

Discussion of Scarring Body and Mind: The Long-Term Belief-Scarring Effects of Covid-19 by Kozlowski, Veldkamp and Venkateswaran

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Navigating the Decade Ahead: Implications for Monetary Policy

Federal Reserve Bank of Kansas City “Jackson Hole” conference

August 27, 2020

Catastrophes can define an economic era for a very long time

- Key element: Because utility is convex, the small probability of a large shock can have outsized impact on real and financial variables.
 - Barro (2006) shows that this can explain the equity premium puzzle. Weitzman (2007) arrives at a similar conclusion from a very different perspective of Bayesian uncertainty
- KVV have in a series of papers introduced tighter connections to empirics, and shown implications for the real economy. The Covid-19 shock suits their framework very well in principle
- They propose that effects on capital utilization and productivity can have long-term effects that in present value terms, are an order of magnitude greater than short-term effects.

NORDHAUS (Brookings, 1974)

on How Rare Disasters Can Have Long-Lasting Impact on Beliefs

What explains the dramatic fall in the cost of capital?

The answer seems to me to lie in the general economic climate and in the gradual dissipation of the fear of a new Great Depression. For many years after the crash,

Investors justifiably worried about a repetition of those events.

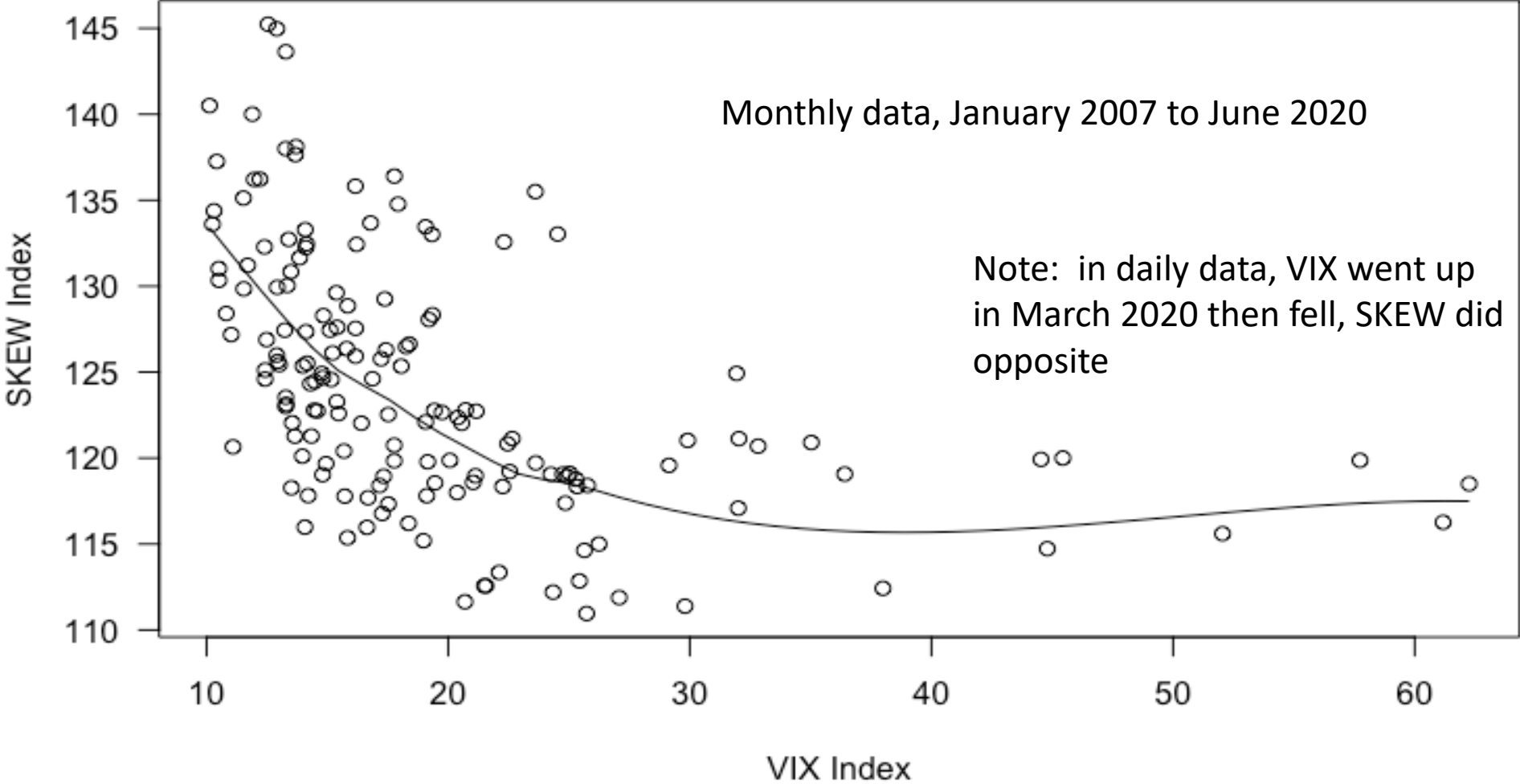
Even as late as March 1955, when the fear might reasonably have faded, the statement by Professor Galbraith that the

Great Crash could repeat itself was sufficient to send the market into a temporary panic-or so he claims. (footnote 21)

Source: William Nordhaus "The Falling Share of Profits," *Brookings Papers on Economic Activity*, 1:1974.

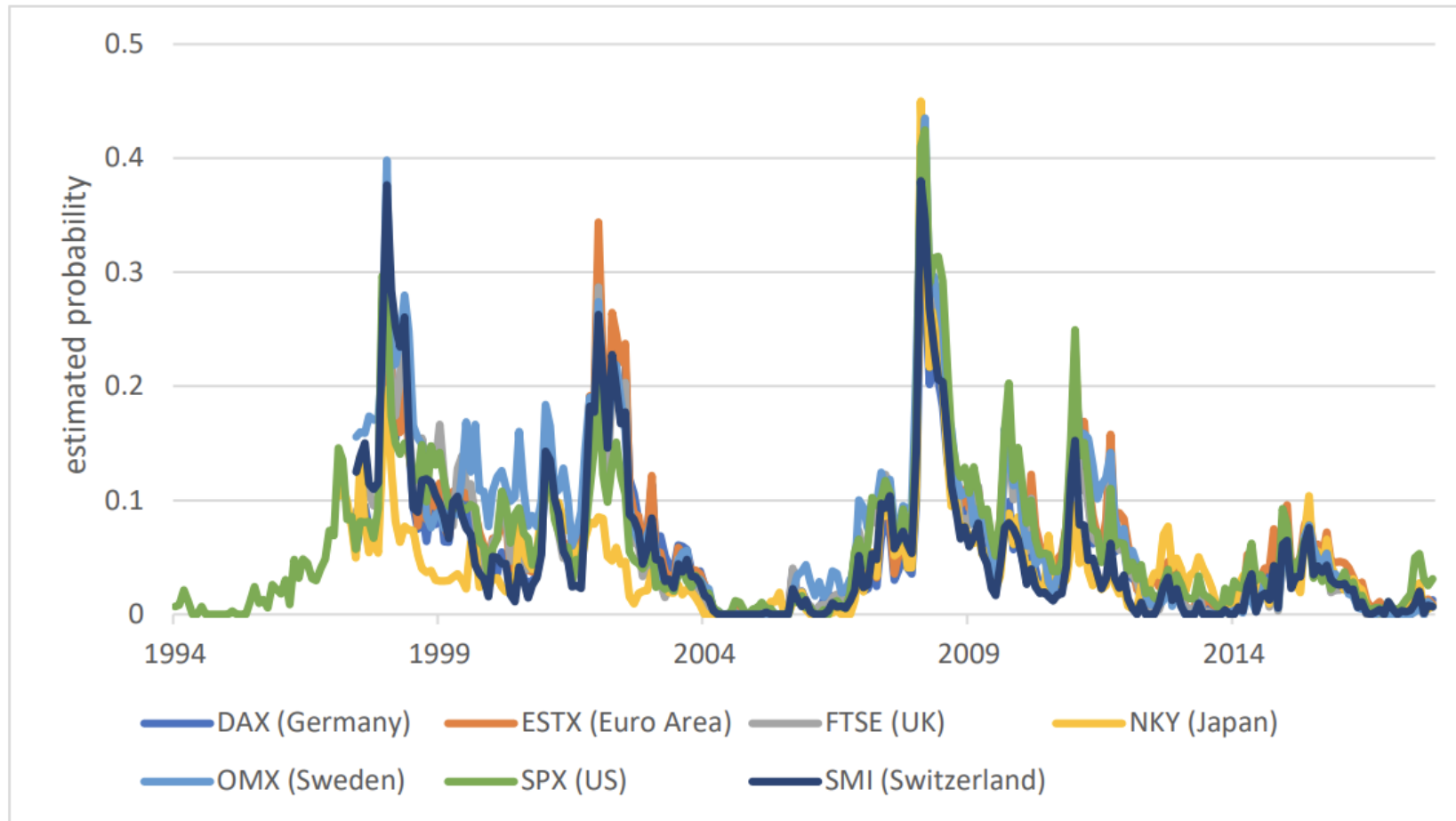
As quoted in Reinhart, Reinhart and Rogoff JIE, 2015, "Dealing with Debt."

Relationship between SKEW index (3rd moment) and VIX (2nd moment)



Market expectations of Extreme Economic Disaster Risk Not Elevated in Run-up to Covid 19

Panel A: Seven Stock Market Indices Individually



Source: Robert Barro and Gordon Liao, 2020