Beware of financial repression as a fiscal remedy

1. Large public debt burdens are a big challenge for advanced economies

Public debt levels in advanced economies have risen significantly in the past two decades. The Global Financial Crisis, the Pandemic and the rapid rise in energy prices in Europe, required large fiscal interventions to help support the economy. At the same time, economic growth has been weak. As a result of these adverse dynamics, public debt levels in many OECD countries are now at high levels relative to history. This makes these countries vulnerable to future ratings downgrades and runs on government debt, as the UK experienced in 2022.

Financial markets and ratings agencies are therefore exerting pressure on governments to either lower or stabilize the path of the current government debt to GDP ratio. There are concerns that yields on government debt will gradually rise to levels that will make public debt to GDP dynamics less sustainable, given the current low growth environment in many countries. At the same time, governments are facing rising spending pressures from an aging population, military spending and investment necessary for the green transition. Given these additional spending pressures on top of already high public debt to GDP, it is perhaps not too surprising that financial markets and ratings agencies are concerned.

Governments have several ways to reduce or stabilize the public debt to GDP ratio. The virtuous way is to raise revenue above expenditure and accumulate primary budget balance surpluses to repay the public debt. This approach often means that difficult spending and tax decisions need to be made and that requires significant political consensus. Governments may hope that higher inflation can reduce the value of their debt. However, this is politically challenging and not effective when a significant share of the debt is indexed to inflation. For example, UK government interest has risen significantly relative to other countries because a significant share of the Gilt market is inflation indexed.

An important historical adjustment channel has been stronger economic growth. But many countries are in a low growth environment today and this is unlikely to improve as populations age and a larger share of the population enters retirement. The easy way to adjust lower debt to GDP

via growth appears less feasible this time around. But lowering debt through primary surpluses when the demand for spending is rising or via higher inflation is highly politically unpopular.

But there is one other way to help reduce the public debt to GDP ratio: Financial repression. This has been an important channel that contributed to lower public debt to GDP levels in many countries historically. Financial repression can also help to keep bond vigilantes at bay. Only very courageous bond market traders would dare to challenge the central banks of advanced economies. Perhaps most importantly, financial repression is a politically acceptable tool to manage public debt dynamics, especially if it is implemented in a gradual and subtle manner.

In this essay, I define financial repression, review historical evidence, discuss how financial repression may gradually be emerging today and explain why this strategy is self-defeating in the medium term.

2. Historically, financial repression helped to address this challenge

Financial repression is defined as any policy which interferes with the free flow of capital to help lower the cost of government finance. In practice, financial repression can take several forms. Financial repression can be subtle. Governments can attempt to lean on central banks to prolong asset purchases of government debt. They can provide strong incentives for their citizens to purchase their debt. Financial repression may result from abuse of financial regulatory policy: Banks may be required to hold much higher levels of government debt than necessary for prudential purposes. Direct financial repression is when governments force costs of their policies directly onto financial institutions: Raising the share of minimum reserves renumerated at 0% to pay for losses from central bank holdings of government debt. Each type of financial repression interferes with the free flow of capital that would have happened in the absence of this policy.

There is historical precedence for financial repression in response to a significant public debt burden. During the Covid-19 Pandemic, the large rise in spending was often compared to emergency spending during a war. Indeed, advanced economies have used financial repression to reduce their public debt burden after the second World War.

There is historical evidence of both subtle and direct financial repression in the United States. Following the debt accumulation of the Second World War, the US Federal Reserve pegged interest rates on government debt at a low level until 1951. Thereafter the Fed kept interest rates

below the level of inflation for many years. Naturally, one of the reasons why interest rates remained below the level of inflation is that inflation kept surprising policy makers to the upside. Historical records show that the Federal Reserve argued that monetary policy couldn't address inflation due to supply shocks well. Furthermore, many academic studies of this period suggest that the Federal Reserve had a much stronger reaction to activity as opposed to inflation. But there was an important element of subtle political persuasion as well. The Federal Reserve's Operation Twist, whereby the Federal Reserve bought long-term government bonds in exchange for selling short-term government bonds, was implemented at the request of the Kennedy Administration in the early 1960s. The result was a lower level of long-term government bond yields. US president Richard Nixon put pressure on Federal Reserve Chair Arthur Burns to ease monetary policy in 1971 ahead of the 1972 election. Burns obliged. Indeed, a recent IMF working paper estimates that these factors together led to a reduction of over 50 per cent in the debt to GDP ratio between the end of the second World War and the early 1970s. Clearly, it is hard to separate out of the effects of the Great Inflation of the 1970s from those of financial repression in that calculation. Nevertheless, it is likely that the use and effects of financial repression were significant.

The UK also relied on financial repression to manage its debt burden after the second World War. The UK used interest rate caps and a number of different policies to channel savings away from the private sector and into government debt instead. The Bank of England kept Bank Rate fixed at 2% until 1951. The Bank of England was nationalized in 1946, which gave the Bank, with Treasury approval, the power to govern the share of government debt that commercial banks held via liquidity regulation. This would turn out to be an important tool of financial repression in the following years. Another very powerful tool of financial repression was exchange controls which restricted some external loans and inward capital flows. By limiting funds that could be invested abroad, domestic savings had a smaller number of alternative destinations. These policies helped the UK to reduce public debt to GDP in the post-war years rapidly. And some of these policies, like exchange controls, stayed in place until 1979.

The UK and US were of course not the only countries to rely on such strategies to manage their public debt to GDP burdens. Central banks in many European countries held a significant share of government debt to help manage yield curves. And Italy had external capital controls until the

early 1990s, when the European single market was created and required freedom of capital as part of membership.

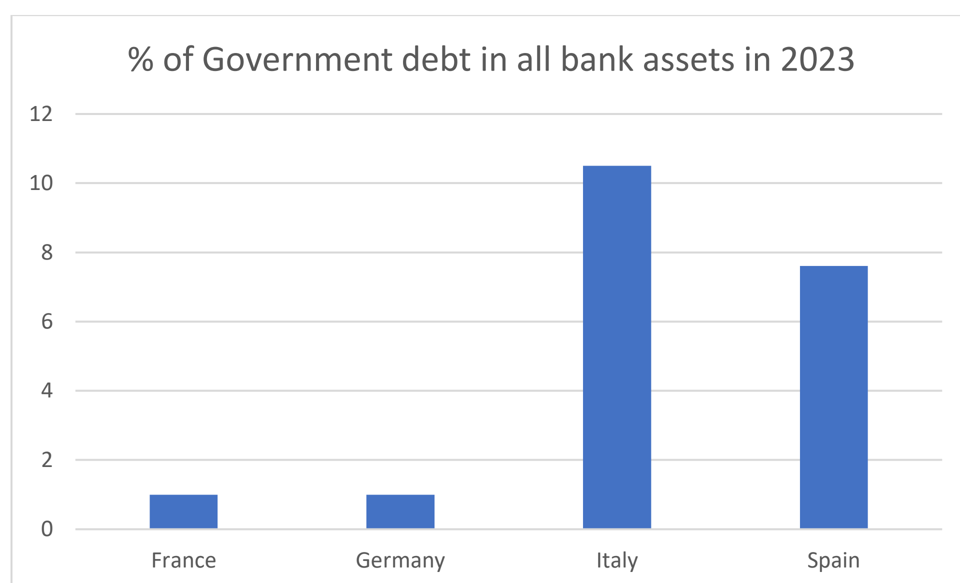
3. Could financial repression return as a debt management tool today?

Given this extensive historical precedence, could financial repression be used again today? The answer is most certainly yes. Indeed, it can be argued that several countries are already beginning to rely on financial repression to help manage the large public debt burden they face. The rationale for this is simple. Reducing spending or raising taxes is difficult. Inflation is very politically unpopular. And in many countries, GDP growth rates are too low relative to real interest rates to reduce the public debt to GDP ratio in any significant way. Financial repression therefore appears to be the path of least resistance.

Permanently larger central bank balance sheets will raise the risk that governments will rely on them as a lender of last resort. Central banks will remain important participants in government bond markets, despite QT. This will help them to intervene effectively in times of market dislocation, such as March 2020 or September 2022 in the UK. This is clearly a desirable feature from a policy perspective. But this new institutional arrangement leaves central banks in a vulnerable position: They will need to decide whether government bond markets are seizing up due to illiquidity or insolvency, and hence whether to intervene or not. Essentially, the central bank will need to apply Bagehot's rule for banking crisis to lending to governments. But in practice, it will be very hard for the central bank to refuse market support when it is needed. This institutional environment is a lot more prone to financial repression than in the previous four decades.

Clearly, the Bank of England has demonstrated that central banks with large balance sheets can strongly resist political capture. It's time-limited intervention in October 2022 was a master class on how to calm down markets, on the one hand, while demonstrating institutional independence on the other. The Bank returned markets to stability, while at the same time allowing markets to continue their market disciplining effect on government finances. However, walking this tightrope with such excellent outcomes will likely not always be possible. In countries with weaker institutions than the UK, achieving such an outstanding result will be harder, especially if the central bank comes under political attack.

A more direct form of repressing banks and bond markets may occur through abuse of regulatory policy. Following the financial crisis, bank liquidity requirements were designed for banks to hold enough liquid assets to sell in times of a run. This liquid asset is normally government debt. Financial repression is requiring banks to hold a significantly larger amount of government debt than is necessary for prudential purposes. Indeed, this has been the strategy of Italy for the past decade. In more recent times, Italian banks have been divesting from government debt securities. But their share of public debt in total bank assets remains roughly 10 times as high as in Germany or France. The Spanish government has been relying on this approach as well. More governments could adopt this approach going forward.



Source: IMF sovereign debt investor database.

Issuing debt directly to retail investors, if large in scale and with the specific purpose of lowering bond yields, could also amount to financial repression. From the perspective of retail investors, investing in government debt provides a high yield and the protection of funds is not limited by deposit insurance. Banks are unlikely to offer the same high yield on their savings accounts due to costs of intermediation. Large direct debt sales to retail investors will therefore significantly reduce the deposits in the banking system. These effects are further exacerbated by tax incentives. In Italy, the tax on government bonds is half that of other bonds. The UK government allows resident retail investors to sell Gilts without capital gains tax. These tax incentives, together with the competitive

levels of yield and security, make retail investments in government bonds a lot more attractive relative to holding bank deposits.

Depending on the nature of the banking system, this direct retail sales of government debt impede the allocation of capital and could therefore be financial repression. In some countries, small banks just re-intermediate deposits back into government debt. Providing the option to invest in government debt to retail investors in these cases raises economic efficiency and there is no harm done. But most of the time, banks are the key allocators of capital: They channel savings to firms and households. But offering large amounts of government debt to retail investors will impede this process. Rather than being intermediated to the private sector, these funds will finance government borrowing. This means that ultimately the costs of borrowing for households and firms rise. Households will not be able to smooth consumption as well and firms may invest less, which could reduce the aggregate potential growth rate of the economy is these effects are large.

In reality, issuing government debt directly to citizens has been a rapidly growing component of government finance in the past year. In 2023, Italy issued 44bn of government debt to retail investors relative to 14bn the previous year. Similarly, Belgium issued 23bn relative to 110mn the previous year. All of these countries have very high debt to GDP ratios and in the current environment of high global interest rates it appears that these measures are aimed at broadening the investor base for government debt. In Belgium, the issuance was 6% of the banking systems deposit base. Some governments are therefore already issuing their debts to retail investors at a scale which can be considered financial repression, because they leave less savings for private investment.

Central banks are currently running large losses from their QE programs. The yield on their investment portfolios of government debt is much lower than the rate on reserves, which the portfolio is financed with. Some central banks, such as the Bundesbank and the Dutch National Bank, have put funds aside when QE was profitable, as a cushion to absorb potential future losses. However, the scale of the rise in policy rates, which is the rate on reserves, means that this cushion is now gone. Fiscal authorities, who are the ultimate backers of central banks, will have to start reimbursing these losses soon. In most other European countries, including France, Italy, Spain and the UK, the profits from QE were transferred directly to governments. This means that their

respective fiscal authorities have been paying for these losses. In many cases, the fiscal resources required to pay for these losses can be as large as 1% of GDP per year.

To lower the costs of this significant fiscal drag, central banks in some jurisdictions slightly raised the minimum required reserves, which are renumerated at zero. But there is a much broader policy debate now on whether a larger share of these reserves should be renumerated at zero. Raising the share of central bank reserves renumerated at zero means that the central bank has to pay less on the liabilities that were used to finance QE. As a result, the fiscal outlay to pay for these losses will become smaller.

But renumerating a greater fraction of zero pushes the costs onto commercial banks instead. Commercial banks hold reserves as an asset. If that asset starts to be renumerated at 0%, their earnings will decline. The natural reaction of commercial banks is to lower the rates they pay on deposits and raise their lending rates to pay for these additional losses. The costs are therefore eventually borne by borrowers and savers. Most importantly, these additional costs also impede the capital allocation process as described above. Changing the institutional reserve framework to reduce the fiscal costs amounts to financial repression, because it interferes with the capital allocation process.

An important argument behind the zero renumeration of reserves is that banks make much stronger profits as a result of the current higher rates environment. They could therefore easily absorb the cost of this policy. But it is unclear if banks will just allow their margins to absorb these costs. Indeed, given the oligopolistic nature of many banking systems, especially in European countries, it is easy to see how banks could choose to pass on the costs onto savers and borrowers instead. A better solution, with less risk of financial repression effects, would be to tax bank profits directly to pay for the greater than expected fiscal costs of central bank QE portfolios.

4. The long-term costs of financial repression far outweigh the benefits

The economic consequences of financial repression are significant, but there are important differences between the short- and long-term effects. In the short term, the absorption of private savings into government bonds leads to less consumption by households. Lower availability of funds and their higher costs will likely crowd out private investment. As a result, private sector demand could fall. For the same amount of supply, this decline in demand will likely lead to lower

inflation. This means that the nominal size of the economy grows by less than expected and therefore the public debt to GDP ratio remains high. But lower monetary policy rates in response to lower inflation will support lower short-term debt financing costs. Similarly, financial repression will lower debt financing costs. These effects will likely more than offset weaker nominal growth in the short term. Financial repression could therefore be an effective short-term solution.

But the much bigger costs occur in the long term. Lower investment reduces the capital stock and the productive potential of the economy. The supply side of the economy will become more structurally rigid. This means that for the same rise in demand, the result will be greater inflation. The natural rate of growth will decline, while the rise in inflation may lead to a higher neutral policy rate and therefore a higher level of the yield curve. By lowering the natural rate of growth and raising the neutral interest rate, public debt dynamics become even more unsustainable in the medium term. Financial repression is therefore a much more costly and self-defeating policy in the medium term.

Investors will resist any financial repression regime. Clearly, it is easier to repress domestic investors than foreign ones. Countries which run persistent current account surpluses like Italy or Japan have greater scope to implement financial repression, since they are not as dependent on foreign flows. But those countries which are dependent on foreign money to finance debt issuance will therefore find it hard to implement such a regime. While not directly attributable to financial repression, the UK's balance of payments crisis in the 1970s demonstrated how rapidly the loss of faith by foreign investors can escalate into a crisis.

It is up to politicians to decide whether financial repression is a way out of developed economies' current fiscal issues. In the short term, financial repression appears to be an attractive solution. After all, this is a political path of least resistance, as it doesn't involve difficult fiscal decisions, inflation or unpopular reform measures. But in the long term, the costs clearly outweigh any benefits. But therein lies the challenge. Those policy makers who implement these policies will likely not experience the adverse consequences. Political cycles therefore also provide incentives to implement financial repression.

Given these political incentives, it should not be surprising that some countries are already on a gradual path towards financial repression. As economists, we understand the long-term adverse

consequences of such policies better than many. It is therefore our duty to keep ringing the alarm bells and point to the long-term costs of financial repression policies.