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The consequences of financial repression

Market Comment, August 2020

The flood of monetary liquidity, which has assumed gargantuan dimensions over the last few months, is designed to support both the global economy and financial markets. However, the level of fiscal support for the economy, the increase in government indebtedness and the bond purchase programmes of central banks amount to a monetization of government debt and what is known as "financial repression". The latter penalizes savers and rewards holders of equities – hence financial repression can have the effect of increasing social inequality. This is not without its problems, as we are increasingly seeing in the US in particular.

In order to counter the economic collapse triggered by the coronavirus pandemic and the associated lockdowns, the world's leading nations have decided to initiate fiscal stimulus packages amounting to some 5–15% of gross domestic product (GDP), which is leading to a sharp increase in budget deficits and outstanding debt levels. In order to finance these growing debts and support financial markets, which suffered huge corrections back in March 2020, central banks have spent the last few months implementing massive government bond purchase programmes, which amount to "monetization" or the financing of what are now hugely increasing debt mountains.

Viewed in historical terms, a high level of government debt – measured as a percentage of GDP – can be brought down by **a) government austerity programmes**, **b) above-average economic growth** for a prolonged period, **c) high inflation** or **d) increased financial repression**, i.e. bond yields (or long-term interest rates) being deliberately kept at a low level. Another option, variant **e), would be a restructuring of debt** involving a partial default, although this looks just as unappealing as variant c). However, even a) (relaunching of government austerity programmes) and b) (achieving above-average economic growth for a prolonged period) hardly look realistic over the next few quarters. After the last financial crisis, the path of austerity was widely experimented with in Europe, but with little to show in the way of success. Governments are not trying to balance their budgets now – not even in Germany, and certainly not in the US, where elections are looming. In most cases, government austerity programmes mean less expenditure on social security and in some cases even tax hikes. Such developments are not only politically unpopular, they are also not economically desirable as far as governments themselves are concerned.

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> Gérard Piasko, Chief Investment Officer

All of this makes financial repression the path of least resistance for governments – but this too is having increasingly negative consequences. The domestic unrest that manifested itself in the US in June 2020 was driven not just by police violence against African Americans, but also by growing social inequality, a problem being exacerbated by financial repression. Social inequality is on the rise because the great majority of savers, particularly in the US, do not have the financial resources to take on equity exposure to a significant degree, while at the same time almost no returns are available on conventional savings deposits. To make matters worse, many people are facing the prospect of redundancy in the current recession. The assets of many pension funds are also suffering because of financial repression, with the yields on government bonds being kept artificially low by central bank activity. On the other hand, a smaller proportion of the population – typically those with equity investments – are benefiting largely from the new monetary stimulation of equity markets that is resulting from the huge flood of liquidity. One response to financial repression can therefore be a strategic (long-term) increase in the weighting of equities, even though most people typically lack the financial resources to embrace the volatility of this asset class.

Where does this financial repression come from? It is partly the result of the purchase programmes of the central banks, which are acting as a fresh source of demand in the fixed income markets, and partly from the regulation imposed on banks (Basel III) and insurance companies (solvency ratio), which likewise has the effect of boosting demand for government bonds, i.e. sovereign debt. In a free market economy, capital market interest rates are decided purely by the markets themselves, whereas at times of financial repression long-term interest rates (bond yields) are kept artificially low by additional demand from central banks and regulated banks/insurers, which is tantamount to a form of "repression".
This is not the first era of financial repression that the world has experienced. Western countries, particularly the US, experienced a massive rise in government debt after the Second World War due to the huge cost of waging that conflict. As a direct consequence, capital markets were tightly regulated in the post-war Bretton Woods Agreement in order to keep interest rates artificially low. In other words, for decades from 1945 onwards, long-term interest rates were kept lower than they would have been in a free market economy. We saw the same thing occur in the aftermath of the 2008 financial crisis and now again because of the coronavirus crisis – interest rates (bond yields) kept artificially low in order to facilitate the financing of government debts.

Conclusion: Financial repression has its consequences: negative for social equality, in so far as the majority of people do not have the financial resources to invest in equities, and negative for advocates of a wholly free market economy. However, another conclusion to be drawn here is that a more balanced spread of investments, including a sizeable equity quota, makes more sense than a high proportion of government bonds that barely deliver positive yields.

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