The Coming "Financial Repression"

Carmen M. Reinhart explains that debt crises lead to "financial repression," which can take different forms, with some alternatives having better outcomes than others.

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Steve Weisman: What is "financial repression"? Carmen Reinhart, senior fellow at the Peterson Institute is with me, Steve Weisman, to discuss the subject. Carmen, you have said that financial repression will be a "solution" that governments and creditors will inevitably look to because of the debt crisis. What do you mean?

Carmen Reinhart: Financial repression, to be clear, is not a term that I have coined. This term has a substantive history. [John G.] Gurley and [Edward S.] Shaw, two economists who wrote quite a bit about the financial markets of the 1950s and 60s, began to use the term. Ron McKinnon of Stanford also used the term extensively. McKinnon was largely talking about emerging markets in the 70s and 80s, but the term goes back to Gurley and Shaw's work and it has many facets.

Financial repression broadly is a system in which there is a strong connection between the government and the financial sector. This is very much unlike the environment we've had since the 1980s, in which the government began to step out of its involvement in the financial industry and also to change the regulations.

What are the manifestations of financial repression? Well, financial repression is usually associated with interest rates that are not market-determined. This could be interest rate ceilings. After all, people forget that in the Unites States, we had Regulation Q, which forbade paying interest on demand deposits on checking accounts and capped saving deposit account interest rates at very, very low levels. The consequence of which was that, as inflation picked up in the 1970s, savers had negative interest rates galore. Even before the 1970s, the interest rate ceilings were set at very low levels, so rates of return were really decided by legislation.

Steve Weisman: You've argued that that's the equivalent of a tax.

Carmen Reinhart: Indeed. If you're holding a financial asset in the bank, a certificate of deposit say, and you're ex post interest rate is negative, you're actually being taxed. More directly, if you're also holding a government bond, and the nominal interest rate on that bond is 3 percent, but inflation is running 4 percent…

Steve Weisman: That's what I was about to ask. That's what we mean by negative interest rates, that your money is earning less than the inflation rate.

Carmen Reinhart: Exactly. And so financial repression has the dimension again in which government is either setting ,directly or indirectly, through moral suasion and lots of legislation, interest rates in the market. It is also characterized by directed lending. What do I mean by directed lending? If the government or government enterprises have financing needs, institutions are directed to lend to the government.

Steve Weisman: Which could be a euphemism.

Carmen Reinhart: Indeed. Indeed.

Steve Weisman: There are all these institutions. Governments in Europe have huge debt burdens. And we're hearing another euphemism in Europe – "private sector involvement." Only economists know what that means, but it is financial repression, isn't it?

Carmen Reinhart: To think that much of this as voluntary is quite a leap of faith. Let me give you a concrete example, something happening in Europe along the lines of directed lending. If you look at the massive data in the IMF [International Monetary Fund] financial stability reports, you see very clearly that Greek banks are holding more Greek debt, Irish banks are holding more Irish debt, and UK banks are holding more UK debt. Now some of this is plain old fashioned moral suasion --that's the polite term. Arm-twisting is the less the polite term. But basically when you have reviewed the way that auctions for government bonds have shaped up in some of the more distressed countries like Portugal for example -- the issue of literally arm-twisting. You know, lining up the banks at auction time to buy government treasuries is part of how we're dealing with this crisis. So directed lending, when the government has dire borrowing needs, directed lending has been part and parcel of how the government has funded itself. In the most obviously repressed economies like China and India, this is even more blatant.

Steve Weisman: The interesting thing about the term is that it elevates the libertarian model of free flow of capital as a kind of ideal, and anything less than that is repression. But is that historically fair or accurate? I think you were saying in your talk that the pendulum has swung back and forth since the late nineteenth century on government controls of flow of capital and return of capital.

Carmen Reinhart: Indeed. Before getting into those long term swings, I want to pick up on something you pointed out, which is another pillar of financial repression. You talked about the free flow of capital, and so another pillar of financial repression is capital controls.

Steve Weisman: Right.

Carmen Reinhart: In the old days they were called also exchange restrictions. If in the 1960s I wanted to travel from New York to London, I basically had to go through all kinds of red tape just to be able to get enough British pounds to have for my expenditures while I was over there. Capital mobility as we know it today is of fairly recent vintage. In effect, countries like Japan and countries like France came later into the process of liberalized capital markets. The UK and the US--being more financial centers and more prone to laissez-faire attitudes when it comes to the financial industry--liberalized international capital controls or exchange restrictions earlier. But as late as the mid-1980s, you had other countries with lots of controls, which we've seen erode--and which I think will re-emerge.

Getting back to the second part of the issue you raised about the long cycles. In the work that [Harvard economics professor] Ken Rogoff and I did in our book, This Time Is Different, we draw importantly on the wonderful analysis that Professors Maurice Obstfeld and Alan Taylor did. They basically -- through their look at international flows -- constructed an index of international capital mobility – or, alternatively put, the globalization of international financial markets. They did this from the 1860s to about 2001. Ken and I took their principles and back-casted it to 1800 and updated it through the present, and the cycles emerged. Very clearly, you had periods, for example, in the run-up to World War I -- that was the golden age of the gold standard – [with] lots of capital market integration, free capital mobility. You saw that bonding issuance in London, from places like Argentina, Brazil, Australia, were booming. Then, of course, the two world wars and the Depression in between really began to erode that sense of laissez-faire in global capital markets. And indeed global capital markets ceased to exist.

Steve Weisman:	It wasn't erosion -- it was an explosion.
Carmen Reinhart:	Indeed. What you had were all kind of barriers. Gold movements go up during World War I. They were relaxed somewhat in the 1920s but never regained their full momentum. Then of course enter the Depression, with the trade protectionism and capital account barriers going up. By the end of World War II, we had a completely different financially repressed global system.
Steve Weisman:	Let's take Europe. Isn't it interesting that Europe may be in the process of dismantling much of the social welfare state in some countries [where that system] stabilized the [history of] political unrest throughout the 20th century? In a way we're moving toward a more libertarian approach on social policy but a less libertarian approach on financial flows. It's ironic.
Carmen Reinhart:	It is. It is essentially policies have become more inward looking. You know, to maintain the kinds of benefits in social programs, you also have to simultaneously deal with a mountain of debt, and there's a big, big tension, a huge tension. One pattern of financial repression over the course of history is that in bad times, who does the government raid? The government raids the most captive audiences. Who are the most captive audiences? Pension funds, and then secondarily the domestic financial institutions. So pension funds are often used as the wholesale funding for government projects. For example, in Ireland which is, of course, strapped under the weight of its enormous banking sector problem, has already liberally used its pension funds to bail out the banking system. Other countries in Europe -- Eastern Europe and Poland among others -- are very openly directing funds toward funding government deficits and debts. In France, public pension funds have been redirected away from equity to more government debt. I do want to lay out that "financial repression" -- just the term "repression" -- sounds all negative. OK? It is not. Let me also point out one fact that jumps out from my analysis with Ken Rogoff in This Time is Different. During that period of financial repression, in which you had pretty tight lids on international financial activity, that did not extend to trade. I would like to point out that during the period of financial repression from 1945 to 1980, you had a rising integration of countries via trade, but not via finance. It's an important distinction. But during that period, we did not have these kinds of big bang banking crisis that we have had since the liberalization of financial markets or that we had before 1945. Indeed the salient feature, when you look at the sheer number of banking crises globally, [is that] they are few and far between in that period. The "repression" term gives it this overwhelming negative connotation. But in effect it's just a description of what is not a laissez-faire financial market.
Steve Weisman:	Not to mention that in a time of crisis, if borrowers have to suffer, profligate lenders have to face the music, too.
Carmen Reinhart:	Absolutely. In effect, one of the points that I make in connection with what you just said is that when one looks at the gross external debt numbers -- and now I'm talking about private debts, largely dominated by bank debts – the surge in private debts in the run up to this crisis -- it was banks that began [to be] very aggressive about borrowing abroad. One asks the logical question: was this a good idea?
Steve Weisman:	Guess not. Thank you, Carmen.
Carmen Reinhart:	Thank you, Steve.