

Financial Repression: Why It Matters by Shane Shepherd, Ph.D.

Financial repression refers to a set of governmental policies that keep real interest rates low or negative and regulate or manipulate a captive audience into investing in government debt. This results in cheap funding and will be a prime tool used by governments in highly indebted developed market economies to improve their balance sheets over the coming decades.

We should all be familiar with the effects of financial repression by now. If not, compare the declining amount of interest income coming out of your savings account to the rising costs you pay for groceries, gasoline, or (shield your eyes) college tuition. It has been nearly five years since we heard a loud “THUD” as the nominal yield of the short term U.S. Treasury note hit zero percent. The resulting negative real interest rates have become a pervasive feature of our economic landscape, and we expect them to persist for a very long time.

What is Financial Repression?

Financial repression, in a nutshell, refers to a set of government policies that create an environment of low or negative real interest rates, with the unstated intention of generating cheap funding for government spending. Monetary policy is a powerful lever to achieve this end. The Federal Reserve, European Central Bank, Bank of Japan, and Bank of England have all set their short-term policy rates near zero. Creating expectations for future policy rates to remain low (expressed, for example, in Ben Bernanke’s “extended period” language) have a powerful effect on the shorter end of the yield curve. If we all believe that the overnight rate will remain at zero for the next three years, then the three-year rate should also provide a yield very close to zero.

Additionally, sizeable Quantitative Easing (QE) strategies keep rates low on longer bonds. These QE programs have not proven to be a temporary fix to a short-term liquidity problem; on the contrary, they are growing larger. The Federal Reserve is now purchasing \$85 billion of assets every month, and the Bank of Japan (BOJ) recently committed to doubling its holdings of JGBs over the next two years, while increasing the average maturity of its purchases from three years to seven years. These initiatives exert downward pressure farther out on the yield curve.

Why Does the Debt Overhang Matter?

At the same time, the massive expansion of central banks’ balance sheets has raised inflationary expectations, and policy statements have shifted toward higher tolerance of inflation. For example, the BOJ is specifically targeting a 2% inflation rate. Similarly, rather than fighting inflation, the Federal Reserve has voiced a preference for the “lower unemployment” side of its dual mandate. It should be stressed that a high rate of inflation is not necessary to achieve negative real interest rates. An inflation rate of 2-3% will do the job just fine, as long as nominal rates remain near zero.

Merely setting interest rates below inflation, however, won’t fully achieve the desired result. The second part of financial repression is convincing a captive audience of buyers to hold government debt at exceedingly low yields. This can be done through the regulation of banks and pensions, capital controls, and good old-fashioned arm twisting—what Carmen Reinhart politely calls “moral suasion.” (See Reinhart, [2011], and Reinhart, Kirkegaard, and Sbrancia, [2011]).

It isn’t hard to find examples of these tactics. The Basel III regulations give banks strong incentives to hold sovereign debt to satisfy their capital requirements. Ireland has pressed their National Pension Reserve Fund into service purchasing government securities and recapitalizing their banking system. Japan Post, the world’s largest pension plan, continues to buy JGBs apace. Capital controls, a prominent feature of the global markets following World War II, have largely faded away over the past 30 years. However, we are seeing a resurgence of stronger capital controls among many Emerging Market countries concerned to protect their currencies by restricting the flow of hot money seeking a higher rate of return. And capital controls were suddenly imposed in Cyprus where a Euro is no longer a Euro.

Why Do We See Financial Repression?

On the surface, these policies are put in place to combat weak economies, spur economic growth, and reduce unemployment. These are certainly laudable goals, but they presuppose that we find ourselves in a typical business-cycle type of recession and the problem is feeble demand. If that were the case, low real interest rates would normally reduce savings, move consumption from future years into the present, and generate stronger economic growth.

Economists decompose interest rates into three components: a real rate of return, an inflation factor, and a risk premium. Investors, an impatient lot, typically demand a positive real rate of return if they are to save rather than consume. Consuming today is generally more attractive than deferred gratification. If that real rate is high, people are motivated to save; if that real rate is low, they have stronger incentives to spend, and as it moves into negative territory, they are actually penalized for saving. Their savings will have lower purchasing power in the future. In a normal economic environment, negative real interest rates would generate stronger present-day demand by reducing savings and increasing borrowing. GDP growth would rise and unemployment fall.

By now you have undoubtedly guessed that we are not in a typical economic setting. Rather than a standard business cycle recession, we find ourselves in a debt overhang economy with weak demand driven or at least exacerbated by deleveraging. The root problem is not the weak demand, but rather the high debt levels which can only be rectified by increased savings. In this environment, our personal financial decisions are largely interest-rate insensitive. In addition to low or negative real interest rates, the dominant features of this economy are slow economic growth, higher unemployment, and low returns on most financial investments. These symptoms are unlikely to disappear until the core debt overhang problem is addressed.

The standard Keynesian prescription for slow growth is to increase government spending in economic downturns to smooth out aggregate consumption. (The corollary—reduce government spending when economic growth returns—is oft forgotten.) This works, up to a point. But when governments reach extraordinary high levels of debt, the increase in government debt actually begins to create a counterproductive drag on economic growth. Checherita and Rother (2010) show that the slowing effect of high debt on economic growth may manifest itself at levels as low as 70% debt-to-GDP. This slower growth results from

an increased need for private savings, reduced public investment, and lower productivity. Reinhart, Reinhart, and Rogoff (2012) present long term evidence that high debt is associated with slower growth, and establish that it takes a very long time to recover from these debt overhangs—historically, an average of 23 years! Despite challenging a portion of Reinhart and Rogoff's (2010) research, a new paper by Herndon, Ash, and Pollin (2013) still shows a slowing (although less dramatic) trend on GDP growth as debt levels rise for the more recent period of developed market countries. Herndon, Ash, and Pollin do not dispute the longer term developed market country results nor the results for emerging market countries.

Most major developed countries are at extraordinarily high debt levels. Unfortunately, we are addicted to debt. In small doses our drug makes us feel better and appears to be a solution to all our problems. But as we come to rely more and more on it, we need the drug just to feel normal. Denial kicks in (remember Dick Cheney's remark that "deficits don't matter"). Eventually our drug loses its effectiveness

and becomes the cause of our problems. We now stand at that turning point. Much of the developed world has become addicted to debt and debt-financed consumption. The solution cannot be more debt.

Financial repression is the practical solution to our debt addiction. No, it is not a fun one,

but consider the alternatives. We are faced with a limited set of options. Ideally, we could reduce debt-to-GDP ratios by holding debt constant and increasing GDP. This requires low deficits and strong economic growth—hardly a description of the current experience in most developed economies. Moreover, with the debt overhang continuing to slow economic growth, this solution is unlikely to materialize on its own.

We could try and dramatically reduce debt through austerity policies. The difficulty here is that GDP drops along with spending, so the economy as a whole shrinks and the debt-to-GDP ratio may not improve.

Like Greece, we could simply walk away from or restructure our debts. However, Greece was forced into this path because they were tied to a hard external currency in the Euro. It is an unappealing and unlikely avenue for governments with control of their own currency.

Or we can turn on our printing presses and remove the debt through sudden, surprise inflation. Imagine if the Fed simply printed \$16 trillion in physical dollars and handed them over to the holders of U.S. Treasuries. This would satisfy the obligation, but at the cost of tremendous sudden

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inflation. Realistically, in fact, hyperinflation on the Weimar scale.

Financial repression relies on inflation, but it is a steady, stealthy process and therefore much more politically acceptable. By keeping interest rates low, governments receive cheap funding, and (as long as deficits are held in check!) debt will grow only slowly. Higher inflation will lead to faster nominal GDP growth. This process will liquidate the size of the government debt burden by an amount equal to the negative real interest rate. Reinhart and Sbrancia (2011) show that this liquidation effect was widely employed by highly indebted governments following World War II. However, the process took several decades. If negative real rates average 2% over the next 20 years, debt-to-GDP will drop from 100% to a manageable 60% level. Higher deficits and slower growth would extend that timeline. The good news: we have a solution. The bad news: it is a very slow one.

What Should We Expect?

The important message is that we need to adjust our expectations to the new economic environment. We are not experiencing a normal business cycle recession. We are mired in a debt overhang problem. The lifespan of financial repression will be measured in decades, not years. Interest rates will not rise anytime soon, but remain at or below inflation for many years. Economic growth will not sharply rebound as it typically does upon exiting a business cycle recession, but grow slowly. Unemployment and under-employment will remain elevated. Remember the meaning of debt: it is a vehicle to transfer consumption (economic activity) from the future to the present. If present economic activity is higher due to debt-financed

consumption, then future economic activity will by necessity be lower when that bill comes due. These pressures have been building up over the course of several decades. We have a lot of catching up to do.

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