Risk of financial repression in the West

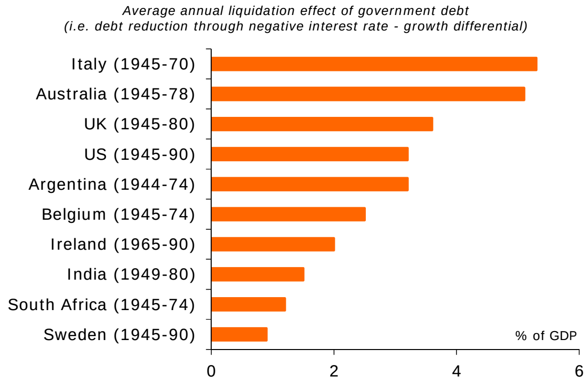
This article is part of a series of Special Reports that discuss the downside risks to the global economic outlook. In this piece, we take a closer look at the risk of financial repression in the West.

Budget cuts are politically unpalatable

Many governments in the industrialised world are stuck between Scylla and Charybdis– the two famous sea monsters in Greek Mythology. If they are to cut their primary budget deficit too quickly to please the market, they risk choking the fragile recovery, if they do it too slowly, they risk falling into the 'bad' equilibrium of rising interest rates and lower growth. In both cases, the incumbent government will have difficulty winning the upcoming elections. History shows that boosting real GDP growth in a period of sluggish domestic and external demand is next to impossible. So how else can a government lower its debt ratio? One solution touted by market participants is making sure the nominal interest rate the government pays on its long-term debt stays lower than the growth of nominal GDP. By keeping the interest rate – growth differential (IRGD) negative, the debt ratio starts to fall, *ceteris paribus*. But how can that be achieved? Since boosting real GDP growth is out of the equation, inflation must rise to push nominal GDP growth upwards. Yet if inflation starts to rise, bond vigilantes will rightfully demand an interest-rate premium. Of course, the effective nominal interest rate on the debt is slow to respond to an increase in market yields because the entire debt stock does not roll over every period. But in due time all the debt stock will have to be serviced at higher interest rates. As you can imagine, all the government will achieve is moving from a low inflation/interest rate equilibrium to high inflation/interest rate equilibrium while the IRGD stays unchanged. This does nothing to improve debt sustainability.

But the study of Escolano et al. (2011) shows that during 1999-2008, IRGDs in the non-advanced economies, on average, have been deep into the red (below -7%-points). Reinhart and Sbrancia (2011) also find that during 1945-80, governments in the advanced economies managed to significantly liquidate their debt ratios via negative real interest rates. For example, the annual liquidation effect in Australia, Italy, the UK, and the US was estimated to be between 3-5% of GDP (see figure x).

Figure 1: Stealthier ways of lowering debt



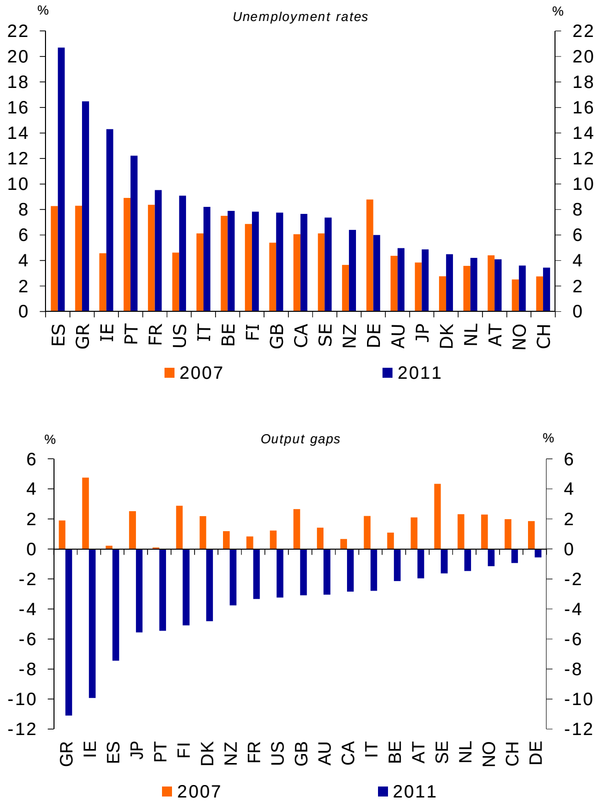
Source: Reinhart and Sbrancia (2011)

Both studies found that the trick was to maintain a steady dose of inflation while pushing long-term interest rates downwards. As regards the former, Reinhart and Sbrancia (2011) find that in 22 of 28 countries in their sample, inflation has been considerably higher in the episodes of debt reduction than for the full sample. In the extreme cases, such as during the German hyperinflation of the early 1920s and the long-lasting Brazilian and Argentine hyperinflations of the early 1990s, inflation has managed to single-handedly liquidate public debt. Even in more moderate cases, the authors argue that the inflation differentials between the debt reduction episodes and the full sample are suggestive of the use of inflation to liquidate government debts.

You may be wondering how they managed to artificially keep interest rates lower while inflation was on the rise. Certainly, one would expect that creditors would wake up to the fact that their returns are being chipped away by inflation and, therefore, start asking for higher interest rates. Even worse, interest rates must have risen above and beyond inflation because investors did not know for sure when inflation would peak. The simple reason this did not happen was due to **financial repression**, which are subtle policies adopted by governments to channel to themselves funds that in a deregulated market environment would go elsewhere. These include directed lending to the government by captive domestic audiences (such as pension funds or domestic banks), explicit or implicit caps on interest rates, regulation of cross-border capital movements, and generally a tighter connection between government and banks, either explicitly through public ownership of some of the banks or through heavy 'moral suasion'. Financial repression is also sometimes associated with relatively high liquidity requirements (or reserve requirements) or securities transaction taxes. Thus, through financial repression, governments kept interest rates lower than they would be in more competitive markets. Other things equal, this policy manages to reduce the public sector's interest expenses for a given stock of debt and contributes to deficit reduction. Voila!

Now that we know governments have indeed liquidated their public debts in the past, can we expect the same phenomenon to occur in the near future? There are good reasons to worry. First let's turn our attention to the risk that central banks (CBs) in the indebted countries allow inflation to rise slightly[1] above their target to hasten the deleveraging process. A number of facts lead some to conclude that this is certainly their intention. Most notably, very high unemployment rates and large output gaps (see figure 2) have made many central bankers nervous that their conventional and unconventional policies[2] are not having the desired effect.

Figure 2: Unemployment and output gap



Source: IMF, OECD

Hence, there are now talks as for ways to lower the real policy rate even more in order to bolster growth and push down jobless rates.

[1] We stress on the word 'slightly' because we do not believe that CBs will allow prices to spiral out of control given the risk of permanently undoing the progress made over the last 20 years in anchoring inflationary expectations and the inflation process itself.

[2] Recently, we have seen a renewed expansion of unconventional policies across the major CBs. The Fed has clarified its intention to keep policy rates low until at least mid-2013 and has renewed asset purchases through Operation Twist (selling short-dated securities and buying long-dated ones to flatten the yield curve). There are now rumours that the third round of quantitative easing (QE3) will be launched in 2012. The Bank of England engaged in QE2 recently. The ECB has reactivated covered bond purchases and its Securities Markets Purchase (SMP) programme is still expanding. And, most radically, the Swiss National Bank has set a minimum rate for the EUR/CHF exchange rate, and has committed to sell unlimited quantities of Swiss francs if needed to defend that level.

Chicago Fed President Evans has publicly expressed the need for a more aggressive interpretation of the Fed's dual mandate of low inflation and unemployment, whereby the Fed would commit to maintaining current policy rates until the unemployment rate fell below 7% or core inflation hit 3%.

Since real rates cannot be lowered much through conventional measures in the advanced economies, the only way possible is if CBs start tolerating higher inflation, for at least some period. Let's not forget that such a radical recommendation was given to Japan a decade ago by none other than Ben Bernanke, the current Chairman of the Federal Reserve. Bernanke (1999) argued that "*a target in the 3-4% range for inflation, to be maintained for a number of years, would confirm not only that the Bank of Japan is intent on moving safely away from a deflationary regime, but also that it intends to make up some of the price-level gap created by eight years of zero or negative inflation*".

CBs can achieve a slightly higher inflation by raising their targets. They could alternatively go for price level or nominal GDP targeting[3]. Regardless of the approach taken, there are risks that CBs allow inflation to rise above their target in the medium term in order to combat high jobless rates and ample spare capacities. The byproduct of such a policy is that public and private debt will be inflated away, at least in the very short run. As such, indebted governments will welcome such policy shift.
As stated previously, sooner or later investors will realise what the countries are up to and so interest rates begin to rise in tandem. Consequently, governments in the advanced economies may once again find 'stealthier' ways (i.e. financial repression) to keep interest rates in check while central banks are inflating away their debt. Such policies are considered by some to be a useful addition to the painful austerity and reform packages already in place or yet to be implemented.

There are already signs that financial repression is re-emerging amid ballooning debt ratios. For example, at the height of the financial crisis UK banks were required to hold a larger share of gilts in their portfolio. Ireland's government used the National Pension Reserve Fund in 2010 to recapitalise Irish banks. The previously privatised Portugal Telecom pension scheme was transferred back to the Portuguese government. Consequently, the government was immediately able to book EUR 2.8bn in extra revenues, about 1.6% of GDP. Meanwhile, the Spanish government imposed interest rate ceilings on deposits in 2010. The Ministry of Finance required institutions offering deposit interest rates the ministry determined to be above market rates to double their contributions to the Deposit Guarantee Fund (Kirkegaard et al., 2011).

More recently, politicians asked banks to not further reduce their exposure on Greece while the country was being bailed out. In the meantime, the Wall Street Journal reports[4] that Italy and Portugal, among other European governments, are leaning on their banks to continue buying –or at least to stop selling– government bonds, according to their sources. The newspaper reports that a senior Italian bank executive has said that "*we know that if we reduce our exposure, we'll be killed by the Italian Treasury*". Apparently, the executive described receiving phone calls from Treasury officials exerting 'friendly pressure' after his bank unloaded some Italian government bonds. It is

[3] **Price level targeting:** The main difference to inflation targeting is that when inflation is lower than target, policy would push it higher than target later (in inflation targets, by contrast, 'bygones are bygones'). Price level targets have been discussed by New York Fed president Dudley and were recommended by Ben Bernanke for Japan in 2003. **Nominal GDP targeting:** A central bank would commit to a for the level of nominal GDP. Like price level targeting, a nominal GDP level target would commit the central bank to make up for any misses.

[4] *European nation's pressure own banks for loans*, the Wall Street Journal, November 29, 2011.

very difficult to independently verify these stories but it does echo the message of Reinhart et al. (2011) that financial repression will return the more desperate the governments become.

Note that governments may also be carrying out financial repression indirectly. A good example, according to Kirkegaard et al. (2011), is the latest international bank regulatory standards (Basel III) that is supposedly designed to ensure the overall health of the financial system. Critics of Basel III have charged bank regulators with tilting the treatment of sovereign risk to provide regulatory incentives for banks to accumulate large sovereign exposures. The biggest criticism is the underpricing of sovereign risk. Banks that adhere to the 'standardised approach' of Basel III are allowed to apply zero risk weight to sovereign debt rated AA- or higher (this rule has been in place since Basel II). Moreover, the large exposure regime in Europe excludes highly rated sovereigns from the 25% of equity limit on large exposures based on Basel Accords. According to the EU capital requirements directives (CRDs), exposures to EU Member States' central governments and CBs denominated and funded in the domestic currency of that central government and central bank shall be assigned a risk weight of 0%. As Sharon Bowles[5] nicely puts it, "*the foolishness of having Greek and German debt treated similarly just because they are both in euros needs little explanation*"[6]. The US situation regarding the treatment of sovereign risk is very similar. It continues to be based on the zero risk weight applicable to OECD countries in the old Basel I framework, as the Basel II 'internal ratings-based approach' is not yet fully in place (Hannoun, 2011). The newly established liquidity coverage ratio (LCR)[7] that requires banks to hold sufficient highly liquid assets[8] further increases the incentive to buy public debt.

As the analysis above shows, it is relatively easy to conclude that governments encourage banks to hold onto their debt by giving it preferential treatment for satisfying capital requirements. As a consequence, Kirkegaard et al. (2011) argue that the need for higher tier-1 (T1) ratios, according to Basel III guidelines, is actually a way of financial repression. To understand the criticism, one must realise that banks can raise their T1 ratio by increasing the numerator (core equity capital), reducing the denominator (risk-weighted assets, RWA), or a combination of both. As for the numerator, it can be done through higher retained earnings and/or raising fresh capital. We know that in times of financial stress and economic slowdown, banks cannot sufficiently boost their core equity through higher profits. This means they will have to raise extra capital. But this is not without problems either. Banks do not see an incentive to raise equity at such low price-to-earnings multiples (see figure 3). Dilution of current shareholders is a highly unattractive option. Besides, who says investors will even sign up to the extra equity the bank hopes to raise given the increased uncertainty in the financial markets? This leaves the denominator (RWA) to do most of the heavy lifting. Financial institutions can opt to 'lower' their RWA by giving fewer loans to the private sector and instead hold more zero-weighted sovereign bonds. The end result is a higher T1 ratio that satisfies regulators. In the meantime, the higher demand for government bonds will lower their interest rates and thereby improves fiscal positions in the Western world.

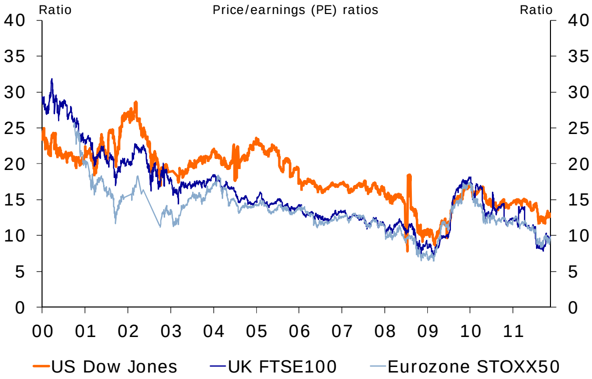
[5] *Chair of the European Parliament's Economic and Monetary Affairs committee*

[6] *Time for sovereigns to swallow their medicine*. Financial Times, November 23, 2011.

[7] The LCR requires banks to hold sufficient highly liquid assets in order to absorb an outflow of funds for a 30-day period in a severe stress scenario.

[8] Note that the liquidity requirements under Basel III do not designate government securities as the only qualifying liquid assets, which are categorised into Level 1 and Level 2. Level 1 assets (mainly highly rated sovereigns) are considered to be of the highest credit quality and best market liquidity. Highly rated corporate and covered bonds are qualify as Level 2 assets, but are subject to a 40% limit.

Figure 3: Price-to-earnings ratios



Source: Reuters EcoWin

An even more indirect form of financial repression is allowing the emerging markets to use capital controls in the hope of controlling destabilising inflows (hot money). Indeed, many emerging markets have already begun to use such policies. But what is interesting is that such policies have found far greater acceptance in the international community, particularly amongst the OECD countries, than at any time since the breakdown of the Bretton Woods system. In desperate need of cash, governments in the West are more than happy to see the non-industrialised world close its doors towards foreign investors. The idea is that investors will be forced to park their money in Europe and the US, whereby a large chunk of it goes to the public sector.

Artificially lowering IRGDs through financial repression comes at the expense of misallocation of resources –both amongst sectors and regions. The highly efficient private sector that serves as the engine of job creation will be starved of credit and this results in a higher jobless rate in much of the industrialised world. And capital flowing 'downhill' (i.e. to poorer countries) generates a higher return on investment. Various studies have shown that higher inflation also negatively affects economic activity[9]. Not to mention that the banks' fortunes will be more strongly tied to their sovereigns. When banks and sovereigns are joined at the hip, financial stability is at risk. Governments must realise financial repression further aggravates this delicate relationship.

Bottom line: In the heavily regulated financial markets of the Bretton Woods system, several restrictions facilitated a sharp and rapid reduction in public debt ratios from the late 1940s to the 1970s. A high incidence of negative real interest rates liquidated or eroded the real value of government debt. The experience so far shows that the pendulum is beginning to swing away from laissez-faire financial markets toward heavier-handed regulation in response to the global banking crisis of 2008-09. But one cannot help noting that one of the by-products of the design principle of the current regulatory framework is to make it easier to work down the massive debt overhang, especially for the public sector. If financial repression makes an unfortunate comeback in the West, then potential growth in the global economy will drop at the worst possible time. We sincerely hope that policymakers will stay clear of such policies. But completely excluding the possibility of financial repression in the future is unwarranted.

December 2011

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[9] For a survey see Rabo Special: demystifying the paths towards debt sustainability – 2010.