

# Financial repression to ease fiscal stress: turning back the clock in the eurozone?

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# Subject of this paper

- Following the financial crisis, many advanced countries have to cope with a **legacy of high (and still rising) public debt**.
- Some observers expect a **return to financial repression**, whereby governments seek to curtail financial markets and exploit their central bank in order to ease their fiscal stress.
- This would mean **turning back the clock** on well-established principles of market freedom and central bank independence.
- This paper in the field of institutional economics asks the question: is there evidence of such **financial repression to the benefit of governments in the eurozone?**

# How to deal with the legacy of high public debt?

- Several ways to cope with a **legacy of high public debt**:
  - Fiscal austerity to create a primary surplus
  - Sell government assets to reduce gross debt
  - Create higher growth and/or surprise inflation
  - Reduce effective interest rate paid on debt
- History shows that governments may also resort to **financial repression** to secure debt financing at low interest rates, or even their solvency. This would show up in pervasive financial market interventions and instructions to the central bank.
- Applied during/after WW I and II, but discarded after 1980 as markets were liberalised, central banks gained independence and governments subjected themselves to **market discipline**.

# Financial repression: for good or for ill ?

Two ways to see the concept of financial repression:

## 1. As a 'public service' in the interest of society

- Curtailing markets may be needed in times of crisis and war
- Markets must be regulated and supervised to ensure financial stability
- Central bank needs leeway to use unconventional monetary policy tools
- Targeted interventions may seek to correct excessive income/wealth trends

## 2. As a 'public vice' in the government's own interest

- Allocates savings to the government at below-market interest rates
- Creates undue government privileges to evade market discipline
- Causes central bank to deviate from its monetary policy mandate
- Leads to market distortions and mostly hidden income/wealth redistribution

**Criteria** to assess whether repressive measures are good or bad:

- do they support efficient functioning of financial markets and institutions, and
- do they respect central bank independence in a credible manner?

# Examples of repression of the financial system

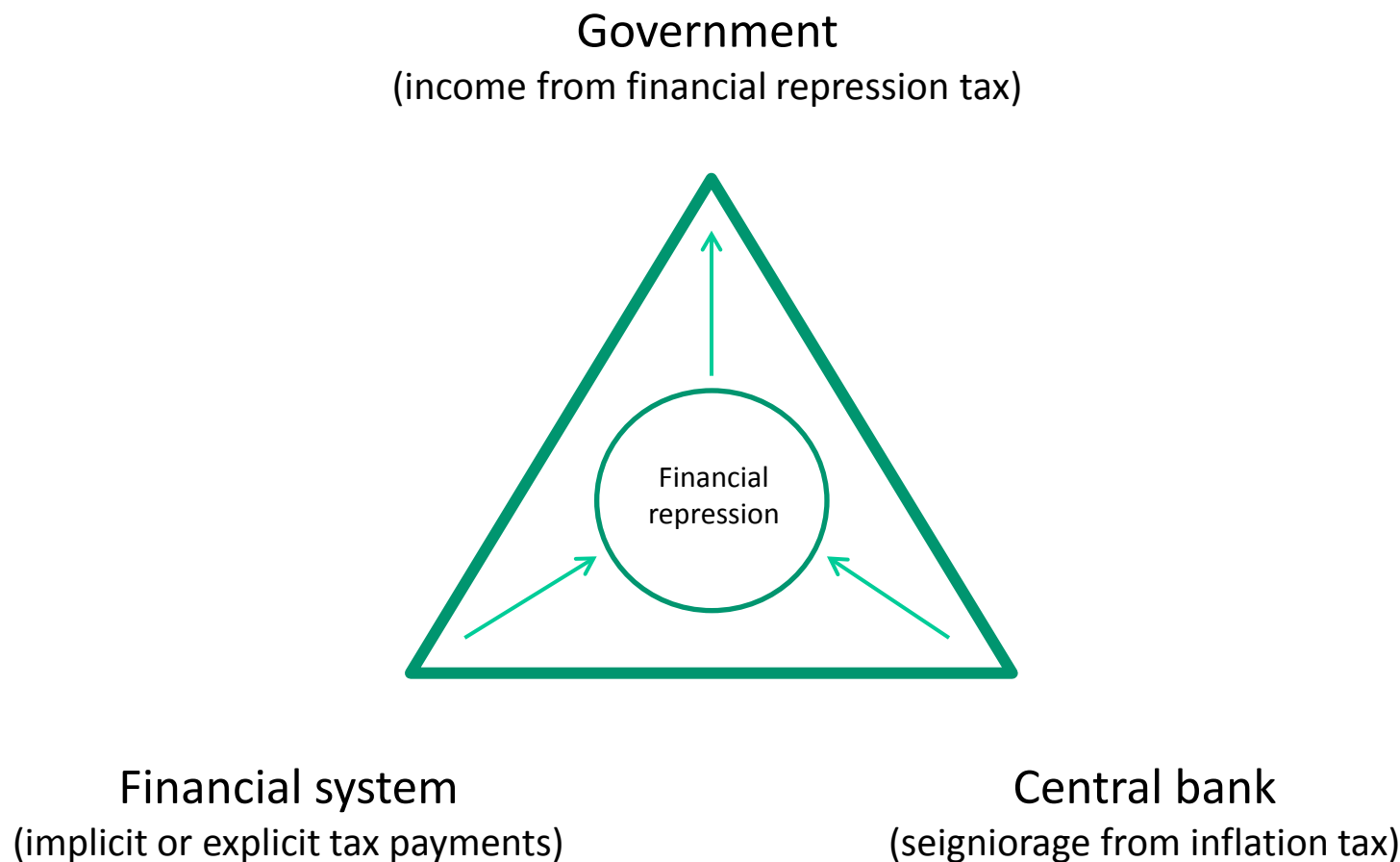
- Faced with a fiscal crisis governments (and national regulators) will use their vast powers to fend off market pressure.
- Many repressive tools create **undue privileges for governments**:
  - moral suasion: exercising pressure to ‘voluntarily’ invest in government bonds
  - financial legislation: prudential rules that suppress sovereign risk, or investment constraints favouring government debt, creating a captive investor base
  - market interventions: to cap bank deposit rates and steer savings to government
  - credit controls: to steer bank lending to state companies and strategic sectors
  - Tobin tax: taxes on financial assets or transactions to throw ‘sand in the wheels’ of finance, while also exempting holdings of or transactions in government bonds
  - capital levies: to confiscate private sector wealth to reduce a public debt overhang
  - public debt restructuring: violating contracts, subordinating private debt holders
  - capital controls: to prevent outflows and create a captive domestic investor base.
- They **distort market signals** and raise **moral hazard**, as they curb market-based fiscal discipline and weaken reform incentives.
- Leads to a largely hidden **redistribution of income and wealth**.

# Examples of political pressure on the central bank

- Governments may also demand central bank support when they face high funding costs, are close to default, or have lost room for fiscal manoeuvre.
- Even when independent by law, **a central bank may face strong political pressure** in a financial, banking and fiscal crisis to
  - guarantee that government bonds will remain 'safe assets'
  - cap government bond yields or reduce them below their 'fair value'
  - undertake large-scale purchases of government bonds in the market
  - offer monetary financing of a fiscal impulse to stimulate demand
  - provide capital support to fragile banks and state companies
  - impose credit controls to steer bank lending to favoured sectors
  - to generate excess inflation or nominal GDP growth
  - engineer an artificial currency depreciation.
- A central bank's independent crisis response is a **balancing act** between securing financial stability and monetary stability; its **credibility** is more at risk, the longer its exceptional measures remain in place and cause unintended side effects.

# Financial repression as a source of public revenues

The government's repressive interventions secure special benefits by effectively imposing a **tax on the financial system** and an **inflation tax on the economy**.



# Scope for financial repression in the eurozone?

- EU Treaty offers **little scope for financial repression to ease fiscal stress**, as it sets rules for sound public finances, subjects governments to market discipline and supports open markets:
  - No excessive deficits: need to adhere to a close to balanced structural budget
  - No preferential access: governments get no favours from financial institutions
  - No bail-out rule: countries are not allowed to take over each other's liabilities
  - No direct monetary financing: ECB is independent from political pressure
  - No financial protectionism: free flow of capital within the Internal Market.
- However, some **'openings'** in EU law can be detected:
  - Peer pressure on countries and enforcement of the EU fiscal rules is weak
  - Preferential access to financial institutions is accepted for prudential purposes
  - Countries may give each other temporary conditional loans on market terms
  - ECB is allowed to intervene in secondary markets for monetary policy purposes
  - Coordinated financial taxes may be targeted at destabilising speculative forces
  - Capital controls may be reinstated for the public interest and as EMU safeguard.
- They allow for **'good' financial repression** to maintain/restore stability in times of stress, but may also create **'bad' government privileges**.



# Eurozone incentives for financial repression

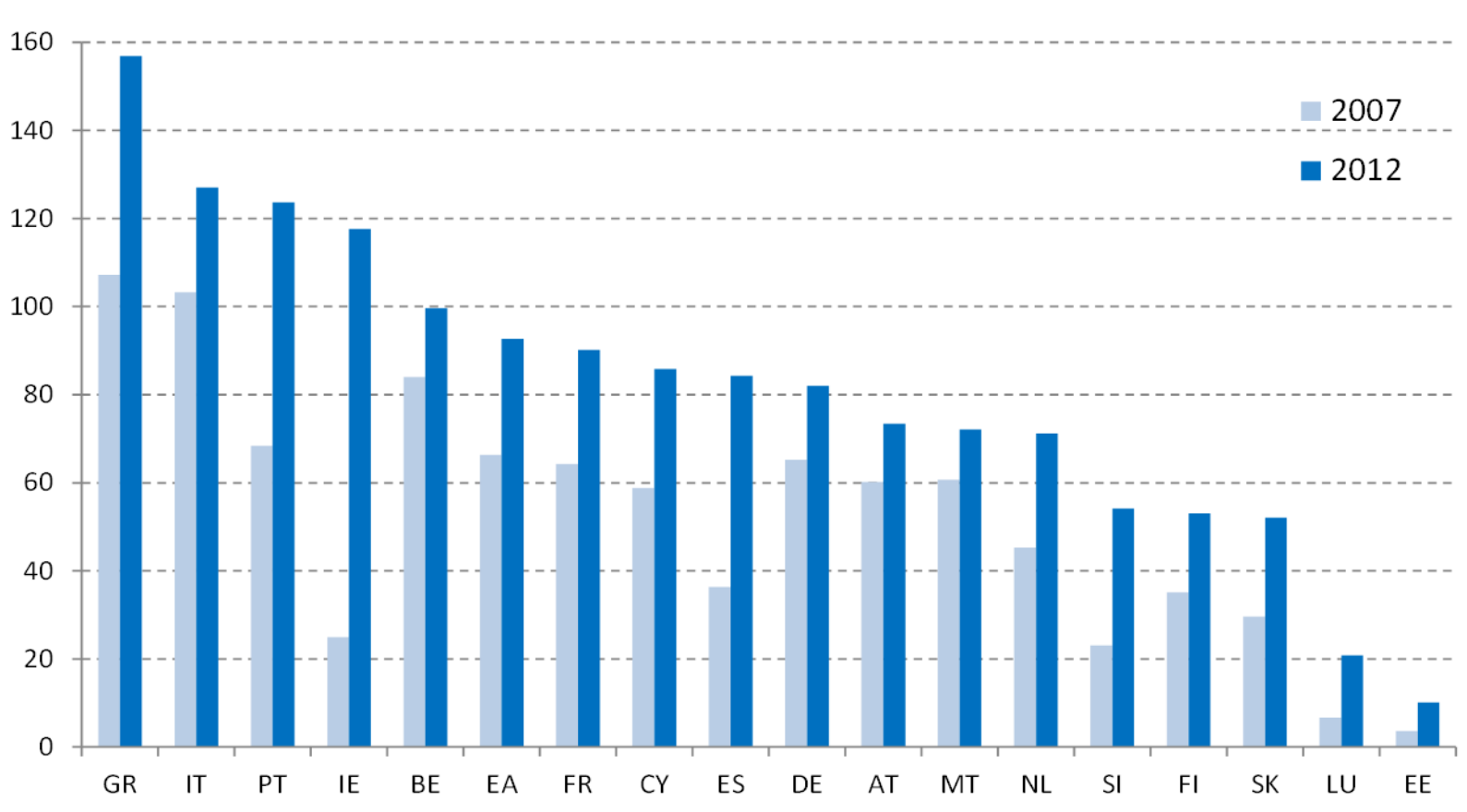
- Financial crisis is blamed on excessive risk-taking by the financial sector, ‘too-big-to-fail’ banks had to be rescued by taxpayers; perception of **severe market and regulatory failures**.
- The euro area sovereign debt and banking crisis caused **extreme market volatility**, severe funding stress, capital flight and rising bond yields, fuelling fears of **self-fulfilling sovereign default**.
- Given contagion, this in turn triggered fears of a **break-up of the euro**, while growing financial market fragmentation hampered **monetary transmission** across the eurozone.
- Policy-makers intervened in response to this destructive market mechanism to **secure financial, fiscal and monetary stability**.
- Did they also create unwarranted privileges for governments?

# Several euro area countries faced fiscal stress

Faced with rising public debt, several countries were faced with **market pressure** and a sovereign debt crisis, fuelled by a **vicious feedback loop** with a fragile banking sector

## Gross government debt of euro area countries, 2007 and 2012

(% of GDP; Euro area countries are shown using their country code. EA stands for euro area average)

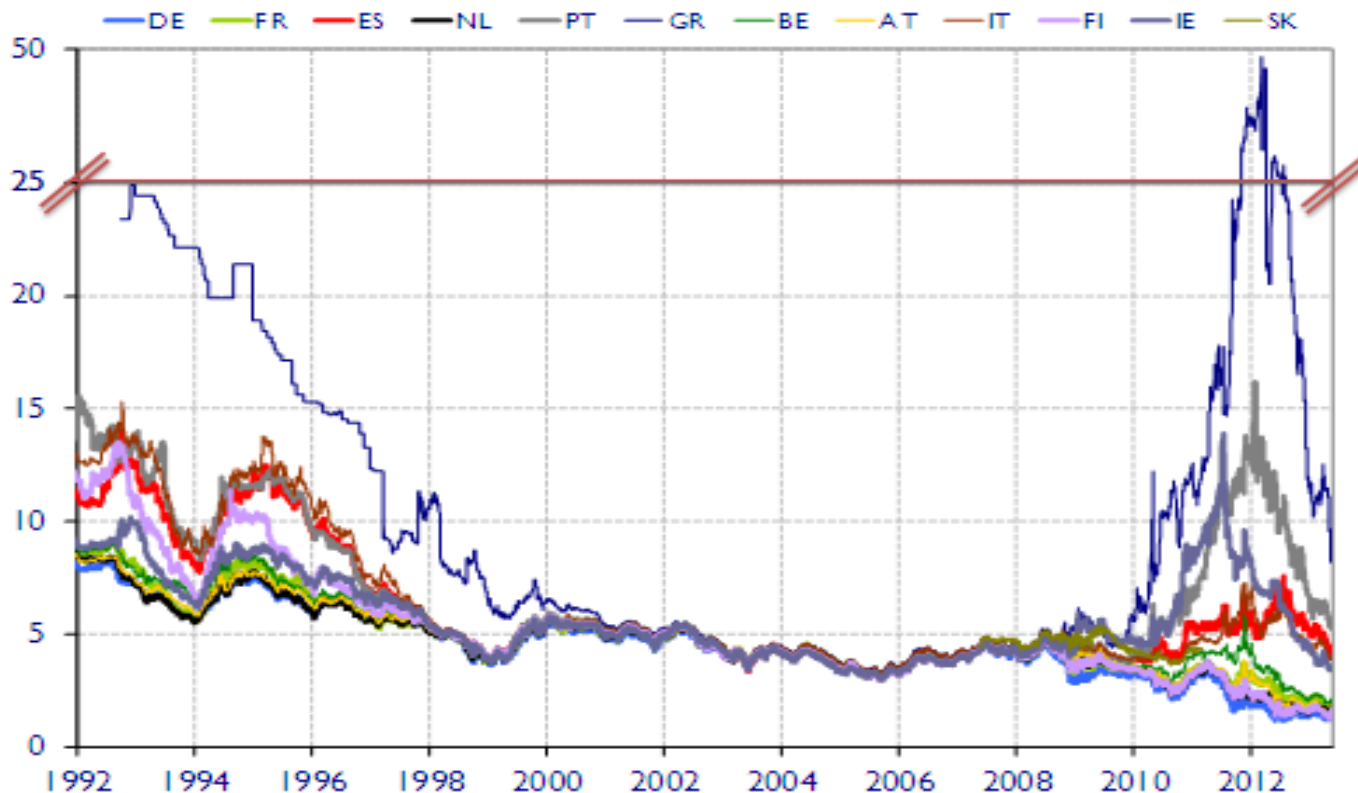


# Contagion and systemic fragility of the eurozone

Euro area sovereign bond markets failed to recognise build-up of credit risk before the crisis, as shown by undue yield **compression**. Afterwards, markets were **overshooting**. This triggered self-fulfilling default expectations, showing **systemic fragility of eurozone**.

## Government bond yields of euro area countries, Jan. 1992 - May 2013

(10-year maturity in %; yields for CY, EE, LU, MT and SI are excluded owing to infrequent or a lack of observations)



# Cases of financial repression at national level?

Aim: fight fiscal stress; create a captive domestic investor base, fill budget holes, avoid costly bank rescues, cut public debt overhang

- Affecting domestic banks
  - **Moral suasion** of banks to take advantage of cheap Eurosystem liquidity offered at exceptional three-year maturity and to park this in government bonds (ES, IT)
  - **Cap on bank deposit rates** temporarily made investing in government bonds relatively more attractive (ES)
  - Reports of **supervisory pressure** on banks to withdraw their foreign assets in the vulnerable countries, or to repatriate funds held in subsidiaries/branches in the stronger countries
- Affecting domestic pension funds
  - **Moral suasion** of pension funds to invest at home, in government bonds (IE, PT, ES)
  - **Use of pension reserves** to fill holes in the government budget (FR, IE, PT, ES)
- Affecting savers and investors
  - **Capital levy** on insured bank deposits below €100.000 (proposal was rejected by CY parliament, but still necessitated capital controls to prevent deposit outflows)
  - 'Voluntary' **public debt restructuring** violated private investors' contract rights (GR, CY)

# Cases of financial repression in European law?

Aim: make the financial system more resilient and markets less speculative; this also created undue privileges for governments

- New prudential regulation (to be phased in from 2014)
  - Capital Requirements Regulation / Directive (CRR/CRD IV) to introduce Basel III standards in EU law set tighter capital and new liquidity rules for banks
  - Central government bond holdings receive **preferential treatment** as they remain seen as **zero-risk, high quality and liquid**, which may contrast with market reality
- Further restrictions on credit rating agencies (since June 2013)
  - Aim is to better supervise rating agencies and make them liable for damages; new sovereign ratings can be verified and can only be issued on 3 fixed dates per year
  - A suggestion to **suspend sovereign ratings** in exceptional times was rejected. Proposal showed favoured trend of repression and to **'shoot the messenger'**.
- New restrictions on short-selling and credit default swaps (since Nov. 2012)
  - EU supervision restricts uncovered short-selling and bans uncovered sovereign credit default swap positions in view of speculation.
  - This has **curbed market pressure**. Unwinding of short-selling positions contributed to a decline in government bond yields and the need to cover sovereign credit default swaps has **forced investors to hold the underlying government bonds**.

# Cases of financial repression in European law ?

- Common financial transactions tax (in 2014 for 11 euro area countries)
  - Aim is to constrain excessive market activity, let financial sector pay part of the bill for bank rescues, collect government revenues
  - Some countries seek to exclude transactions in government bonds, creating a **cost advantage over private sector instruments**
- Protective measures against market turmoil (since May 2013)
  - Allow euro area countries in distress to counter market turmoil and encourage private investors to 'voluntarily' maintain their sovereign exposure and
  - This amounts to **moral suasion** and could **legitimise repressive measures**
- Capital export restrictions (European Parliament proposal of June 2012)
  - Aim was to restrict capital outflows in support of fight against tax evasion
  - This would **infringe the free movement of capital** in Europe and was rejected
- New euro area rescue fund (ESM) (operational since Oct. 2012)
  - One tool is to provide conditional secondary market access support to countries in distress facing exceptional market circumstances (ECB to be consulted)
  - The interventions in secondary government bond markets might be misused to **suppress yields below their 'fair value'** and the **conditionality may be less strict or less effective** than warranted

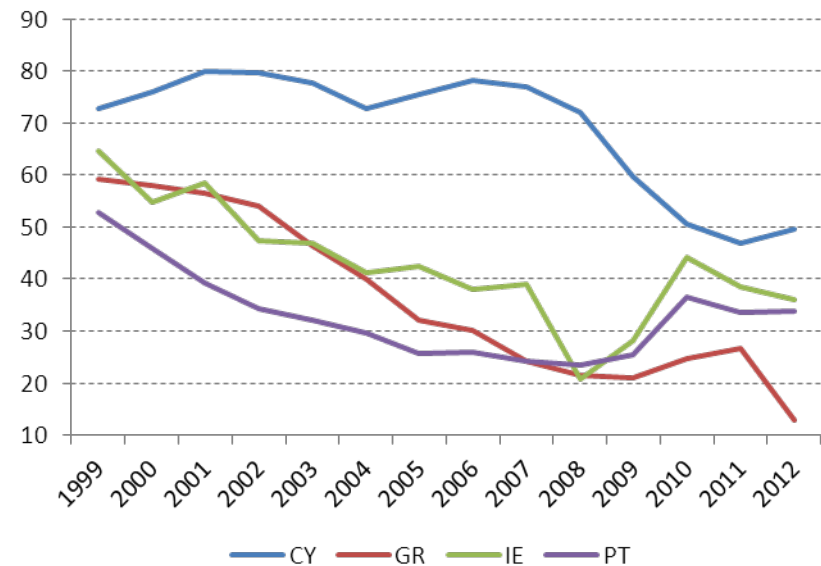
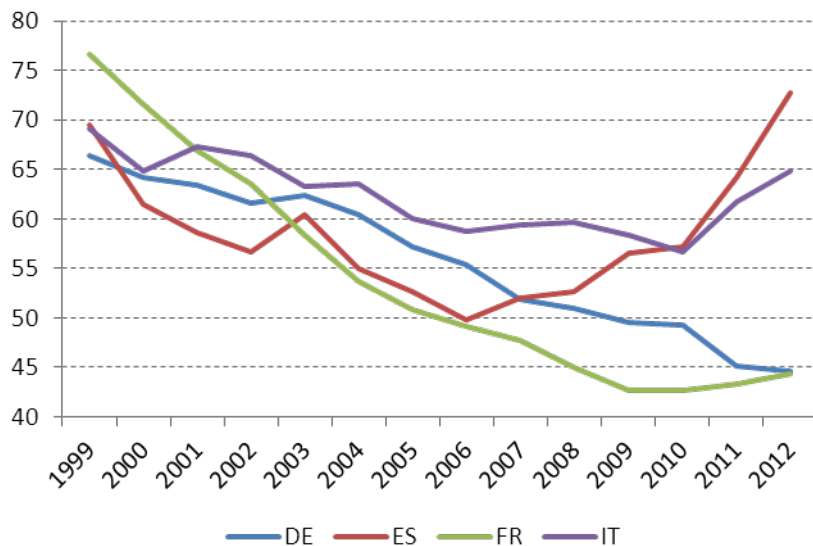
# Evidence of renewed 'home bias' in sovereign debt

Successful financial repression could lead to a **captive domestic investor base**, i.e. an enforced 'home bias' of sovereign debt holders and suppressed interest rates.

After falling for long, the share of residents holding government debt has increased in several euro area countries. This **renewed 'home bias'** may reflect financial repression, or also a voluntary choice of residents and a flight to safety by foreign investors.

## Government debt held by residents in selected euro area countries

(% share of residents in total gross consolidated debt of general government, 1999-2012)



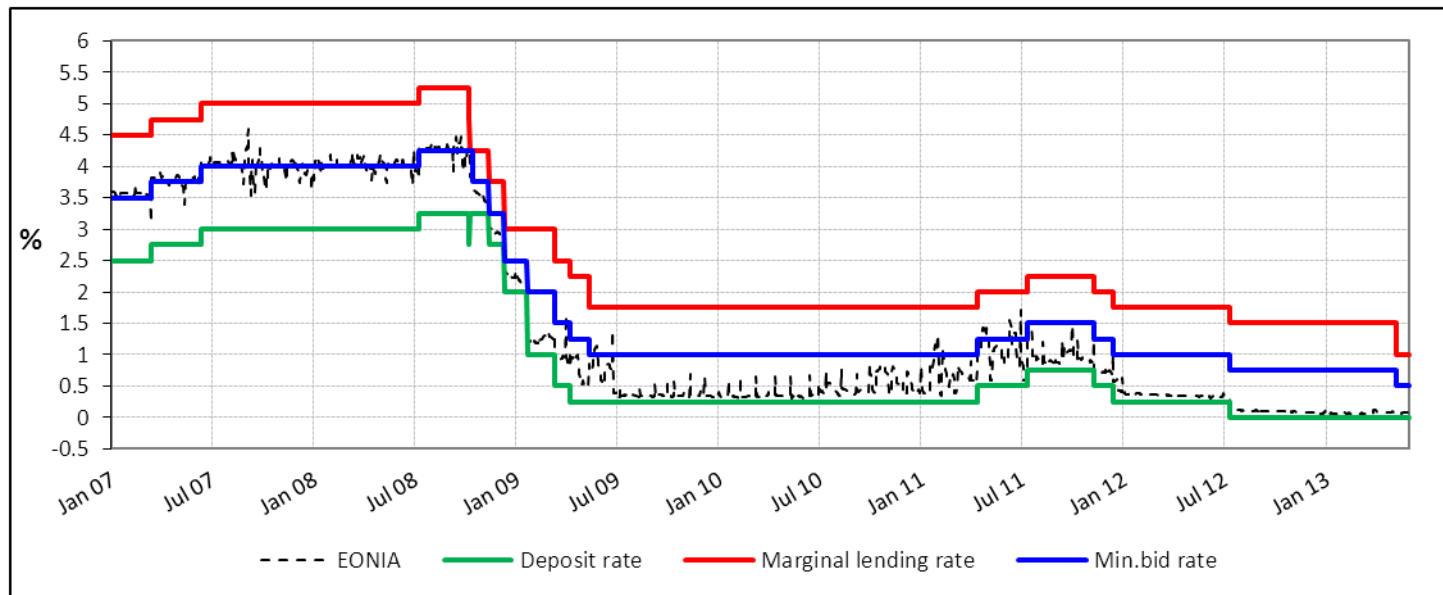
# Cases of financial repression by the ECB?

ECB official interest rates were lowered close to the zero lower bound

- justified for monetary policy reasons (as in other major economies)
- no efforts to steer the currency, as ECB has no euro exchange rate target
- negative real bond yields in the euro area do benefit some governments, but reflect exceptional monetary easing, safe-haven capital flows, subdued growth outlook

## ECB key interest rates and the overnight interest rate (EONIA)

(daily data from Jan. 2007 to May 2013, percentages per annum)





# Cases of financial repression by the ECB?

## Non-standard measures to enhance the supply of bank credit:

- fixed rate full allotment (FRFA) of liquidity to the banking system
- offers of more, larger and longer maturity refinancing (LTROs)
- more eligible collateral, by lowering minimum credit rating threshold (also for low-rated government paper, as long as credible policy adjustments are being made) and widening the collateral base (with bigger haircuts to offset larger credit risks)
- foreign currency lending to eurozone banks, lending in euro to foreign central banks
- cooperation with European Investment Bank to enhance the flow of credit to SMEs.

## Non-standard measures to repair dysfunctional securities markets:

- two covered bonds purchase programmes (CBPPs) to revive crucial markets for bank funding
- Securities Markets Programme (SMP) of temporary and limited interventions in the impaired government bond markets to repair monetary transmission
- commitment to unlimited Outright Monetary Transactions (OMTs) in the impaired government bond markets to repair monetary transmission; focused on eliminating 'tail risk' in bond yields due to fears of a break-up of the euro.

# Cases of financial repression by the ECB?

ECB responded to the crisis by pursuing an exceptional monetary easing while addressing financial stability risks, financial market fragmentation, bank funding needs, and fears of a euro break-up.

The scope of these monetary policy actions triggered intense debate inside the Governing Council of the ECB and before the German Federal Constitutional Court, showing the diversity of opinions on what was necessary and legitimate.

ECB countered perceptions of being under political pressure to engage in financial repression by just buying time for governments and banks to adjust.

Communication on SMP and design of OMT sought to set the right incentives, counter moral hazard and maintain market-based discipline over governments.

Also no direct credit allocation to favoured sectors (governments, SMEs)

→ Although governments certainly benefited from the ECB's measures, these were taken independently and in line with its mandate. As a result, the ECB stayed credible in its focus on price stability.

# Conclusions

- There is ample evidence that financial repression is reappearing in the eurozone: policy-makers are turning back the clock on the freedom of financial markets, *inter alia* to reduce the burden of high public debt.
- Several euro area governments have arm-twisted financial institutions, savers and investors in order to ease market pressure and their own fiscal stress.
- EU legislators have stepped up their control over the financial system. Correcting market and regulatory failures is in the public interest, but the new rules also created government privileges that limit market discipline.
- A captive investor base reduces incentives to save and invest, hampers the efficient allocation of capital across EMU, tightens link between sovereigns and banks, crowds out bank credit supply, and promotes shadow economy.
- The ECB has been active in restoring financial stability and saving the euro. Although governments benefited from its extraordinary monetary policy actions, the ECB focused on maintaining price stability while creating incentives for policy-makers to underpin the stability of the eurozone.

Thank you  
for your attention!

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