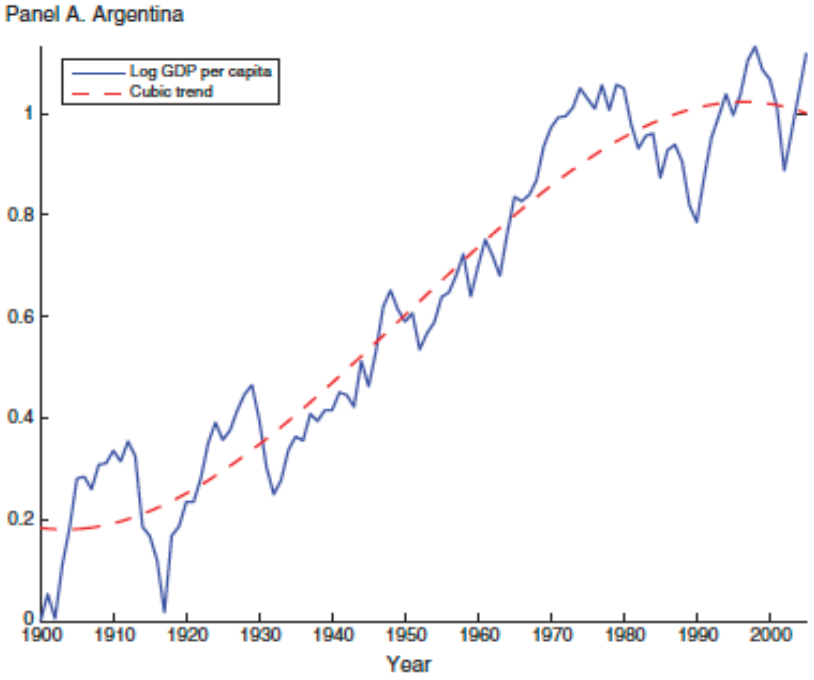
- Technology: Neoclassical model featuring no distortions and driven solely by (permanent, transitory) shocks to total factor productivity, Kydland and Zarazaga (2002), Aguiar and Gopinath (2007)

- Financial frictions: Country risk premium and shocks (default), García-Cicco, Pancrazi-Uribe (2010)

- Solution-century of data:
  - Long time series is motivated by drawback of the use of short samples both for the characterization of observed business cycles and for the estimation of the parameters of the theoretical model.

Financial Crisis… In Perspective

Kehoe and Meza (2012)

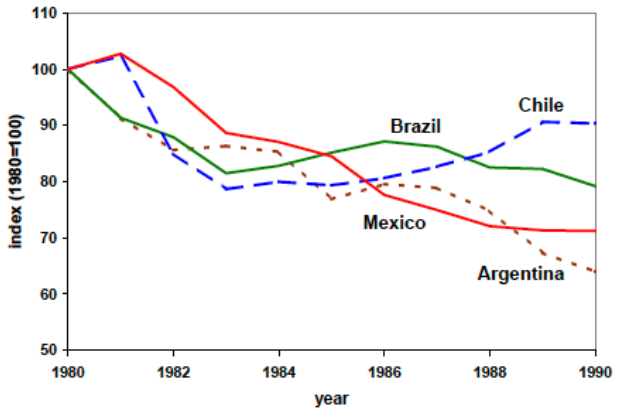


García-Cicco, Pancrazi-Uribe (2010)

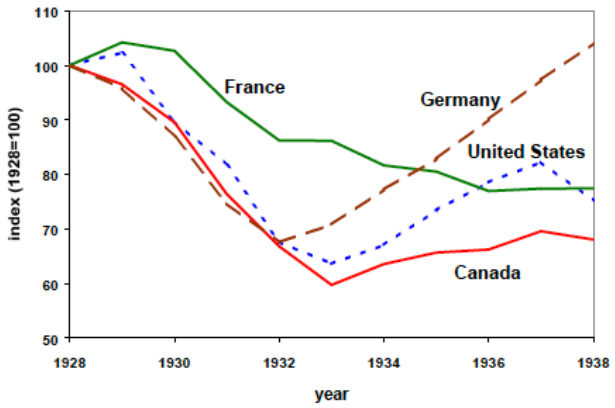
Financial Crisis
Protracted Debt Resolution

- **Baker Plan:** IFIs lending to developing countries + banks contribute to finance market-oriented reforms + US funds to WB to support such programs.
  - 1982 and 1987, 15 HIPC **no growth + debt** remained a constraint on their performance.
- **Brady Plan**: annul debt through private sector lenders. Hardships prolonged due to banks and their own government's **failure to agree on costs bearers, debt overhang**
  - 1989 and 1995. many countries of the 16 countries regained stability and growth, successful economic reforms; others failed to grow.

Detrended output per working-age person during the 1980s in Latin America (Kehoe and Prescott, 2002)



Detrended output per working-age person, Great Depression (Kehoe and Prescott, 2002)

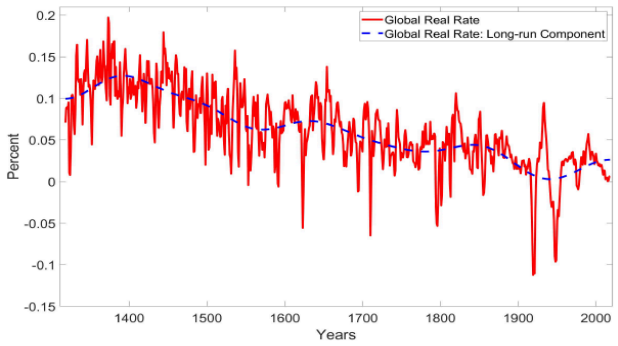


II. Evidence: Interest Rates since 1300 Rogoff, Rossi and Schmelzing (2024)

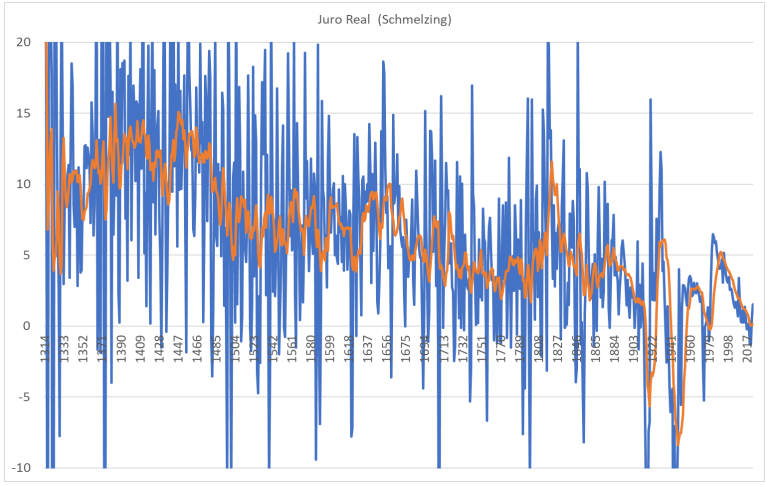
New data set of real interest rates data since 1300 (Schmelzing): Results

- Clear break (around 1500s): Black Death and "Trinity" default (Spain, France, Holland)
- After that, no breaks–a temporal trend (it does not have a unit root!)
  - Trend is stable and decreasing, of the order of 150bps per century.
    - Much less than the 300bps we observed just after the global financial crisis.
    - Much less than the 300bps in 4 decades that Rachel and Summers (2019) discuss.

Figure 1: Headline global real rates, and its long-run component, 1318-2022



Notes: Data based on Schmelzing (2023)'s GDP-weighted global real rate data. Long-maturity ex ante basis, deflated by using seven-year progressively-lagged inflation, excluding current year *t*. The dashed line reports the long-run filtered component, isolating fluctuations above 100 years, based on the Müller and Watson (2018) estimator.



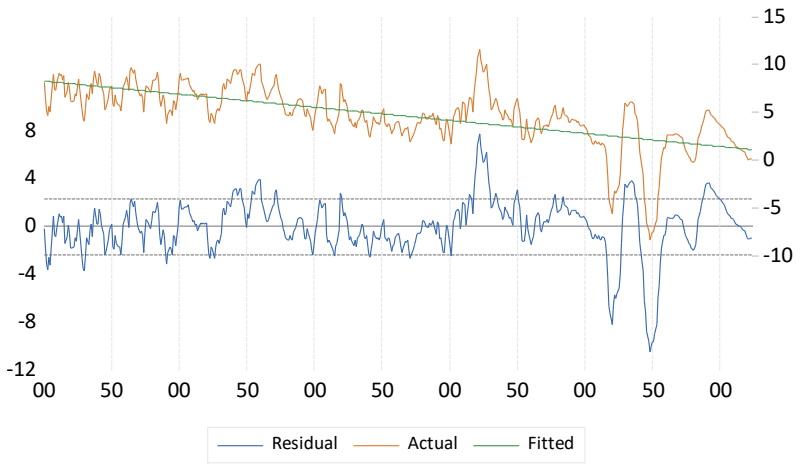
Global Financial Crisis
Large Decline in Interest Rates

- The decline during 2008 was indeed very rapid.
- Now it would return to the trend. Which is the trend?
- Rogoff, Rossi and Schmelzing (2024) data, run regression after break.
  - Obtained that real rates should be around 1% now
  - **Huge standard deviations**

Dependent Variable: REAL10AVG
Method: Least Squares
Date: 05/06/24 Time: 17:33
Sample (adjusted): 1500 2023
Included observations: 524 after adjustments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	10.80771	0.319135	33.86563	0.0000
TIME	-0.013700	0.000676	-20.27902	0.0000

R-squared	0.440658	Mean dependent var	4.676752
Adjusted R-squared	0.439586	S.D. dependent var	3.124921
S.E. of regression	2.339341	Akaike info criterion	4.541425
Sum squared resid	2856.654	Schwarz criterion	4.557690
Log likelihood	-1187.853	Hannan-Quinn criter.	4.547795
F-statistic	411.2387	Durbin-Watson stat	0.115517
Prob(F-statistic)	0.000000		

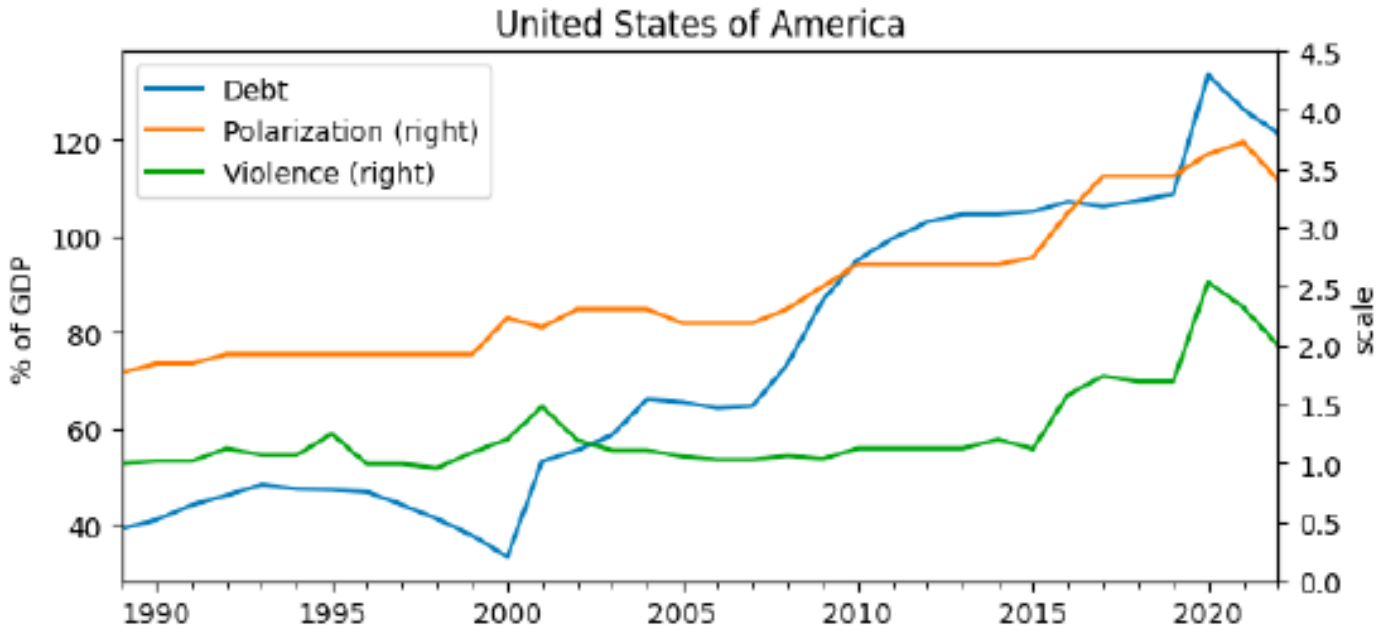


Which R Path Should We Expect?

- 1% now is a little lower than the observed rates
- How should we think about it?
  - Of course, it is hard to forecast (long-term trend, high standard deviation).
    - Biggest deviation: Interest rates just before GFC or after?
  - But what's the best forecast?
    - Will interest rates go back to "equilibrium" (down)
    - Or will there be another debt build-up and real rates much above equilibrium?
    - Which I actually think is the case.
- If rates should go up more: Where should we look for pressures?
    - Where is the next "bubble"? Government (Climate Change? AI?).

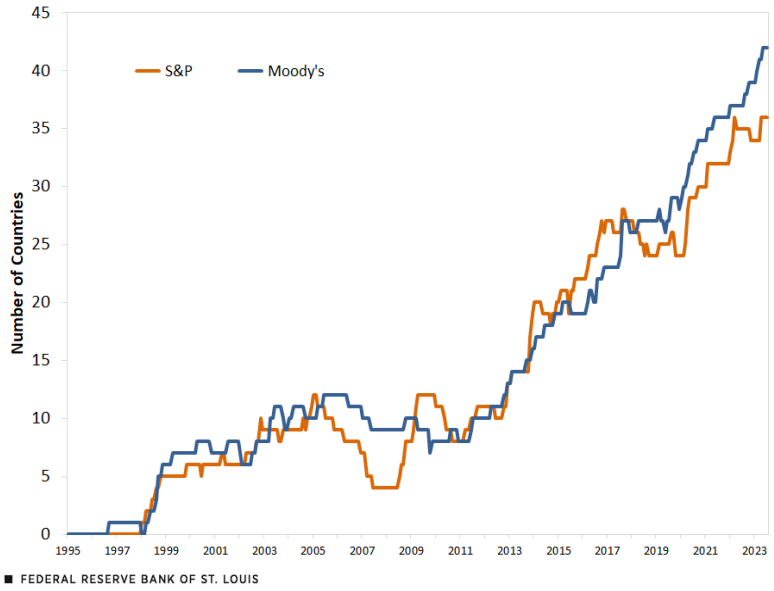
Debt Build Up
Pessimistic Outlook … Other Countries

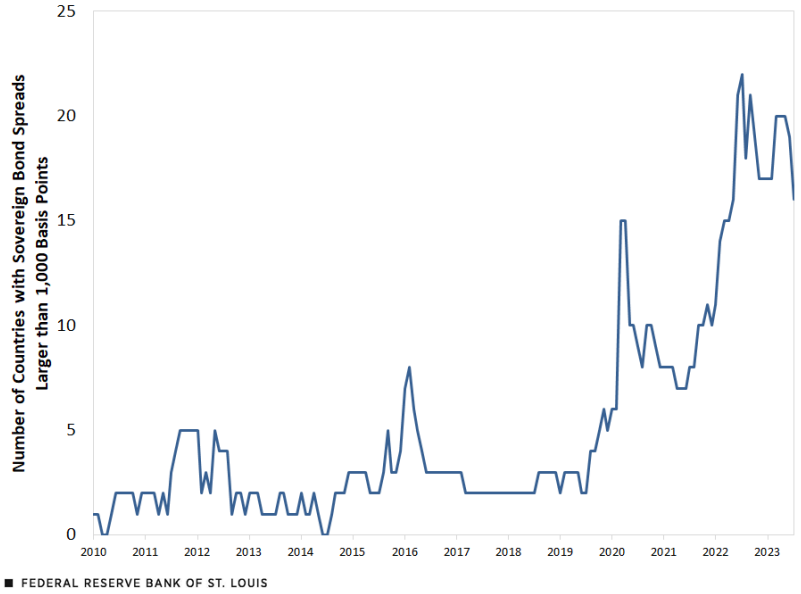
- Arslanalp, Eichengreen and Henry (2024): pessimistically outlook for the US



Pessimistic Outlook …
Other Countries …Debt Distress

- Developing countries face increased debt payments in the coming years in a more complex, polarized geopolitical environment.





Implications
International Financial Architecture

- Lessons on how the IMF should (have) handle:
  - Debt Build up? High-debt countries?
  - China?

Public debt

The Fiscal and Financial Risks of a High-Debt, Slow-Growth World

Higher long-term real interest rates, lower growth, and higher debt will put pressure on medium-term fiscal trends and financial stability

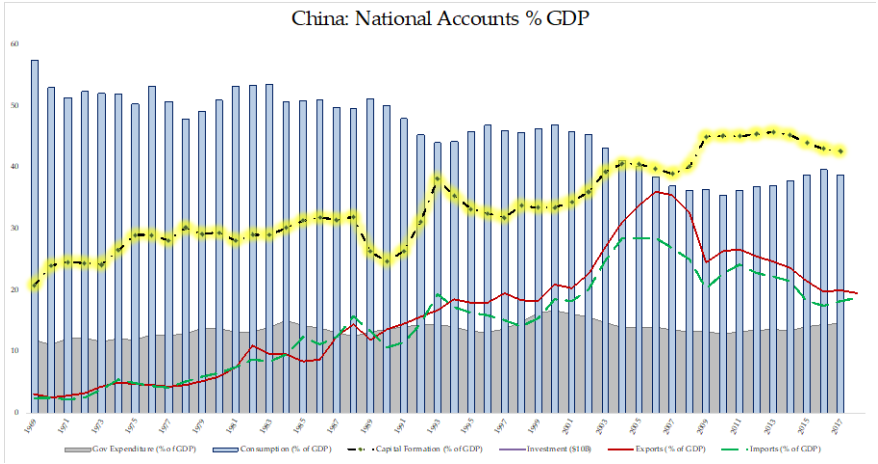
Tobias Adrian, Vitor Gaspar, Pierre-Olivier Gourinchas

March 28, 2024

Inflation-adjusted interest rates are well above post global financial crisis lows, while medium-term growth remains weak. Persistently higher interest rates raise the cost of servicing debt, adding to fiscal pressures and posing risks to financial stability. Decisive and credible fiscal action that gradually brings global debt levels to more sustainable levels can help mitigate these dynamics.

Public debt sustainability

Debt sustainability depends upon four key ingredients: primary balances, real growth, real interest rates, and debt levels. Higher primary balances—the excess of government revenues over expenditures excluding interest payments—and growth help to achieve debt sustainability, whereas higher interest rates and debt levels make it more challenging.



Final Thoughts

- As always, must read!
  - Critical research agenda with first-order policy implications