THE SUNDAY TIMES

KENNETH ROGOFF
february 3 2019,

Never mind the debt: if there's a hard Brexit Britain will have to splash the cash

Kenneth Rogoff

As the Brexit drama continues to unfold, most of the world, not least the Treasury and the Bank of England, is hoping for the best. But what, exactly, is the game plan in the event of a no-deal Brexit, or some other unscripted chaotic outcome? A lot depends on how events unfold, but here are some thoughts on macroeconomic policy response.

First, a hard Brexit would provide an overwhelming argument for using the government's strong balance sheet to cushion the transition. What's the point of saving for a rainy day if you don't use the savings in an epic storm? Instead of attempting to reduce the UK's debt-to-GDP ratio (now 84%), the government should find ways to strengthen investment in physical and human capital, to help the poorest, who will be hit the hardest, and to incentivise international businesses not to abandon ship. (Of course, fiscal stimulus would be on top of all other measures the government might be contemplating to mitigate potential panic and uncertainty.)

To be frank, it has never been remotely obvious to me why the UK should be worrying about reducing its debt–GDP burden, given modest growth, high inequality and the steady (and largely unexpected) decline in global real interest rates. It is one thing to have an exit plan for controlling the rate of debt increase after a deep financial crisis; it is entirely another thing to be in any rush to bring debt levels down.

Winston Churchill as chancellor. In 1925 he put sterling back on the gold standard at its prewar rate, and disaster ensuedHULTON DEUTSCH

Yes, there is a deep-rooted democratic bias towards ever rising government debt, especially from populist governments aiming to spread largesse to their constituencies, as for example the Trump administration has done with its near trillion-dollar deficits in the United States. But again, the whole point of having a political detente on excessive borrowing by incumbents is precisely to be able to better deal with adversity. Governments that entered the financial crisis with very high debt (for example, Greece and Italy) or that were on the hook for large pools of risky private housing debt (for example, Spain and Ireland) were far less equipped to resist the crisis than America and the UK, which both enjoyed far greater fiscal space.

Yes, it is wise not to let debt grow inexorably, but there is also no need to run suddenly into reverse.

Sustained very high debt levels have more often than not been associated with somewhat lower growth rates. But there is certainly no magic threshold of debt to GDP at which growth suddenly falls, any more than having one’s cholesterol reading go from 199 to 201 means that you are going to have a heart attack tomorrow. Very high debt does matter, precisely because low-debt economies feel less constrained in reacting to unexpected events. But the events of the past decade have surely pushed up any definition of “very high debt”.

Like most wealthy countries, the UK has benefited enormously from a generalised global decline in interest rates on “safe” advanced-economy government debt, which has brought 10-year yields on UK Treasury bills down from more than 3.5% in 2010 to less than 1.25% today. Even Italy, with a political situation arguably far less anchored than that of the UK, a much higher debt level (more than 130% of GDP), and significantly weaker growth prospects, is paying about 2.75% in 10-year borrowing. An aggressive UK fiscal response to a hard Brexit is not likely to scare off investors and — if posed in a rational way, emphasising benefits to long-term productivity and stability — would probably be seen as reassuring.

Perhaps the major argument against fiscal stimulus is that a hard Brexit is better thought of as a “productivity shock” that is not easily met with demand-management measures. If (irresponsibly) blowing up trade agreements unravels global supply chains and reduces competition, then pump-priming the economy is not going to solve the underlying structural problems. It is only going to push up inflation.

True, but unfortunately by far the greatest dangers from a hard Brexit are panic, loss of public confidence and — from the markets’ perspective — the unhinging of the political consensus underlying the UK’s recovery from its 1970s growth malaise. If stimulus is done sensibly, for example by finding ways to invest in modern internet tools to improve youth and adult education, by continuing to strengthen infrastructure and by improving public health and diet, the upside is likely to far outweigh the downside.

What of monetary policy? The same basic strategy should apply, trying to ease the long transition and stem loss of confidence, although the tactics are less obvious. In all likelihood, an unexpected move towards a hard Brexit is likely to push the pound exchange rate down sharply. It is easy to imagine the pound dropping to $1.10 or below, and much further if a change in government follows.

Still, although an inflation spike is likely to be a concern, one guesses that preventing growth from spiralling downwards would be the larger issue, and it seems far more likely that the Bank of England would want to reduce official interest rates towards zero than to raise them.

No one knows how bad a hard Brexit might be for the macroeconomy. Even the worst Brexit should not be nearly as painful as Churchill’s disastrous choice to deflate the economy in 1925 by going back on the gold standard at too high an exchange rate.

It is even possible Brexit will be much less of an event than most economists fear. But the government should be preparing now for the worst. Forceful fiscal and monetary policies are hardly going to solve all the diverse implications of a hard Brexit, but if they are properly tuned, perhaps they can be a useful tool of short-term damage control.

Kenneth Rogoff is professor of economics at Harvard and currently visiting faculty at London Business School