What would financial repression look like in EMs?

- Several EMs in Latin America, as well as South Africa, Nigeria, India and Turkey could use financial repression policies to deal with the legacy of higher public debt burdens resulting from the coronavirus crisis. This Update explains what form these policies might take and the economic implications.

- **What is financial repression?** Financial repression broadly means policies that keep government borrowing costs artificially low by channelling funding to the public sector (although it can also refer to intervention in the process of credit allocation to the private sector).

- It usually consists of a combination of i) interest rates caps, ii) creating a captive domestic audience for government debt (e.g. via capital controls or financial regulation), and iii) institutional structures (e.g. state banks) that increase demand for government debt. By reducing real interest rates, these policies act as a tax on savers, which is transferred to borrowers (the government) and can help to improve the public finances.

- In practice, the boundaries between financial repression and monetary policy (or financial regulation) can be blurry. After all, interest rate cuts and quantitative easing programmes loosen monetary conditions and also lower governments’ borrowing costs. Perhaps the best way of categorising financial repression is when the primary goal of the policy (whether explicit or not) is supporting the public finances.

- Such policies are by no means new in the emerging world, and still are in wide use in the two largest EMs, China and India. China employs an extensive system of capital controls and interest rate caps; in India, regulations require banks to hold large amounts of liquid assets like government bonds.

- **What would financial repression look like this time around?** Broadly speaking, it looks likely that financial repression policies will consist of central bank bond purchases and/or financial regulation policies. In DMs, it generally likely to be the former (in some cases accompanied by yield curve control). (See our Global Economics Focus.) And some emerging markets have recently gone down this path too.

- Most explicitly, Indonesia’s central bank has agreed to purchase sovereign bonds with the aim of financing the budget deficit. Elsewhere, many EM central banks have launched asset purchase programmes with the stated objective of ensuring financial stability (particularly during the market stress earlier this year), although financing large budget deficits seems to be an underlying concern. (See here.)

- Historically, however, financial repression in EMs has tended to take the form of bank regulation or the use of state banks to buy government bonds. And some countries have moved in this direction recently. For example, Colombia’s government decreed in April that banks must buy “solidarity bonds” issued by the sovereign. Elsewhere, Turkey’s bank regulator set a minimum loan-to-deposit ratio (in which debt securities were included within the definition of loans), that could boost lending but also demand for sovereign bonds.

- **Which countries will turn to financial repression?** Financial repression is only effective at reducing local currency debt burdens. For many of the smaller frontier markets which are suffering debt problems resulting from foreign currency liabilities (e.g. Ecuador, Angola and Zambia), default and/or support from international financial institutions are the most likely ways out.

- In the large EMs, most public debt is local currency. And as we’ve argued before, governments in a handful of countries will need to take action to prevent debt ratios from rising on an unsustainable path. (See here.) Brazil and South Africa stand out for the dire state of their public finances, but debt trajectories also look worrying elsewhere, including Colombia, Mexico, India, Turkey and Nigeria.

- Financial repression is likely to be an attractive option to help stabilise the public finances given the alternatives. We doubt that policymakers in the major EMs would be amenable to default, partly because of the reputational risks, but more importantly because a large share of government debt is held by residents – so default would hurt the domestic economy.

(Continued overleaf)
• A few countries (e.g. Brazil and South Africa) will turn to austerity in 2021. But the scale of the fiscal squeeze needed to stabilise debt ratios looks politically unpalatable. (See here.) Financial repression probably wouldn’t trigger the same public discontent as austerity. After all, the costs are far more opaque than conventional tax rises or spending cuts; they depend on the impact of the policies on interest rates, how inflation develops, and a comparison with the counterfactual (real interest rates without these policies).

• In practice, countries with very weak public finances (Brazil and South Africa again) might need to use a combination of financial repression and austerity to stabilise debt ratios. Others such as India and Turkey might be able to avoid the need for austerity by employing financial repression.

• Another factor to consider is whether countries have the institutional structure in place for financial repression. In general, such policies seem more likely in countries that have state ownership of banks (Brazil, India, Turkey), a financial account that is not fully liberalised (Brazil and India again), or politicised central banks (Turkey, India).

• What are the economic implications? The economic advantage of financial repression is that it allows governments to run looser fiscal policy than would otherwise be the case. In the current circumstances of depressed private demand and large output gaps, looser fiscal policy will help to support recoveries. That said, there are other side effects, which could materialise over the medium term.

• First, financial repression policies might lift a restraint on fiscal policy which, while welcome during a time of crisis, could fuel inflation if fiscal policy is excessively loose during more normal circumstances. Second, monetary policy could end up being used primarily for the benefit of the public finances rather than inflation targeting. Again, that points to inflation risks. These inflation risks are greater in those countries without well-anchored inflation expectations.

• And finally, if commercial banks buy more government debt, lending to the government will come at the expense of lending to the private sector (which will be ‘crowded out’). That, in turn, is likely to result in a misallocation of resources and weaker potential GDP growth. Overall, the economic damage from the side-effects of financial repression are likely to be largest in those countries where the policies are most severe (most likely those countries with the worst fiscal dynamics such as Brazil).

• A study by the IMF last year, which focused on the impact of interest rate caps, suggested that financial repression could reduce GDP growth by 0.4-0.7%-pts. In practice, though, the economic implications depend on how financial repression fits into the overall policymaking framework. For example, in the 1970s and 1980s financial repression policies were employed in both East Asia and Latin America. But while they supported very rapid growth in the former, they didn’t in the latter.

• That same IMF study showed that these policies (perhaps unsurprisingly) also reduced the risk of debt crises. But, in extreme cases, financial repression policies intended to reduce domestic debt burdens can cause balance of payments strains that weaken a government’s ability to service its external debt. Large negative real interest rates increase the incentive for residents to squirrel money abroad, triggering capital flight if controls are porous. That seems to have been the case in Venezuela and Argentina in the 2010s and could become a problem in Nigeria (we will be writing on this in more detail on our Africa service.)

• What does it mean for EM financial markets? We will be looking at this in more detail in a forthcoming Global Markets Update. In short, the impact is likely to depend on two things: the severity of financial repression measures and the size of the domestic investor base. In countries where financial repression policies are relatively modest and the domestic savings pool is large, the effects will be similar to developed markets – lower sovereign bond yields.

• In countries where financial repression policies are more drastic and/or the country is more dependent on foreign investors (who have far wider choice about where to invest than the captive domestic audience), low real interest rates and increased country risk premia might cause currencies to weaken sharply.
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