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Research Brief

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Financial repression as an “easy way” out of debt?

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Financial repression is intended to help the government deleverage over time, for example following crises, by artificially lowering the yield on government bonds. However, its impact on the deb-to-GDP ratio also depends on how it affects the economy as a whole, as financial repression also influences private investment and saving decisions. In view of these macroeconomic interrelationships, financial repression can lead to a net rise in the government debt-to-GDP ratio. A new study suggests that this is what happened in the United States following the Second World War.

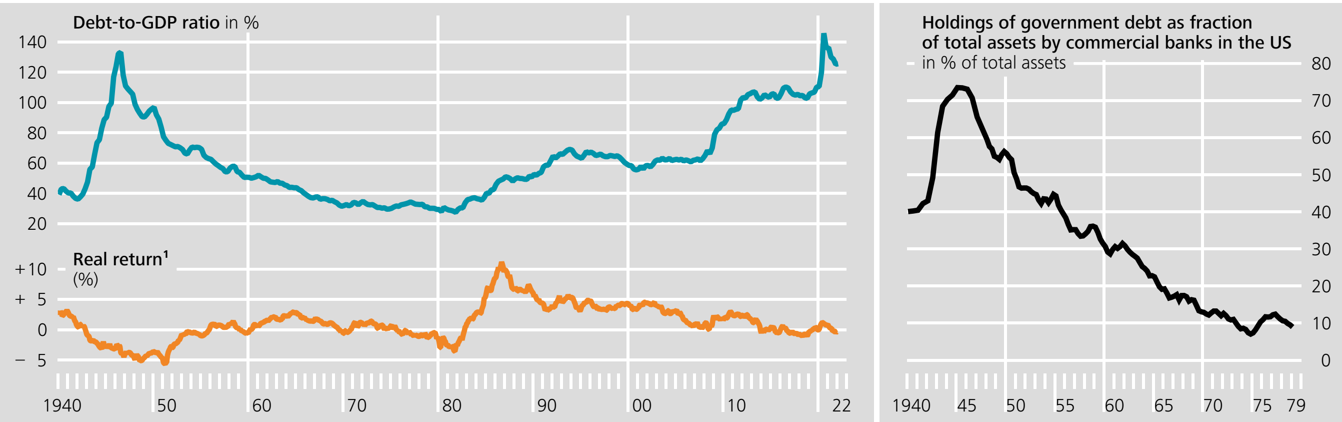
Government debt has risen sharply in many countries over recent years, partly as a result of the pandemic. Consequently, there are often calls to bring debt-to-GDP ratios back down in order to ensure that there is sufficient fiscal space to deal with future crises (IMF, 2023). However, conventional policy measures to lower the debt-to-GDP ratio, such as measures to promote economic growth, higher primary budget surpluses and inflation, are often difficult to implement, in part because of political opposition (Arslanalp and Eichengreen, 2023).

Another unconventional policy for reducing debt-to-GDP is what is known as “financial repression”. This term denotes various policy measures that enable a government to place its debt with financial institutions at artificially low interest rates. Such measures may include binding interest rate caps. In addition, the government can take explicit action via regulation or implicit action, say, through moral suasion to ensure that private investors are willing to increase their holdings of government debt despite low yields (for an overview of historical measures, see also Reinhart and Sbrancia, 2015).

Chart 1 shows that US government bond yields were very low during and after the Second World War, even though the debt-to-GDP ratio initially rose on a massive scale during the Second World War and was then reduced up to the mid-1970s. The right-hand panel shows that, despite these low yields, commercial banks initially expanded their holdings of government debt. The literature debates the extent to which this observation already constitutes a sign of financial repression (Reinhart and Sbrancia, 2015; Acalin and Ball, 2023).

Government debt and yields

Chart 1



Source: Hall et al. (2021), Board of Governors of the Federal Reserve System. **1** Ex-post average annual 5-year holding period real return of an average maturity government bond portfolio.
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Financial repression crowds out private investment

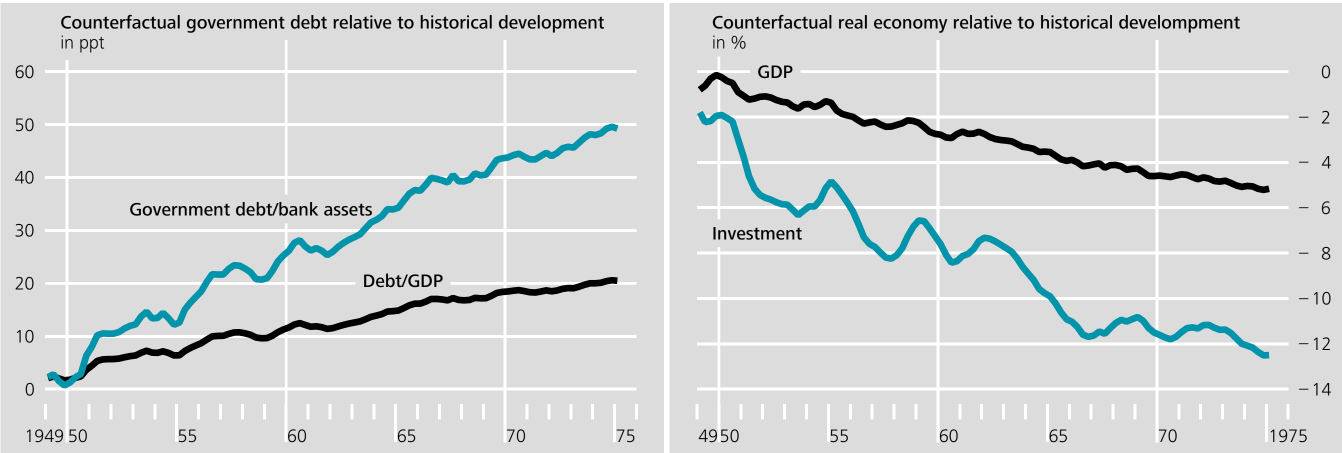
In a new study (Kliem et al., 2024), we examine whether and, if so, how financial repression influenced the US government debt-to-GDP ratio following the Second World War. In our analysis, we focus in particular on the impact of financial repression on commercial banks' balance sheets to enable us to gauge the effect, via a change in lending, on private real investment and economic growth. To this end, we assume that commercial banks must hold a minimum share of their total assets in the form of government bonds (Chari et al., 2020). A tightening of this regulation reduces the expected yield on government bonds (interest rate effect) but, at the same time, also crowds out lending to firms, which reduces investment activity and slows down economic growth. Quantifying these macroeconomic effects is conceptually challenging for two reasons. First, the interest rate that would have existed in the absence of financial repression is not directly observable. Second, financial repression changes the government debt-to-GDP ratio not just directly via its impact on interest rates, but also indirectly through its effect on real growth in gross domestic product (GDP), as well as on inflation and tax revenue. We address these challenges by mapping the aforementioned interdependencies in a general equilibrium model for the post-war period in the United States. Consistent with the literature, our results show that financial repression did take place during the Second World War, but was gradually reduced in the decades that followed.

Real economic effects outweigh the interest rate effect

To assess the impact of financial repression on developments in the US government debt-to-GDP ratio and the economy as a whole, we construct a counterfactual scenario in which we assume that financial repression – specifically the regulation of commercial banks – was not loosened following the Second World War (as happened in reality), but remained constant over the entire period between 1948 and 1974. The left-hand panel in Chart 2 shows that, in this counterfactual scenario, commercial banks would have held more government bonds on their balance sheets and the government debt ratio would have been higher. At first glance, this finding is surprising, as it runs counter to the general understanding of financial repression, or at least the aim thereof. However, we can explain this in the model: the interest rate effect is outweighed by general equilibrium effects. In the counterfactual scenario, commercial banks grant fewer loans, resulting in reduced private real investment and thus lower GDP and lower inflation. Given such consistently high financial repression, investment would have been 12% lower and real GDP 6% lower by the end of 1974 (see the right-hand panel in Chart 2). The counterfactual scenario thus illustrates that greater financial repression would not have led to a faster reduction in the US government debt ratio; on the contrary, the ratio would have been 20 percentage points higher at the end of 1974.

Quantifying the counterfactual scenario

Chart 2



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This result demonstrates the importance of adopting a general equilibrium perspective when quantifying the effects of financial repression. A (partial) accounting analysis that isolates the interest rate effect alone may give rise to the fallacy that financial repression lowers the debt-to-GDP ratio, even though exactly the opposite occurred.

Conclusion

Faced with today's high levels of government debt, policymakers may find the notion of reducing government debt via financial repression appealing. However, our analysis of the US economy during and after the Second World War demonstrates its potential side effects: not only could financial repression potentially have a severe negative impact on the economy as a whole, but such knock-on effects might also ultimately drive the government debt-to-GDP ratio up, not down. Our results thus suggest that calls to use financial repression as a means of reducing government debt should be treated with caution.

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News from the Research Centre

Publications

“What Drives Startup Valuations?” by Björn Imbierowicz (Deutsche Bundesbank) and Christian Rauch (American University of Sharjah) will be published in the *Journal of Banking and Finance.*

“Are Tax Cuts Contractionary at the Zero Lower Bound? Evidence from a Century of Data” by James Cloyne (University of California, Davis), Nicholas Dimsdale (Oxford University) and Patrick Hürtgen (Deutsche Bundesbank) will be published in the *Journal of Political Economy.*

Events

22. – 23. October 2024
”Research Workshop on Numerical Methods in Macroeconomics“ joint with The Institute of Monetary and Fiancial Stability at Goethe University Frankfurt, Germany

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