Discussion of:
Sovereign default and the decline in interest rates
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Macroeconomics and Monetary Policy Conference
Federal Reserve Bank of San Francisco
March 2021

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What drives decline in interest rates? Inflation!

▶ Nominal rates were high due to the high inflation expectations of the 1970
What drives decline in real interest rates after 1990?

Real rates continues secular decline

- Many papers: aging population, global central banks savings, low growth, inequality
- This paper: still inflation dynamics!
Inflation cyclicality

From Hur, Kondo, Perri (2018)

- Recessions used to be inflationary, now deflationary
Real rates and inflation cyclicality

From Hur, Kondo, Perri (2018)

- Hedging properties of inflation has changed
- Also in: Campbell-Pflueger-Viceira 2020, Jiang-Lustig-VanNieuwerburgh-Xiaolan 2019, 2020
Real rates and inflation cyclicality

Mechanism

- Procyclical ($y \downarrow \pi \downarrow$) inflation makes nominal debt less risky for lender
  - Real payouts ↑ when $y \downarrow$
  - Nominal debt a good hedge
  - Low rates compensate for these good hedging properties

Paper Part I: Proof of concept and additional implications

- Pricing kernel with consumption process that depends on disaster shock
- Reduce covariance of disaster shock with inflation $\rightarrow$ rates fall
- Consistent with stable price-dividend ratio
**Real rates and inflation cyclicality**

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**Comment I: Use empirical measures of covariances changes**
Real rates and inventory

Paper Part II: Production economy with inventory (money)

- Inventory provides economy extra safe asset in addition to capital
- Inventory crowds out capital and gives equilibrium with low risk free
- Government debt with inflation risk priced externally with new kernel from this economy
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Comment II

- Inventory plays role similar to government debt
  - U.S. debt is a safe asset with interest rates that contain convenience yields
  - Khrishamurthy-Vissing Jorgenson 2012, Reis 2020
- Integrate inflation risk into production economy with government debt
- Emphasis on inflation dynamics would be sharper by having a nominal debt as the “inventory”
- Debt as good hedge, natural reason for low rates
Inflation as default

Comment III: Not the same objects

- Historically different objects, default more prevalent in foreign currency debt but not always (Reinhart-Rogoff 2012)


- VAR analysis with 19 OECD countries from Hur-Kondo-Perri 2018
  - Covariance of inflation and consumption growth lowers real rates
  - but only in countries with high credit ratings!
Summary

- Important emphasis on inflation dynamics as driving low real rates — sold on this idea
- Safety properties of government debt important for low rates — sold on this idea
- Wishlist: unified framework merging these two points — work in progress

Embrace nominal government debt!