

theirview

Financial repression redux

One of the biggest casualties of the return of financial repression is the independence of central banks

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Financial repression is a term used to describe a policy environment where central banks and governments deliberately keep interest rates below the rate of inflation. Left to market forces, real interest rates would never turn negative. They do so because the central bank is willing to supply unlimited amount of credit, with sovereign guarantee, at repressed rates. This has the effect of boosting government coffers and/or effectively reducing debt, both public and private. It is a tax on savers as it transfers benefits from lenders to borrowers.

Financial repression can spur investment as it makes borrowing cheap. China systematically used financial repression as a developmental tool to telling effect. But it has led to over-investment and a potential debt crisis.

In market economies with a developed financial system, where alternative avenues of investment are available, financial repression discourages financial savings. It pushes savings into risky assets and unproductive sectors such as gold, speculative real estate and moneylending.

Informal sector activities may be more lucrative in these circumstances, but they are not as efficient or productive as large enterprises that exploit economies of scale. It therefore reduces resources directly available for more productive investment and higher growth.

Between 2000 and 2007, when real interest rates (the Reserve Bank of India (RBI)'s repo rate minus consumer price inflation) were consistently positive, India's gross domestic savings as a percentage of gross domestic product (GDP) rose from 23.8% in 2000 to peak at 36.8% in 2008.

India's current account deficit, which reflects aggregate savings/dis-savings in the economy, was contained at under 1% of GDP. Investment increased sharply and GDP growth approached double digits.

Between 2008 and 2013, real inter-

est rates were negative. India's savings declined to 33% during this period. Investment and growth also declined. Meanwhile, India's current account deficit ballooned, peaking at 4.5% of GDP in 2012-13. The decline since is attributable to the sharp decline in oil prices and aggregate demand and not to higher savings. During the past couple of years, interest rates have again turned positive through a combination of declining inflation and explicit inflation targeting by the central bank.

Although largely considered a developing country sin, today's advanced countries had indulged in financial repression in the past. But by and large, they moved away from repression since the Volcker era of the 1980s through rule-bound monetary policies, such as the Taylor Rule. They have, however, returned to financial repression in the wake of the global financial crisis for reasons that are familiar, namely, cheap credit to private investors to raise growth rates, and to pay down public debt that has ballooned since the crisis broke. Japan's return began over a decade earlier.

The deviation from the Taylor Rule predates the financial crisis, through what is frequently called the "Greenspan Put", a likely cause of the investment bubble that fuelled the crisis. One possible reason for the deviation was the global savings glut that put downward pressure on the equilibrium interest rate (constant), an input into the Taylor Rule equation.

Be that as it may, the deviation is very pronounced since the crisis and the use of unconventional monetary policies. Central banks in developed countries have apparently either reverted to discretionary monetary policy, or are working with a lower neutral rate of interest, deviating by about 3%, plus or minus 0.5%, from the Taylor Rule. Interest rates were not negative in the pre-crisis period. The current Fed Funds Rate is, however, over 1% below the annualized July 2016 All Urban Consumer Price



Inflation, raising fears of another financial bubble, even as real economy investment languishes.

This deviation coincided with a decline in US personal savings to around 5% at the turn of the century, from an average of 8.3% of GDP between 1959 to 2016. Falling briefly from this level during the 2003-07 boom, and rising briefly after the crisis, they seem to have reverted to 5%. Japan's saving rate, once the highest among the Organisation for Economic Co-operation and Development countries, has turned negative.

Likewise, the US current account deficit, in balance in the early nineties, widened sharply to touch 6% just prior to the crisis. Falling to just over 2% in the wake of the crisis, it has widened again over the last couple of years.

One of the biggest casualties of the return of financial repression is the independence of central banks. Their institutional independence is not set in stone, deriving less from formal autonomy, by which the treasury never pronounces a view on interest rates, and more from the conquest of inflation and fiscal dominance. This battle for independence is still being fought in developing countries.

Zero and negative interest rates

polices, with central banks holding large amounts of government debt through repeated quantitative easing, herald the return of fiscal dominance that is undermining central bank independence. Public debt is so high in the wake of the global financial crisis that it may be constraining central banks to keep interest rates low. At current levels of low growth and high public debt, fiscal deficits could spin out of control through an ever rising interest burden.

The effective loss of monetary independence in advanced economies is undermining the battle that developing country central banks, such as the RBI, have been waging to carve out their own institutional autonomy based on the advanced economy model of inflation and debt—both public and private—control. RBI's return to positive real interest rates attracted sharp criticism from the government, which apparently held it accountable for declining investment and growth, notwithstanding evidence to the contrary from the last decade. This was also a likely reason for the recent leadership change in the central bank.

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