BY JOHN MULLIN

A Look Back at Financial Repression

The policies were gradually phased out in many advanced and emerging economies. Will they come back?

In the early 1960s, South Korea's economy was far from the dynamic performer that would later become known as an "Asian Tiger." On the contrary, its disappointing growth drew unfavorable comparisons to North Korea at the time.

In their seminal 1973 treatises on financial markets and economic development, Stanford University economists Ronald McKinnon and Edward Shaw labeled South Korea's ailment "financial repression." According to their diagnoses, the country's economic development had been impaired by well-intentioned but counterproductive policies — chiefly interest rate ceilings and administratively directed investment programs — that combined to tax savings and misallocate investment. The country's prospects improved greatly after it introduced fiscal and banking reforms in 1964-1965 that substantially removed these polices and allowed interest rates to increase toward market-clearing levels.

Many policies have been associated with financial repression over the years, and they have had many rationales. For example, governments have often barred domestic residents from buying foreign currency to invest abroad. These restrictions, known as "capital controls," are regularly used in tandem with domestic interest rate ceilings in order to channel inexpensive funds toward a government or its preferred beneficiaries. But capital controls are also motivated in many cases by the more benign goal of insulating domestic financial markets from volatile international capital flows.

Bank reserve requirements are also often implemented with mixed goals. While there is no doubt that they can facilitate deficit financing by creating a captive market for government debt, in most cases they are at least partially motivated by the goal of reining in excessive risk-taking by private banks, particularly when governments provide bank deposit insurance.

The work of McKinnon and Shaw focused on emerging markets, but policies that fit their definition of financial repression were also used extensively in Europe, Japan, and the United States in the aftermath of World War II. Some economists have argued that these policies helped governments lower the real returns on their debt obligations and thereby helped reduce their debt-to-GDP ratios.

Arguably, financial repression was baked into the postwar international financial system from the start. The Bretton-Woods exchange rate system encouraged free foreign exchange convertibility for export and import transactions. But the system expressly permitted capital controls, which gave governments increased latitude to control the pricing and allocation of credit in their domestic economies.

As the postwar period progressed, financially repressive policies were phased out in many countries. Recently, however, financial market observers have hypothesized that the accelerating trajectory of government debt levels around the globe may increase the incentives for governments to impose financially repressive policies.

BRETTON WOODS SETS THE STAGE

The Bretton Woods agreement — which profoundly shaped the postwar international financial system — was formed in response to the incredible financial turbulence of the period between the world wars. In 1931, over 40 of the world's 54 major economies were on the gold standard, meaning they pegged the value of their currencies relative to gold by standing ready to buy and sell gold with their currencies at a fixed price. International capital flows under this system were highly mobile, and the ability of countries to maintain the value of their currencies in the face of outflows depended on their credibility and the size of their gold reserves.

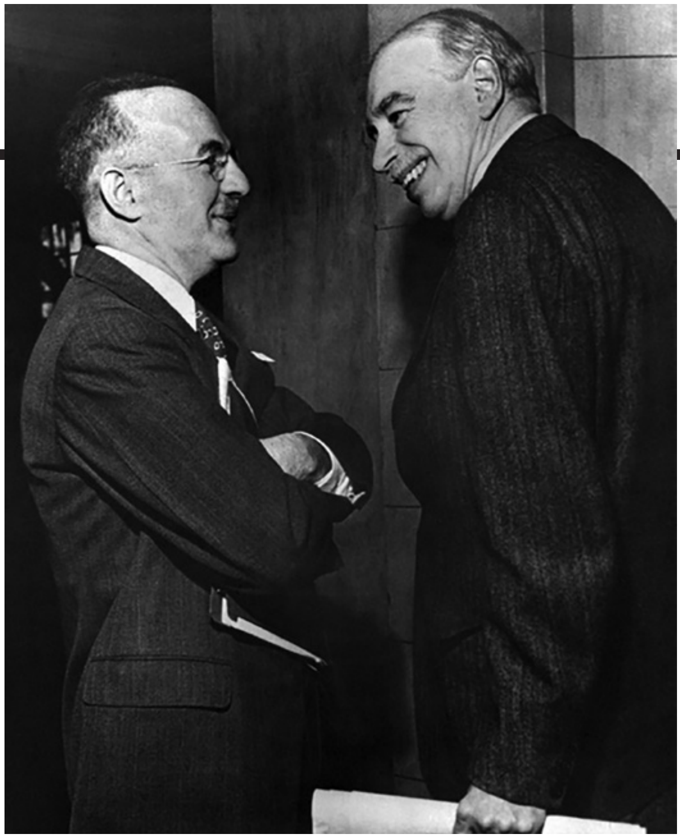
In May 1931, the failure of Creditanstalt, a large Austrian bank, raised doubts about the ability of Austria and Germany to service their World War I reparations debts, and the resulting anxiety sparked a conflagration that ultimately destroyed the interwar gold standard. Surges of money outflows forced country after country to suspend gold convertibility, ultimately forcing the United States off the gold standard in 1933. By 1937, fewer than five of the world's major economies remained on the gold standard. The speculative attacks and resulting currency collapses contributed significantly to the Great Depression.

Having lived through this chain of events, John Maynard Keynes — one of the main architects of the Bretton Woods agreement — came away with a highly skeptical view about the compatibility of free capital mobility with other valued objectives. "Keynes was quite uneasy about the volatility of international capital flows and the global financial cycle," says World Bank chief economist and Harvard professor Carmen Reinhart. "In the aftermath of the war, he viewed controls on capital flows as necessary to stabilize what was a very frail international system." Keynes viewed restrictions on international financial transactions as a price worth

Share this article: http://bit.ly/financial-repression paying for the sake of a stable environment conducive to free international trade of goods and services.

Moreover, Keynes believed that free capital mobility could interfere with a crucial tool of domestic macroeconomic management: the ability to conduct an independent monetary policy. History told him that, in order to maintain a fixed exchange rate in the face of free capital mobility, a central bank must be willing to adjust domestic interest rates in response to changing international financial conditions, thereby sacrificing monetary independence.

The Bretton Woods system effectively operated as a fixed exchange rate system — with countries other than the United States pegging their exchange rates to the dollar, and the United States pegging the dollar to gold at $35 an ounce. The system specifically allowed countries to place foreign exchange controls on capital account transactions, placing greater emphasis on the desirability of maintaining foreign exchange convertibility for current account transactions.



John Maynard Keynes (right) and Assistant U.S. Treasury Secretary Harry Dexter White, seen here in March 1946, were two of the main architects of the Bretton Woods system.

IMAGE COURTESY: INTERNATIONAL MONETARY FUND

RATIONING SCARCE CAPITAL IN EUROPE AND JAPAN

Capital controls were a widespread feature of postwar Europe. Across the continent, U.S. dollars were in short supply, particularly in the early postwar years, and capital controls were seen as a way to keep scarce capital from fleeing abroad. The controls allowed countries greater autonomy to set domestic interest rates and facilitated a host of policies that allowed governments to influence the allocation of funds across sectors in their domestic economies.

With regard to the intensity of government intervention in financial markets, France and Germany represented two ends of the European spectrum. Successive French governments took a highly hands-on approach to the allocation of credit. In 1945, the French government passed legislation that nationalized the country's largest banks and authorized the government to direct the economy-wide volume, distribution, and terms of credit. This was achieved through a variety of administrative means. In the early postwar period, the government ranked economic sectors from A to E, giving priority to bank loans for the "indispensable equipment" of category A and discouraging loans to finance the "superfluous economic activities" of category E. In addition, French banks were required to hold minimum amounts of government debt as reserves.

Germany took a much less interventionist approach and liberalized its comparatively light system of domestic credit controls as early as 1967. Controls on bank deposit and lending rates were ultimately seen by the German government as inefficient and impractical to administer. The French backed away from controls later, liberalizing domestic financial markets extensively in the 1970s and 1980s.

For the most part, capital controls were abandoned by the major European countries during the 1980s. The growing international reach of European companies had made capital controls more difficult for authorities to enforce, and the growing sophistication of financial markets had made controls easier to elude. "Capital controls could not survive too long after financial markets were liberalized and new financial products were designed to circumvent the controls," says Reinhart. Nevertheless, some capital controls were continued, including bans on the foreign acquisition of companies that were viewed as strategically important.

As in Europe, Japan adopted policies to administratively ration scarce capital in the immediate aftermath of World War II. The country adopted an outward-looking economic strategy that directed credit to export-oriented firms through highly regulated banks. Japan also imposed strict controls on cross-border financial transactions. The subsequent liberalization of the controls in the 1970s and 1980s coincided with the growth of Japanese firms' international activities, which made capital controls more burdensome and easier to circumvent.

FINANCIAL REPRESSION IN THE UNITED STATES

Financial repression as a tool of government finance in the United States goes at least as far back as the Civil War when, under the National Bank Act, banks were required to hold U.S. government securities as reserves in order to receive national charters. Policies that arguably amounted to financial repression were pursued again during World War II. Widespread rationing of consumption goods and restrictions on consumer credit boosted savings and, combined with war bond drives, facilitated the selling of government securities.

These wartime policies were complemented by the Fed's 1942 agreement with the U.S. Treasury to peg interest rates on short-term government bonds at the extremely low rate of three-eighths of a percent. The Fed maintained the interest rate peg until well after the war, ending the arrangement with the Treasury-Federal Reserve Accord of 1951.

Policies of financial repression became increasingly important in the United States during the 1960 and 1970s, and their role was intimately tied to the Bretton Woods system — its growing and unsustainable imbalances, its demise, and the Great Inflation that followed. Whereas the immediate postwar period was marked by dollar shortages among the major non-U.S. economies, the "economic miracles" of Germany, Japan, and other countries dramatically changed the picture. By the 1960s, Japan and Germany were running persistent current account surpluses, and the United States found it increasingly difficult to maintain the dollar's $35-an-ounce peg to gold.

To sustain the peg while maintaining the latitude for discretionary monetary policy, the United States imposed a new type of capital control in 1963 called the Interest Equalization Tax. The measure attempted to stem capital outflows from the United States by placing a 1 percent tax on foreign bonds sold in the U.S. market (the tax was later extended to short-term bank loans to foreigners). This was followed by various executive branch efforts to improve the U.S. balance of payments, including the use of "moral suasion" to put pressure on U.S. firms to repatriate funds and on U.S. allies to forgo converting their dollar holdings into gold. Despite all of the fingers in the dam, the Bretton Woods system of pegged exchange rates ultimately gave way.

As inflation and U.S. Treasury rates increased during the 1970s following the collapse of Bretton Woods, the distortionary effects of U.S. interest rate ceilings, known as Regulation Q ceilings, became more pronounced. Authorized by the banking acts of the Great Depression, Regulation Q prohibited banks from paying interest on demand deposits (such as checking accounts) and allowed the Fed to set interest rate ceilings on bank time and savings deposits. Originally, there had been several motivations for Regulation Q, but two of the more important goals were to restrain speculative competition among banks and to encourage country banks to lend more in their communities and divert smaller amounts of funds to deposits at money-center banks.

Many financial institutions and relatively wealthy savers found ways to circumvent Regulation Q ceilings and earn higher interest rates through the eurodollar market, repurchase agreements, and money market mutual funds. But these innovations created an uneven playing field. They were generally inaccessible to smaller savers, who were therefore deprived of billions of dollars in potential interest payments. They also put depository institutions at a competitive disadvantage. By the early 1980s, it was broadly recognized that Regulation Q had outlived its usefulness, and Congress passed legislation to phase it out.

By some definitions, however, other financially repressive policies have remained in place. For example, government-sponsored enterprises such as Fannie Mae and Freddie Mac continue to exert a powerful influence on the supply and demand for credit in the United States. To many economists, this counts as financial repression, despite these institutions' goal of promoting broad homeownership.

MIXED EMERGING MARKET EXPERIENCES

During the 1950s and 1960s, many Keynesian economists maintained a skeptical view of the role of free capital markets in the economic development process. Against this intellectual backdrop, many emerging markets took a highly interventionist role in financial markets. Brazil, for example, pursued a policy mix known as "import substitution." The idea was to preserve scarce foreign exchange reserves and increase economic independence by developing domestic industries to produce goods that could serve as substitutes for the country's imports. To pursue this goal, the Brazilian government adopted a wide set of policies associated with financial repression, including capital controls, domestic interest rate controls, and a highly hands-on approach to domestic capital allocation.

In retrospect, this policy mix has been widely deemed a failure. "Today, many Brazilian economists are extremely allergic to the idea of financial repression," says Richmond Fed economist Felipe Schwartzman, a native Brazilian. "In Brazil, financial repression has gone hand-in-hand with industrial policy that has proved to be extremely inefficient over the long run."

Liberalization policies were pursued in many emerging markets in the postwar period, but the results were not always positive. Carlos Diaz-Alejandro of Columbia University analyzed several unsuccessful cases in his 1985 *Journal of Development Economics* article "Good-Bye Financial Repression, Hello Financial Crash." Chile, after privatizing its banking sector and liberalizing capital controls in the 1970s, had experienced rapid increases in capital inflows and domestic credit. As the title of the article suggests, this all ended badly. Chile became engulfed in banking and debt crises as global financial conditions dramatically worsened in the early 1980s.

In light of these failed liberalization episodes, economists devoted a great deal of effort to trying to understand the necessary conditions for successful liberalization and the best ways to sequence the policies. Some economists stressed the need for solid legal and regulatory superstructures; others recommended that domestic financial market liberalization precede capital account liberalization.

To this day, economists hold divergent views on the efficacy of capital controls. The International Monetary Fund (IMF) has acknowledged that controls on capital inflows can be a useful policy tool to protect emerging markets from destabilizing inflow surges, but the institution has generally not encouraged their use as a practical matter. As for controls on capital outflows, there is a great deal of evidence that suggests that they are often evaded and provide little long-term relief in the face of persistent macroeconomic imbalances.

The trend toward capital account liberalization has been reflected in the diminishing numbers of emerging market countries with parallel foreign exchange markets (which, like black markets, arise in response to capital account restrictions). But the tools of financial repression are still evident in many emerging markets. In China, a prime example, low administered nominal interest rates continue to combine with inflation to provide cheap funding for government-owned enterprises — a policy mix that is complemented by capital controls.

A TOOL OF DEBT LIQUIDATION

In many countries during 1945-1980, financial repression effectively lowered the real returns to government debt holders and helped governments reduce their debt-to-GDP ratios, according to research by Reinhart and M. Belen Sbrancia of the IMF. Based on their calculations, real returns on government debt were negative in many countries over 1945-1980. The real returns to bond holders averaged -0.3 percent in the United States, and real returns were even lower on the bonds of those European governments that had been particularly ardent practitioners of financial repression, coming in at -6.6 percent in France and -4.6 percent in Italy. Real returns in Argentina over the period were a confiscatory -21.5 percent per year.

The researchers' analysis highlights a measurement problem: In practice, it is hard to determine the extent to which these low real rates were caused by distortionary financial controls, such as interest rate caps, versus how much they were caused by inflationary surprises. "It is very difficult to decompose the two effects causing low real returns," says Reinhart. "That is why I divide the period into two eras. The early postwar era was the heyday of financial repression, and interest rate caps and low nominal rates were the main mechanism. Then in the 1970s, it was also driven by inflation surprises."

And this is not just a measurement question. It also raises an important conceptual issue. Ever since McKinnon and Shaw, financial repression has been associated with inflation, and in practice the two have often gone hand-in-hand to create low real returns on financial assets. Yet in important ways, they are distinct. In principle, it is possible to have financial repression without inflation, and it is also possible to have inflation without financial repression.

REEMERGENCE?

Concerns about a reemergence of financial repression have been raised by the cumulative effects of the 2007-2008 global financial crisis, the European debt crisis, and the COVID-19 pandemic. In Europe, the process of placing public debt at below-market rates has arguably been underway for some time. Between 2007 and 2013, domestic banks in eurozone countries more than doubled their holdings of government debt, and it looks like the buildup has not been completely voluntary. "A common complaint I have heard from private bankers is that they were being leaned on by their governments to buy at debt auctions," says Reinhart.

In the United States, banks are also holding vastly increased levels of government debt, largely due to the 2014 implementation of the Liquidity Coverage Ratio (LCR), which requires banks to hold certain levels of high-quality liquid assets. The LCR was mostly motivated by macroprudential considerations, but policies usually end up having side consequences, and one of the side effects of the LCR is that it has substantially increased banks' demand for U.S. government debt obligations, including Treasury securities and reserves.

Has this contributed to a recent trend toward lower interest rates in the United States? Reinhart believes this to be the case. Other economists prefer a prominent alternative explanation — secular stagnation — which posits that low interest rates mostly reflect an aging demographic profile and disappointing productivity growth. To this, Reinhart counters that "they are not mutually exclusive."

Regardless of the causes of recent low interest rates — and of course, the Fed's countercyclical monetary policy is itself a major factor — in some ways today's situation appears to be quite distinct from the early postwar period. "During World War II, it was different," says Schwartzman. "Treasury rates were kept low with the explicit goal of facilitating deficit finance. I wouldn't want to call today's low interest rates financial repression. That would be a bridge too far." **EF**

READINGS

McKinnon, Ronald I. *Money and Capital in Economic Development*. Washington, D.C.: Brookings Institution Press, 1973.

Reinhart, Carmen M., and M. Belen Sbrancia. "The Liquidation of Government Debt." *Economic Policy*, April 2015, vol. 30, no. 82, pp. 291-333.

Shaw, Edward S. *Financial Deepening in Economic Development*. New York: Oxford University Press, 1973.