FINANCIAL REPRESSION: ANTIDOTE FOR DEPRESSION OR PRESCRIPTION FOR FINANCIAL TROUBLE?

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Although the term “financial repression” has been in usage about 40 years, governments have been practicing forms of it much longer with arguably varying degrees of success. The current episode is notable for its breadth and depth. And while many economists and central bankers believe that an economic depression was averted with the adoption in recent years of non-traditional monetary policy (including so-called quantitative easing), it remains to be seen if the continued use of such measures breeds serious financial problems for policymakers and investors. This research note briefly examines the impact that financial repression has had so far on stakeholders and financial markets and concludes with several thoughts on what might lie ahead, including the need for sound fiscal policy as part of a successful exit strategy.

What Is Financial Repression?

The term “financial repression” was first used in the 1970s to describe a phenomenon in developing countries in which governments interfered with free market activity and pricing of financial market instruments. For example, governments could choose to control the setting of interest rates and the freedom to allocate credit by banks. They could restrict the scope of market activities and competition by imposing controls on securities markets and capital account transactions. Entry barriers for new businesses and state ownership in the banking sector were common forms of financial repression. Also, market intervention by governments supported certain sectors or groups of investors, helping them obtain funds on favorable terms.

In recent years, “financial repression” has been associated with central banks’ monetary measures to keep policy and market interest rates too low for too long. Such policies (including quantitative easing) have been created in the hope of not only stimulating economic activity among consumers and businesses, but also to help relieve pressures of servicing onerous public debt. In the United States, the Federal Reserve (the “Fed”) has kept the target federal funds rate at 0-0.25 percent since late 2007. This extremely low interest rate range is expected to continue for “at least as long as the unemployment rate remains above 6-1/2 percent”, which could last several more years, according to our estimate. As discussed below, this form of financial repression is likely to distort market activities in the medium-to-long term by interfering with the proper pricing of risk and, by extension, the true cost of capital.

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1 See Abiad and Mody (2005) and Abiad, Detragiache and Tressel (2008).
The Mechanics of Financial Repression in the United States

In response to the onset of the financial crisis in the summer of 2007, the Federal Reserve used traditional and nontraditional monetary policy tools to avert a potential global economic disaster. Within 16 months of August 2007, the Fed cut the target federal funds rate from 5.25 percent to 0-0.25 percent. When conventional policy tools proved ineffective as economic conditions worsened, the Fed turned to a nontraditional approach – consisting of purchases of long-term securities (mortgage-backed and U.S. Treasury securities), known as quantitative easing (QE) – beginning in late 2008.

Figure 1. Fed’s zero interest rate policy and quantitative easing

According to Federal Reserve Chairman Ben Bernanke and others, QE is designed to boost economic recovery through the portfolio balance channel. “Federal Reserve purchases of mortgage-backed securities (MBS), for example, should raise the prices and lower the yields of those securities; moreover, as investors rebalance their portfolios by replacing the MBS sold to the Federal Reserve with other assets, the prices of the assets they buy should rise and their yields decline as well” (Bernanke, 2012). The QE tool, which has been mobilized on three occasions, represents a major effort by the Fed to further reduce long-term market interest rates and keep them low by circumventing the usual transmission mechanism of monetary policy.

As shown in figure 2, the real yield on 10-year U.S. Treasury bonds has fallen and even turned negative in some recent periods after factoring in inflation. Market factors could help explain the decline in yields. For example, the global financial crisis and economic uncertainty have increased the demand for U.S. Treasuries – which are viewed as high-quality, safe-haven assets by most investors – pushing bond yields lower. Other factors include shrinking global availability...
of risk-free government securities, resulting from the euro zone sovereign debt crisis and the need to pledge bond collateral in order for European financial institutions to access emergency lending facilities. However, research suggests that the extent of the decline in market interest rates goes beyond identifiable market factors and reductions in traditional policy interest rates.\(^3\)

**Figure 2.** U.S. real 10-year Treasury yield

![U.S. real 10-year Treasury yield](image)

**The Beneficiaries of Financial Repression**

Historically, financial repression has been found to play an important role in reducing public debt-to-GDP ratios in many advanced economies, especially after World War II, according to a study by Reinhart and Sbrancia (2011). In their estimation, real U.S. interest rates turned negative at least 25 percent of the time between 1945 and 1980. These episodes corresponded to annual deficit reduction of 3 percent to 4 percent of U.S. GDP, equivalent to debt reduction of 30 percent to 40 percent of U.S. GDP in the decade after World War II. Financial repression contributed to public debt reduction by lowering the government’s interest expenses for a given stock of debt. In particular, when financial repression produces negative real interest rates (i.e. when inflation exceeds the nominal interest rate paid on government debt), it reduces or liquidates existing debts (through what the authors call “the liquidation effect”).

With today’s nominal interest rates kept below the inflation rate, Reinhart, Kirkegaard and Sbrancia (2011) state that “governments are once again finding ways to manipulate markets to hold down the cost of financing debt.” Nevertheless, in the aftermath of the recent financial crisis, the U.S. government has managed to double the amount of net public debt from about

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\(^3\) This issue is subject to empirical testing. In a recent study, Swanson and Williams (2012) estimate the effect of the Fed’s zero bound target policy rate on medium- and longer-term Treasury yields and find that Treasury yields were responsive to the zero bound policy rate until 2010, but not thereafter. For further review on this issue, see Thornton (2012).
37 percent of GDP in pre-crisis years (2005-2006) to 73 percent of GDP in 2012, the highest level since the end of World War II (figure 3). Total public debt is now more than $16 trillion, up from about $8 trillion before the start of the financial crisis, and prospects for its continued rise will make it difficult to restrain debt-servicing costs even with negative real interest rates.

**Figure 3.** U.S. public debt held by the public, 1790-2012

The benefits of low-cost borrowing associated with financial repression have not been limited to governments. Businesses have been able to issue debt at low costs as well. In the current environment of high levels of public and private debt, pushing interest rates lower can help reduce system-wide debt servicing. However, from society’s point of view, borrowers’ gain is creditors’ pain. Financial repression gradually transfers wealth from creditors (savers and investors) to borrowers (including governments).

Although the beneficiaries of financial repression are easy to identify, it is far from certain that this practice has helped to stimulate overall growth in the real economy. Indeed, the U.S. recovery remains the slowest in post-war history. Whether strong headwinds, such as private-sector deleveraging, policy uncertainty and high levels of political and economic risk elsewhere in the world, can be overcome soon remains to be seen. In the meantime, continued reliance on financial repression could pose a host of problems for stakeholders and investors.

**Unintended Consequences of Financial Repression**

Prolonging the Fed’s current zero interest rate and quantitative easing policies can distort the path to a full, sustainable economic recovery in the medium-to-longer term. At least one prominent economist has gone so far as to say that Fed policy is a drag on the economy.4

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4 See Taylor (2013).
Several explanations can account for this negative impact:

1. **Financial repression impedes bank lending**

One explanation of the sluggish U.S. economic recovery is the funding gap in the banking sector – banks’ funding availability and reluctance to lend to match borrowing needs of households and businesses. This problem occurs partly because financial repression distorts incentives for banks to lend and for borrowers to borrow.

Banks and other institutions have less incentive to lend in times of financial repression because artificially low interest rates put downward pressure on banks’ net interest margin, which is the profit the banks make from lending and investing. Low interest rates also make it possible for banks to roll over rather than write off bad loans, which could lead to accumulated unproductive assets on bank balance sheets. Other changes in the investment and regulatory environment further discourage banks from lending. These include the low opportunity cost of holding excess reserves, and stricter regulations requiring banks to hold additional capital and set aside additional liquidity.

For borrowers, financial repression is generally viewed as creating a more favorable environment. However if interest rates are expected to remain low, borrowers have less incentive to seek loans that lock in favorable rates. This might help explain the volatility of demand for loans in recent years shown in figure 4. The volatility could also be explained by increased access to bond markets as investors search for yield.

**Figure 4. Demand for commercial and industrial bank loans**

On balance, as noted by John Taylor (2013), the effect of the near zero interest rate is much like the effect of a price ceiling, i.e. when the price is set below equilibrium. With the lower rate, the lenders will supply less credit. As a result, “the decline in credit availability reduces
aggregate demand, which tends to increase unemployment, a classic unintended consequence of the policy.”

2. **Financial repression can distort asset prices and adversely affect investors’ decisions**

In an environment of low yields and abundant liquidity, investors are increasingly searching for higher returns most often found in riskier assets. This situation seems reminiscent of the pre-crisis boom. Spreads over U.S. Treasuries of both investment-grade and high-yield corporate bonds have shrunk to the point of raising concerns about a new bubble. Corporate bond issuance has risen significantly to take advantage of lower borrowing costs and strong investor demand (figure 5). The belief that the Federal Reserve will continue with its policies for an extended period has given investors comfort, despite the fact that the Fed’s policies are heightening investors’ credit and interest rate risks by distorting market pricing. With yields pushed so low, investors are prodded to increase their exposure along the long end of the yield curve, bringing additional jeopardy in the form of duration and convexity risk. For a 10-year U.S. Treasury bond, given its current yield, a one-percentage-point rise in yield would result in a drop in price of roughly 9 percent versus about 7 percent under more normal yield conditions.

![Figure 5. U.S. corporate bond yield spreads and issuance](image)

Note: The spread data are based on the Barclay Bond Index. Sources: DataStream, SIFMA and Milken Institute.

Financial repression has postponed the day of reckoning for some firms as they seek to avoid restructuring or default. Excess liquidity in the financial system is widely attributed to helping push default rates to near-record lows after spiking to near-record highs in the wake of the financial crisis. However, with the U.S. economy continuing its slow recovery, default rates are projected to rise this year. This could catch “repression-influenced” investors off guard and unsettle the high-yield bond market.
3. **Financial repression reduces the income of many retirees**

Fixed-income investors (especially retirees) holding U.S. Treasuries and other investment-grade bonds could experience significant losses in real wealth as nominal yields no longer compensate for inflation risk. A decline in the wealth effect for retirees most likely has contributed to the slowing of economic recovery in the United States, given the relatively large size and spending power of this group\(^5\). Besides the direct impact on retirees’ portfolios, financial repression is prompting more retired people to return to the workforce\(^6\). This makes it harder for young people to find jobs and for more-experienced workers to advance in their careers.

4. **Financial repression does not lead to stock market wealth effect**

Although the theory that financial repression could give rise to a stock market wealth effect has been the topic of much discussion, there is little evidence to support this proposition. This relationship between Federal Reserve action and rising equity prices is tenuous at best. The minor effects that have been empirically observed most likely are connected to the initial announcement of policy action. A more plausible case for rising equity prices can be tied to positive expectations for earnings as firms tightened operations to raise margins in anticipation of lackluster economic conditions.

Even if one wishes to conclude that the impressive resurgence in the U.S. equity market since its low in March 2009 is related to policies of the Fed, translating this into a wealth effect is difficult. Often-cited research on this subject suggests that the wealth effect from equities is statistically significant but small. Rising home prices have been determined to exhibit a much stronger wealth effect, but so far the U.S. housing market has shown only early signs of rising prices, according to the S&P/Chase-Shiller Composite-20 Home Price Index.

5. **Financial repression raises uncertainty about future policies**

Uncertainty about future policies is a major concern for investors. The Fed’s exit strategy has been outlined in testimony before Congress by Chairman Bernanke. Major components include:

- Normalizing the terms of regular discount window loans
- Passively redeeming agency debt and MBS as they mature or are repaid
- Increasing the interest rate on reserves
- Offering term deposits, which could be counted as reserves, to depository institutions
- Reducing the quantity of reserves via reverse repurchase agreements
- Redeeming or selling securities in conventional open market operations

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\(^5\) Brandon (2012)  
\(^6\) Cahill, Giandrea and Quinn (2011).
While none of this is out of the ordinary for central banks, the execution could be problematic in view of the size of the Federal Reserve’s balance sheet, which now stands at about $3 trillion. Given this size and the much smaller daily trading volume in Treasuries and MBS, the Fed would be lucky to shrink its balance sheet by half in less than two years without seriously disrupting the market. Even assuming this would not trigger massive front running (heroic to say the least), the losses to the Fed could be significant. This would have important implications for its remittances to the Treasury. In addition, if the Fed’s capital were to become negative, a paradoxical situation could emerge where a hike in policy rates induces inflation.\(^7\)

The situation the Federal Reserve finds itself in as it contemplates future policy measures might best be summed up by Alan Blinder, former vice chairman of the Federal Reserve Board. In his Homer Jones Memorial Lecture in April 2010, Professor Blinder commented that, “the Fed now finds itself on an alien planet, with a near-zero funds rate, a two-trillion-dollar balance sheet, a variety of dodgy assets, holes in the wall separating the Fed from the Treasury, Congress up in arms, and its regulatory role up in the air.”

“Your mission, Mr. Bernanke, since you’ve chosen to accept it, is to steer the Federal Reserve back to planet Earth, using as principal aspects of your exit strategy some new instruments you have never tried before. As always, should you or any member of the Fed fail, the Secretary and Congress will disavow any knowledge of your actions. This lecture will self-destruct in five seconds. Good luck, Ben.”

**Conclusion**

While most reasonable people would agree that the Federal Reserve was justified in its actions to avert an economic and financial meltdown beginning in 2007, the same cannot be said for the continuation of non-traditional policies beyond QE1. Federal Reserve officials have acknowledged the potential costs and risks of their actions but believe that the resulting economic benefits will outweigh the collateral damage. They stress that in due course the economy will return to a path of sustainable growth.

But, in the end, will the benefits of current Fed policies offset the unintended consequences? The debate over this issue among economists, investors and others has intensified in recent months. Several members of the Federal Open Market Committee have expressed feelings that

\(^7\) Park (2012). The author supposes that a central bank with negative capital suffers additional losses from long-term bond holdings while it tries to increase short-term interest rates in response to inflationary pressures. As the real value of holding the central bank’s net liabilities falls below equilibrium with a negative return shock, then the private agent tries to decrease holdings of the central bank’s liability (nominal money balance) and increase consumption. In the end, the general price level increases, and the central bank passively increases nominal money supply in order to satisfy real money balance demand.
could be interpreted as buyers’ remorse. As this debate continues, financial market participants and observers have considered the possibility of bubbles developing in some asset classes, particularly fixed income. The term “great rotation” has emerged to describe the perceived exodus from bonds into equities.

In looking ahead, it appears that an even greater rotation will be needed to move from a period of artificial prosperity propelled by liquidity and central bank market manipulation to one characterized by sound fiscal policy and properly functioning financial markets with prudent regulation. From our perspective, the continuation of financial repression risks stymieing capital formation and job creation, thus hindering the economy from reaching its full growth potential. For the Federal Reserve, it risks the loss of credibility and influence as financial repression generates smaller and perhaps worse outcomes.

**Figure 6.** U.S. net private fixed asset stock and real GDP

Sources: Federal Reserve Bank of St. Louis and U.S. Bureau of Economic Analysis
References


