THEMATIC GLOBAL VIEWS

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Monetary policy is only one angle of the financial repression triangle

The triangle of financial repression

The idea that we are entering a phase of financial repression regularly returns to the fore as real interest rates are negative and nominal interest rates are very low. As the Federal Reserve begins to normalise its policy with tapering and as US Treasury yields are rising, investors might believe this is only a temporary phenomenon. In fact, we believe we entered a regime of financial repression soon after the Global Financial Crisis 15 years ago, the intensity of which could increase in the context of the Covid-19 and climate crises. Indeed, financial repression is not only a function of monetary policy but also includes regulation and government decisions, forming a triangle with a moving barycentre. It appears to be a reasonable policy to ensure a smooth energy transition.

Financial repression is usually described as institutional constraints on interest rates designed to reduce the government's cost of funding and eventually shrink public debt. The "repression" comes from the fact that these measures distort the bond market, where sovereign bond interest rates are lower than free interest rates, and channel funds to governments. Low funding costs for fiscal policies mean lower returns for savers and investors.

The triangle of financial repression

Measures leading to financial repression are usually seen as mainly linked to central bank's policies (QE, low or negative policy rates) because it is the most visible part. **Financial repression can actually be defined as a triangle, which includes monetary policy, financial regulation and government actions.** Regulation plays an important role as it ensures a tied investor base (usually institutions), which is obliged to buy and hold government debt. Changes in prudential policies for banks and insurance companies, for instance, incentivise them to increase their holdings of sovereign securities, despite poor or negative returns. Capital and reserve requirements, liquidity and leverage ratios are among the regulatory constraints that take part in financial repression. The third angle is government direct control of financial flows, where it caps interest rates or dictates financial returns or make investment compulsory. Direct lending to the state from the banking sector and capital mobility constraints are other examples seen in the past.

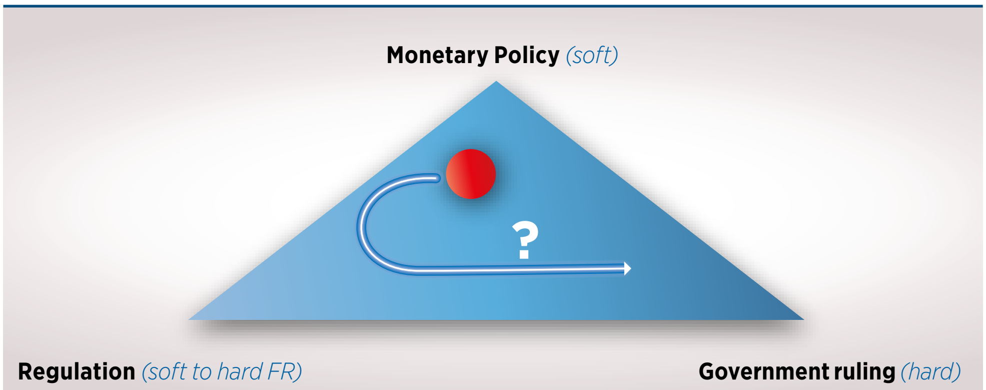
The intensity and effectiveness of each angle are different, and so is its strength. *Monetary policy* can be considered as soft and *regulation* as soft to hard, while *government* ruling is, by definition, hard. Moreover, financial repression is not an iterative mechanism. Each angle can be "on" or "off", with different intensity and strength at different periods. Today in advanced economies, monetary policies and regulations are "on", while government ruling is mostly "off". **Each of the three angles holds its own rationality and is perceived as a good or at least reasonable choice by the consensus in the current circumstances** (for instance, QE is seen as positive). The dynamics of financial repression are generated by crises. Hence, the fact that one or several angles of the triangle are switched "on" or heightened following episodes of financial or economic distress. Financial repression shouldn't therefore be defined as a level, but as a barycentre, of the triangle.

"Financial repression": the wrong word for the right concept

Financial repression has been widely used post-WWII in Europe and the US to manage public debt and reduce it relative to GDP[1]. In the 1980s, reforms removed restrictions on financial markets and the banking sector. **The concept of financial repression was coined in**

[1] *The Liquidation of Government Debt, Carmen Reinhart and Belen Sbrancia, IMF Working Paper 2015*

1/ **Financial repression position as the barycenter of triangle**



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Monetary policy and regulation should be enough to channel investments towards decarbonisation of the economy

the 1970s[2] as the opposite of liberalisation and therefore has a negative connotation, since everyone aspires to freedom. The word "repression" illustrates the merits of the liberal doctrine and the positive outcomes expected from deregulation. The main argument was (and still is) that restrictions on the financial sector discourage savings and investments, limit financial intermediaries' capabilities and fail to efficiently channel capital. Over the long run, financial repression would lead to a suboptimal allocation of capital and reduce growth potential.

The Global Financial Crisis brought back the idea of regulation, supervision and control, since self-regulation by financial markets was a clear failure. With the Eurozone crisis came the need to keep interest rates low, in order to maintain public debt sustainability and avoid a fragmentation of the monetary zone. Financial repression restarted a decade ago after 30 years of liberalisation, which saw major crises and unprecedented income inequalities.

Covid-19 and climate change are bringing new imperatives in the context of historically high global public and private debt, deglobalisation and unsustainable wealth disparity. The concept is therefore back on the agenda[3]. The need to fund the energy transition and rebuild some form of industrial autonomy in the main regions has become paramount, but requires a lot of capital and long lead investments. **We believe "repression" will not recede** but actually intensify, with the regulatory angle strengthening and probably government ruling switching on, as the need to channel capital to achieve decarbonisation will be critical. This "repression" is likely to be seen as a positive and not a negative to achieve the higher purpose of net zero versus return on savings. We should therefore assume that interest rates will remain low relative to nominal growth for a long time.

Channel funding for the energy transition

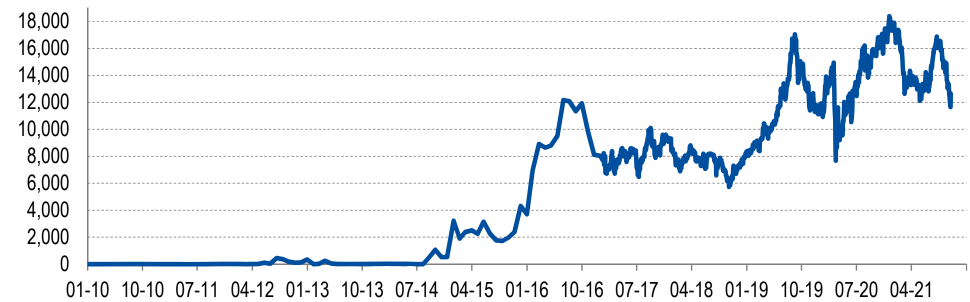
Financial repression is more effective when combined with inflation, which itself could be the consequence of excessive money creation, expansionary fiscal policy or excess leverage in the private sector, wage-increase spirals or supply shortages. Any of these, combined with the twin angles of monetary policy and regulation, should be enough to ensure an efficient transition to decarbonisation. However, the harder version of financial repression involving governments can't be excluded. It would require some market turbulence, though, and maybe another crisis to be justified and implemented.

Finalised on 18 October 2021

[2] *Shaw, Edward S. Financial Deepening in Economic Development. Oxford University Press, 1973. McKinnon, Ronald I. Money and Capital in Economic Development. Brookings Institution, 1973*

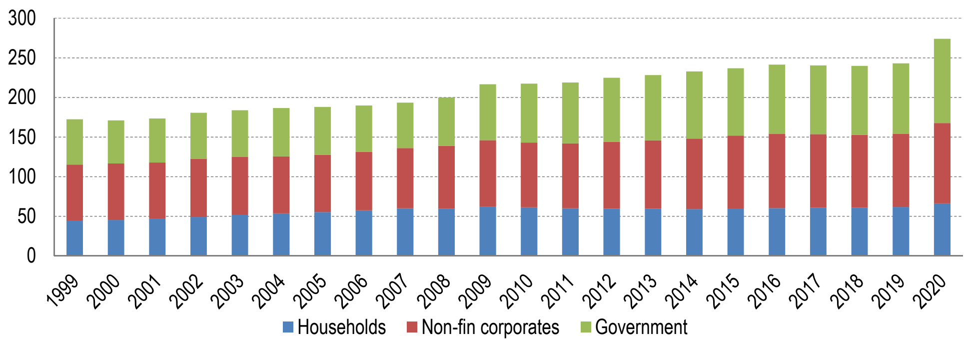
[3] *Financial Repression is Knocking at the Door, Again. Jafarov, Maino, Pani. IMF Working Paper 2019*

2/ **Negative Yielding Debt (USD bn)**



Source: Bloomberg, Amundi Research, Data as October 2021
Bloomberg Global Agg Negative Yielding Debt Market Value (USD bn)

3/ **Global Debt (% of GDP)**



Source: Amundi Research, Data as of October 2021

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