FINANCIAL REPRESSION TO EASE FISCAL STRESS:
TURNING BACK THE CLOCK IN THE EUROZONE?

Ad van Riet *

First draft: 14 February 2013

Second revised draft: 4 July 2013

Abstract

Policy-makers are addressing the sovereign debt crisis, which is undermining financial stability and the cohesion of the eurozone, in various ways. History suggests that they may also attempt to revive two age-old tactics of financial repression: curtailing financial markets and calling on the central bank to ease fiscal stress. Several euro area governments have indeed applied various repressive techniques directed at domestic financial institutions, savers and investors in order to secure debt financing, induce lower funding costs, fill budget holes or resolve a public debt overhang. Moreover, European legislators have stepped up their control over the financial system to correct market and regulatory failures. Some of their interventions, however, also established government privileges which unduly restrain market-based fiscal discipline. The European Central Bank has been actively engaged in restoring financial stability and preserving the euro. Although governments benefited from its extraordinary monetary policy actions, the ECB pursued its mandate in an independent manner with a credible focus on maintaining price stability and creating incentives for policy-makers to underpin the stability of the eurozone.

JEL codes: E44, E58, E63, F36, G18, G28, H63

Key words: financial repression, financial crisis, fiscal stress, monetary policy, central bank independence.

Cut-off date for data used in this paper: 31 May 2013.

* European Central Bank (ECB). The views expressed in this paper are those of the author and should not be reported as representing the views of the ECB. Helpful comments from Giovanni Callegari, Geert Langenus, Philippe Moutot and Guido Wolswijk are gratefully acknowledged.
1. Introduction

In the wake of the financial crisis that erupted in September 2008, several euro area countries have been confronted with a sovereign debt crisis that created a negative feedback loop with their fragile banking sector and posed a threat to financial stability in the euro area as a whole. As a result, the European Economic and Monetary Union (EMU) was thrown into an existential crisis, triggering the question: what will happen next? (Mongelli and van Riet, 2013)

The experience of past crises and post-war episodes, when advanced economies were also faced with exceptional circumstances and very high levels of public debt, might provide an answer. To ease public sector budget constraints, governments often resorted to “financial repression” with a quasi-fiscal character, i.e. they curtailed the domestic financial system and exploited the conduct of monetary policy to secure the necessary demand for sovereign bonds at favourable real interest rates. Reinhart and Sbrancia (2011, p.46) point to the response to the Great Depression of the 1930s, when “the pendulum had begun to swing away from laissez-faire financial markets toward heavier-handed regulation”. Moreover, central bank independence was compromised during this period (McCulley and Pozsar, 2012). World War II provided further arguments for pervasive financial restrictions, implemented with the help of central banks, which, after the war, continued to protect governments from market stress and help reduce their massive public debts. Only from the 1980s onwards was financial liberalisation embraced and were international capital controls progressively abolished. Moreover, central banks gained legal independence in the conduct of monetary policy. As a result, governments subjected themselves to market discipline, which required them to pursue credible stability-oriented economic policies.

Are policy-makers now turning back the clock on the freedom of financial markets? Is the pendulum swinging back towards more subservient central banks? For many politicians, the approach taken in dealing with previous crises may look attractive again today. The larger the debt overhang of the public sector, the weaker the health of the banking system, the longer the balance sheet recession lasts and the more foreign investors withdraw from domestic markets, the more likely governments are to support a revival of financial repression. Goodhart (2010, p.15) foresees a new era with “more intrusive regulation, greater government involvement and less reliance on market mechanisms”. In addition, “the idea of the central bank as an independent institution will be put aside” to allow for close interaction
with the government. Reinhart and Sbrancia (2011) argue that financial repression is resurfacing in the crisis, partly under the guise of changing prudential regulation. Kirkegaard and Reinhart (2012) foresee a global return to tighter restrictions on international capital flows designed to produce a “home bias” and create a captive domestic audience for public debt. They view the high incidence and persistence of negative real interest rates far out along the yield curve as a sign of widespread financial repression across advanced economies. Lorenzen (2012, p.3) also sees a “distinct leaning in recent policy towards gradually creating a captive buyer base that can hold more of sovereign debt through voluntary or coercive means”. He points to the extraordinary monetary policies and huge expansion of central bank balance sheets during the crisis as further evidence of financial repression. Eijffinger and Mujagic (2012) observe central banks venturing into capital markets to maintain negative real interest rates and pronounce a new “age of financial repression”. Others note that some central banks are under political pressure to manipulate the exchange rate and even speak of a “currency war” between competing nations.

This paper discusses the reappearance of financial repression in the eurozone, as policymakers seek to address a sovereign debt crisis that coupled with an undercapitalised banking system is undermining financial stability and the cohesion of EMU. Section 2 looks at the concept of financial repression both from a public interest and a public finance viewpoint. Section 3 reviews how advanced economies accepted market discipline over their policies from the 1980s onwards, and why politicians may now wish to step back once more from liberalised markets and independent central banks. Section 4 asks how realistic this option is for euro area authorities. Section 5 examines the evidence of quasi-fiscal forms of financial repression in the eurozone. Section 6 discusses the view that financial repression has also affected the European Central Bank (ECB). Section 7 asks whether the exceptionally low level of interest rates in the eurozone can be linked to financial repression designed to ease fiscal stress. Section 8 draws some conclusions.

The evidence suggests that various forms of financial repression are indeed making a return in the eurozone as one way to address the sovereign debt crisis. Several euro area governments have resorted to repressive techniques as a shortcut to easing their budget constraints. At the European level, many changes in legislation have been introduced to preserve financial stability in the eurozone. While these interventions are generally in the public interest, some of them also privilege governments and unduly restrain market-based
fiscal discipline, especially in times of funding stress. This could create moral hazard on the part of governments and undermine their incentives to undertake necessary reforms. Governments also benefited in various ways from the extraordinary monetary policy actions taken by the ECB, triggering an intense debate on whether it was still acting within its mandate. However, in terms of its price stability objective, the credibility and independence of the ECB have been preserved. This also reflected the central bank’s focus, as guardian of the euro, on creating incentives for policy-makers to underpin the stability of EMU.

2. Financial repression: for good or for ill?

The term “financial repression” is generally used to describe a comprehensive policy regime put in place by the government to manage the domestic financial system – with assistance from the regulator – by imposing tight restrictions on financial markets, intermediaries and services, often complemented by capital account and foreign exchange controls to prevent evasion or currency speculation.\(^1\) The governance framework of financial repression comprises all kinds of moral suasion, financial policies, legislation, taxes, distortions, and qualitative and quantitative restrictions that determine price, quantity and entry conditions in financial markets and affect the allocation of capital (see, for example, Battilossi, 2003). Such a pervasive regime of financial market interventions is often augmented by government instructions to the central bank regarding the conduct of monetary policy.

Governments in advanced economies have a long history of intervening in the freedom of financial markets and compromising the independence of the central bank. Apart from helping the government finance its military effort in times of war, the declared intention of such interventions was to make the financial system better serve public policy goals (see, for example, Honohan and Stiglitz, 2001). Taking this *public interest viewpoint*, financial repression is necessary and unavoidable when trying to preserve financial stability, facilitate monetary management, achieve a proper allocation of credit, generate a favoured distribution of income and wealth, and protect the economy from external shocks.

An additional objective of financial repression has often been to ease public sector budget constraints and to loosen market-induced fiscal discipline (Giovannini and de Melo, 1993;...
Wyplosz, 2001; Battilossi, 2003). According to this *public finance viewpoint*, the broad range of financial controls represents a “financial repression tax” that directs resources to the public sector (Reinhart and Sbrancia, 2011). The financial repression tax may comprise both income from an implicit or explicit tax imposed on the financial system and seigniorage from an inflation tax if the central bank is subservient to the government and therefore unable to maintain price stability (Graph 1). These quasi-fiscal revenues accrue to the government budget and relieve the need for painful fiscal adjustment. This makes financial repression most attractive in times when public debt is high, and most effective in combination with a steady rate of inflation that erodes the real value of debt and keeps real interest payments low.

**Graph 1 – Financial repression as a source of public revenues**

Against the background of these two alternative views, one may distinguish between beneficial and harmful forms of financial repression. Financial repression can be seen as a “public service” in the interest of society if the interventions are introduced with the strict objective of correcting market and regulatory failures and for financial and monetary stability as well as distributional purposes. Some of the instruments of financial repression are an indispensable part of the toolkit of regulators seeking to control excessive risk-taking in open market economies. Supervisors need to be able to use them for prudential purposes and to ensure a safe and sound financial system (Honohan and Stiglitz, 2001). For example, prudential regulation should enhance the capacity of banks to withstand major shocks and reduce excessive market volatility. Taxation of the financial sector may be required to fill
bank resolution and deposit insurance funds or to correct externalities not accounted for in market prices. Also, the central bank must have the opportunity to employ unconventional tools that enable it to conduct monetary policy effectively, for example aimed at addressing severe market disruptions, bank funding constraints and factors hampering the supply of credit to the economy. A positive assessment of financial repression would require that all these safeguarding and stabilisation measures are designed so as to support the efficient functioning of financial markets and the resilience of financial institutions while maintaining market-based discipline and avoiding moral hazard. In addition, the independence of the central bank must be guaranteed to preserve its credibility in conducting monetary policy in accordance with its mandate.

A negative assessment would instead be appropriate if the repressive measures are to be seen as a “public vice”, because they introduce financial privileges for the government that enable it to evade market discipline or transfer private resources to the public sector in a quasi-fiscal manner. This is the case when regulatory distortions undermine the ability of financial markets to send disciplinary signals about economic fundamentals and, in particular, the soundness of fiscal positions. This type of financial repression is also characterised by efforts to persuade or force the private sector to allocate savings to the government at below-market interest rates. For example, the fiscal authorities may coerce domestic banks into helping to relieve public sector funding constraints or supplying credit to state companies. Or they may claim the reserves from pension funds to fill their budget holes, thereby enjoying current windfall income in exchange for taking over future pension commitments. They may even go as far as confiscating private wealth and violating creditor rights to resolve a public debt overhang. The treasury may also cajole the central bank into adjusting its monetary policy to favour the government by capping its interest rates, buying large amounts of sovereign bonds in the market, providing monetary financing, supporting fragile banks or generating excess inflation and higher nominal GDP growth. In addition, repression may comprise controls over the free movement of capital in order to prevent investors from escaping abroad.

The economic and distributional distortions of financial repression with a fiscal motivation are severe. A diversion of private savings towards the public sector could crowd out private investment, and the creation of captive domestic markets for government bonds implies a misallocation of international capital. Moreover, monetary financing and lasting episodes of repressed negative real interest rates sow the seeds of future inflation and asset price bubbles.
The corresponding below-market real returns on bank deposits and bond holdings imply a mostly hidden redistribution of income from savers and creditors to taxpayers and debtors. In addition, government decisions to expropriate private assets or to restructure public debt involve a potentially disruptive wealth reallocation and hit financial institutions in need of savings and as large owners of government bonds. Also, persistently low interest rates or a treasury claim on pension reserves could lead to underfunded pension systems, affecting the income and wealth distribution between generations. Altogether, financial repression undermines incentives to save and invest, or stimulates savers and investors to escape to the unregulated shadow financial sector or offshore. Furthermore, the prospect of moral hazard on the part of sovereigns should be considered, as privileged funding of the government reduces its incentives to undertake fundamental reforms. The longer-term impact of such harmful financial repression on output growth is therefore likely to be negative.

Taking a broader view, assessing the costs and benefits of financial repression requires a balanced approach. This is warranted, because the distinction between beneficial and harmful market curbs is not always clearcut. For example, some less benign forms of repression may still be preferable over inaction in times of strong market volatility, as long as they succeed in restoring stability and the interventions remain transitory. Furthermore, even well intentioned repressive measures undertaken for public policy purposes may have unintended side effects and demand offsetting coercive action, for example, to counter undesirable consequences for asset prices or the income distribution. This could still be justified, as long as the overall balance of financial repression remains positive for society.

3. Market freedom and central bank independence: turning back the clock?

History offers many examples of how governments in advanced economies applied the above forms of quasi-fiscal financial repression for their own benefit. Reinhart and Sbrancia (2011) offer an extensive survey of the efforts to control sovereign interest rates and/or direct lending to the government between 1945 and 1980. These measures were initially motivated by the desire to facilitate the repayment of massive amounts of public debt incurred during World War II and to finance war reparations. After the War many governments continued to use subservient central banks to administer direct controls over the financial industry and to manage financial markets (Goodhart, 2010). They also kept interest rates low to limit sovereign borrowing costs and support investment by public corporations. In addition, governments used central banks to apply quantitative bank lending controls to steer credit
supply as part of industrial policies designed to promote strategic sectors and favoured companies (Wyplosz, 2001). Hence, many advanced economies resorted to a “financial repression tax” (reflected in suppressed real interest rates) in order to cut back their mountains of public debt. As this tax was imposed on savers in a relatively stealthy way, it avoided difficult political discussions over how to cut budget deficits and distribute the burden between taxpayers and savers. This repression of savers was also made easy due to the tight bank regulation in place.

Furthermore, capital account and foreign exchange controls were used to manage international capital movements. While initially relaxed after World War II, they gained traction again after the mid-1960s in order to maintain the pegged but adjustable Bretton Woods exchange rate system. The collapse of the Bretton Woods system in 1971 then led to a further intensification of capital and currency controls. Apart from stabilising the exchange rate, these restrictions sought to shield domestic economies and provide room for manoeuvre to pursue autonomous monetary, fiscal and industrial policy objectives and, sometimes, to delay necessary policy adjustments (Bakker and Chapple, 2002; Battilossi, 2003).

Among others, McKinnon (1973) and Shaw (1973) promoted the neoclassical view that financial markets and institutions should be relieved from the shackles put in place by governments, central banks and supervisors, arguing that financial liberalisation would support financial intermediation, savings and investment, and thus promote economic development. The efficient markets hypothesis gained ground and, from the 1980s onwards, the authorities in advanced economies largely relinquished their control over financial markets and the central bank. Financial markets were widely liberalised, international capital controls were progressively lifted and central banks gained legal independence in the conduct of monetary policy. This required governments to pursue credible stability-oriented economic policies in order to convince the markets of their creditworthiness and to establish their securities as safe assets.

Even though the principles of free markets and central bank independence are firmly established nowadays, these characteristic features of advanced economies could come under threat in the wake of the financial crisis. For many politicians, a return to financial repression looks attractive again today as a way to ensure more stable and sustainable market outcomes. There are two key reasons why they may want to turn back the clock and resort to such a strategy.
First, many observers have blamed a mix of excessive speculation, light-touch regulation and lax supervision for causing the financial crisis. The private sector in many countries was able to accumulate an unsustainable amount of debt. The “too-big-to-fail” systemic banks faced a funding squeeze and either relied heavily on central bank liquidity or succeeded in passing their rescue bill on to taxpayers. To secure financial stability in the future, authorities in advanced economies are therefore tightening market regulations while also stepping up the supervision of financial institutions and putting in place effective bank resolution regimes (see European Commission, 2010). They find some support in empirical studies that qualify or question the neoclassical hypothesis that has prevailed since the mid-1970s, which states that open markets are always efficient and liquid and that financial liberalisation is good for growth. For example, while acknowledging that financial deregulation works as an engine for growth, Arcand et al. (2012) and Cecchetti and Kharroubi (2012) conclude that, beyond a certain point, a fast-growing financial sector will turn into a drag on the economy.

Moreover, the financial crisis developed into a sovereign debt crisis that, for several euro area countries, was accompanied by extreme market volatility, high bond yields, capital flight and fears of a break-up of the euro. The affected fiscal authorities perceived this market behaviour as an excessive response to their deteriorating budgetary situation that reflected irrational fears and unduly constrained their room for policy manoeuvre. In other advanced economies, the fiscal legacy of the crisis also weighs heavily and governments are looking for ways to control markets and reduce their debt burden. Against this background, Reinhart and Rogoff (2011) expect that the legacy of high levels of public sector debt will probably lead advanced economies back towards a regulated financial system more akin to the one that existed prior to the market-based reforms of the 1980s. Going even further, Aloy et al. (2012) find that a continuation of financial repression (in France) after the mid-1980s would have supported output growth and thereby fiscal sustainability.

A second signal that politicians could be looking to turn back the clock is that fiscal authorities are expecting their central bank to resolve the financial crisis and its adverse consequences for financial institutions, the government and the economy. Most central bank mandates include at least a shared responsibility for safeguarding financial stability, in addition to their core task of maintaining price stability (which in a few cases extends to broader economic objectives). Given the central bank’s control over monetary and financial conditions and its “deep pockets” for crisis management, it is well placed to carry out its
traditional roles of lender of last resort for banks in need of liquidity and as market maker of last resort for dysfunctional securities markets.

Governments under fiscal stress may also have a third central bank objective in mind, namely the task of supporting the state’s financing needs in times of crisis (Goodhart, 2010). This applies in particular if a government comes to the brink of default, public sector bonds lose their attractiveness as safe assets and an expansionary fiscal policy faces severe constraints (Goodhart, 2012; Turner, 2013). In such circumstances, the fiscal authorities may lure the central bank into actions that are aimed at easing the public sector’s funding strains or, more generally, at protecting governments from market pressure. For example, the central bank may be asked to guarantee that government bonds always remain safe assets by providing a credible monetary backstop against the risk of an uncontrollable sovereign default (Gourinchas and Jeanne, 2012). This would secure the supply of safe public sector assets at critical times, keep securities markets liquid and thereby support financial stability. Given the limited room for fiscal manoeuvre, the central bank could also face political demands to stimulate the economy by pegging official interest rates at a very low level and making large purchases of public and private debt to suppress market interest rates. Where there is a high risk of deflation and a liquidity trap reduces the effectiveness of monetary policy, the central bank may also be called upon to cooperate with its highly indebted government and to finance a fiscal stimulus by printing money or overt monetary financing (McCulley and Pozsar, 2012; Turner, 2013). Such central bank financing of a fiscal expansion would circumvent the missing demand for credit from an over-indebted private sector that is forced to deleverage its balance sheet. In addition, the central bank may be urged to engineer a lower exchange rate and higher net exports, which would offer an external source of output growth during a balance sheet recession. Or it could face the demand to accommodate permanently higher inflation or nominal GDP growth to facilitate deleveraging.

The above discussion suggests that, during times of crisis, the central bank may be confronted with substantial political pressure. Even when the central bank is legally independent from political interference, it will be expected to intervene on an unlimited scale while paying less attention to its core task of securing price stability (Hannoun, 2012). The question is how long the central bank can sustain very low official interest rates and an active expansion of its balance sheet, as its actions can only buy time but not be a substitute for structural adjustments. The longer its exceptional measures remain in place, the greater the risk that
they cause unintended side effects which destabilise the economy. Moreover, being seen as giving in to political pressure undermines the central bank’s credibility and, hence, its ability to anchor inflation expectations. This also unavoidably creates moral hazard, whereby in future cases governments will again rely on monetary policy to save the day. At the same time, crisis-related interventions may be required for monetary stability purposes, since a distressed sovereign and a weak banking system that are stuck in a negative feedback loop can disrupt financial markets, trigger disorderly deleveraging and hamper the transmission and effectiveness of monetary policy. The central bank thus faces a balancing act between the need to ensure financial stability without creating perverse incentives, and the need to guard against the risks to price stability (see Cour-Thimann and Winkler, 2012; Caruana, 2013).

4. Financial repression to ease fiscal stress: a realistic option in the eurozone?

*A priori*, the revival of financial repression to ease fiscal stress faces a number of legal constraints in the euro area (van Riet, 2013). The Treaty on the Functioning of the European Union (EU) (henceforth: EU Treaty) requires the Member States and the EU as a whole to act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources. This protects the free flow of capital and limits the scope for creating low-interest rate havens (Lane, 2012). Furthermore, financial institutions are not allowed to give the public sector privileged access to their funds, which in principle prevents governments from creating a captive investor base. The ECB’s legal independence in the conduct of monetary policy and its statutory focus on price stability secures the ban on monetary financing of governments. Hence, the ECB cannot accept political instructions to peg interest rates at an artificially low level to ensure cheap government funding or to finance governments by printing money. Moreover, the “no bailout” rule forbids EU countries from taking over each other’s liabilities.

All these legal constraints ensure that EU governments are subjected to market discipline and cannot fund their debt independently from the capital market. Since unconstrained access to a large capital market facilitates the financing of budget imbalances, the EU legal framework also sets rules for national fiscal policies in order to ensure sound and sustainable public finances. These fiscal rules require Member States to prevent excessive deficits that might otherwise make financial repression an attractive policy option. Governments are thus well-advised to build confidence in their stability-oriented economic policies. This should enable them to get access to savings at affordable, market-determined (real) interest rates.
Given these legal constraints, how could politicians turn back the clock and revive financial repression to relieve fiscal strain in Europe? The answer is that this policy option is not excluded, especially in times of fiscal stress and volatile financial markets. When adopting the euro, the participating countries largely kept their national sovereignty over fiscal and financial matters. This gives governments and regulatory bodies room for policy manoeuvre within the margins of common rules and procedures to introduce national coercive measures. Moreover, EU law permits, within certain limits, taking measures at the European level to support the proper functioning of markets, the soundness of financial institutions and the stability of the euro. However, such interventions may also distort incentives and undermine the ability of financial markets to exercise discipline over fiscal authorities.

Graph 2 – Gross government debt of euro area countries
(percentage of GDP)

Source: European Commission’s spring 2013 economic forecast.
Note: Euro area countries are shown using their country code. EA stands for euro area average.

Since the financial crisis broke out, public debt-to-GDP ratios have steadily increased for most euro area members, reaching values far above prudent levels (Graph 2; see also van Riet, ed., 2010). Growing market concerns about the sustainability of public finances have, for several countries, led to a rapid increase in their bond yields as default risk premia were adjusted upwards, in combination with declining sovereign credit ratings and cross-border contagion effects (von Hagen et al., 2011; De Santis, 2012). Highly indebted countries with a
weak economy and a fragile banking sector became especially vulnerable to sudden shifts in market sentiment. As witnessed since the start of the sovereign debt crisis in late 2009, even a small deterioration in their fiscal, financial or macroeconomic fundamentals contributed to market volatility and tighter funding conditions as investors reassessed their creditworthiness. This gave these vulnerable countries a strong incentive to employ age-old financial repression tactics that would suppress this fierce market pressure and allow them more time to restore public debt sustainability.

The euro area sovereign debt crisis also had systemic consequences. The close correlation between government bond yields that had characterised the euro area since the start of the single currency gave way to wide divergences in interest rates from late 2009 (Graph 3). According to De Grauwe and Ji (2012), the unsustainable high bond yields of Greece, Ireland, Portugal, Spain and Italy represented, to a significant degree, a mispricing of sovereign risk. Even if these countries were, in principle, solvent, the fear of uncontrollable debt dynamics made in particular investors from abroad “run for the exit” (Lane, 2012, p.60). The increasingly restricted government access to market funding at ever-higher interest rates, in turn, made a sovereign default ever-more likely. Apart from country-specific risk factors, the “flight-to-safety” also reflected investors’ awareness that euro area countries which, as members of EMU, can no longer issue debt in their own national currency, have no monetary autonomy to deal with episodes of severe fiscal stress. Without an effective backstop or fiscal risk-sharing mechanism at the euro area level, market panic could easily feed expectations of a self-fulfilling sovereign default (Kopf, 2011; De Grauwe, 2012). This apparent systemic fragility of the eurozone called the continued existence of the euro into question, leading to currency conversion risk premia appearing in sovereign bond yields (Battistini et al., 2013).

As a consequence, crisis-affected countries faced capital flight, a liquidity squeeze and very high nominal and real funding costs, reflecting the deep risk aversion of markets. By contrast, the strongest countries in the euro area enjoyed massive net capital inflows, leading to very low or even negative interest rates during the crisis. This gave their governments the opportunity to fund themselves at exceptionally low cost. However, the disintegration of euro area financial markets accompanying these capital flows hampered the singleness of monetary policy and challenged the ability of the ECB to maintain price stability throughout the euro area (ECB, 2012, 2013).
At the European level, the financial and sovereign debt crisis spurred new initiatives aimed at strengthening the resilience of the financial sector, protecting taxpayers from having to pay the bill of resolving failing banks, ringfencing governments against undue market pressure and ensuring the singleness of monetary policy in the euro area. The adverse interaction between an undercapitalised banking sector and highly indebted governments unable to keep their banks afloat, fragmented euro area money and capital markets that hindered the transmission of monetary policy, and market fears of an involuntary dissolution of EMU, had to be addressed in a decisive manner. The new institutions and instruments (being) created, in essence as a means to reinforce the architecture of EMU (Mongelli and van Riet, 2013), also opened the door to stabilising financial market interventions at the euro area level. Many of the interventions are well intentioned and in the public interest. However, some may overshoot and create unwarranted privileges for governments.

**Graph 3 – Government bond yields of euro area countries**
(10-year maturity, weekly averages from January 1992 to May 2013, percentages)

Sources: Thomson Reuters and ECB.
Notes: The yields for Cyprus, Estonia, Luxembourg, Malta and Slovenia are excluded owing to infrequent or a lack of observations. The chart is truncated at 25% in order to be able to show the peak of the Greek government bond yield of almost 50% on 8 March 2012.
5. Evidence of quasi-fiscal forms of financial repression in the eurozone

Since the start of the sovereign debt crisis, several euro area countries have used a number of financial repression techniques to directly ease their budget constraints and relieve the market pressure (see also Reinhart, 2012). Their objective was to fill budget holes, prevent expensive new bank rescues with public funds, or simply to direct domestic lenders towards their government securities. A selection of cases is presented below.

The banking sector in most of the vulnerable countries has recently increased the “home bias” in its sovereign exposure (see also Graph 4). This initially reflected an opportunistic portfolio reallocation towards the more risky but higher yielding bonds of their own country (Battistini et al., 2013; Acharya and Steffen, 2013). For a short period until end-2010 this appeared to be an attractive strategy for banks (including for those located in the stronger countries) given the regulatory risk weight of zero applied to government bond holdings and the low cost of short-term funding. After this “carry trade” had backfired, and the European Banking Authority had introduced a haircut on risky government bonds in its stress testing of large banks, crisis-affected countries had to look for alternative ways to secure their financing needs. From late 2011 to early 2012 many banks became reportedly subject to moral suasion by their stressed government to take advantage of the ECB’s exceptional offer of cheap liquidity for three years and to park these funds in sovereign debt (Buiter and Rahbari, 2012).

Furthermore, Spain temporarily put in place an interest rate ceiling on bank deposits. While the aim of the rate cap was to defuse a damaging price war between banks desperately looking for funds, the regulation could also be expected to induce savers to hold government bonds instead. Cyprus came close to imposing a one-off levy on all bank deposits, before deciding to resolve and restructure the two largest banks in distress by bailing in their shareholders, unsecured creditors and uninsured depositors. The fear among deposit holders that their money might no longer be safe, however, also necessitated the Cypriot authorities to place temporary restrictions on bank transactions, deposit withdrawals and capital outflows.2

2 According to an assessment by the European Commission, the restrictions on the free movement of capital in Cyprus were permitted under the EU Treaty, because they constituted a matter of overriding public interest and were time-bound, non-discriminatory, suitable and proportionate.
Moreover, cross-border banking in the euro area was, at least temporarily, affected by repressive prudential measures. Several national supervisors in the stronger euro area countries urged the banks in their jurisdiction to limit their exposure to troubled euro area members and a potential break-up of the euro. Also, regulators in distressed countries encouraged the banks under their supervision to repatriate funds held in foreign subsidiaries or branches, which triggered reactions from the authorities of the affected host countries seeking to preserve these funds and to secure the availability of local bank credit. Taken on its own, this promotion of a “home bias” was justified for prudential reasons. However, it may also be interpreted as creating disguised capital
restrictions inside eurozone in order to support a captive domestic investor base for governments. This prudential repression further tightened the financial nexus between sovereigns and banks; if maintained beyond the crisis episode, it will hamper the efficient allocation of capital across EMU. The envisaged establishment of a banking union in Europe should break this close embrace, provided that it enables the resolution of unviable systemic banks without stretching the fiscal capacity of their country of residence.

Pension funds were also confronted with financial repression to help out the public sector, as in several euro area countries they were nudged into investing more at home, for example in domestic government bonds, infrastructure or the housing market. As a case in point, regulatory changes in Ireland allowed occupational pension funds (with their support) to purchase the high-yielding sovereign annuities that the government started to issue. Private pension funds in Ireland also faced a levy to finance job creation schemes. France changed the liquidation process of a pension reserve fund to help pay off social security debt. Going even further, accumulated pension reserves were transferred to the government budget (Portugal), used to fund gaps in the pay-as-you-go social security system (Portugal, Spain), or diverted to recapitalise troubled banks (Ireland).

Altogether, several euro area governments were able to secure sometimes considerable short-term benefits from the various forms of financial repression, as a complement to other debt stabilisation policies. This was apparently vital for them in times of volatile bond markets and funding stress, and even more so when they had lost market access. Greece (in February 2012) and Cyprus (in June 2013) even decided to default and resolve a public debt overhang by imposing a ‘voluntary’ debt restructuring upon private creditors in the form of a haircut and/or debt maturity extension. Over the longer term, savers and investors are likely to hedge against such government practices, both by reducing their participation in regular sovereign debt auctions and/or demanding a higher risk premium. In addition, they may decide to move into the shadow economy or move abroad for market-based higher returns. This could require governments to intervene even more forcefully in order to maintain captive markets and affordable interest rates.

Additionally, some of the recent changes in European legislation appear to establish unwarranted privileges for governments, or at least to move in that direction. This is particularly the case where they enable governments to circumvent the disciplinary force of the capital market. Table 1 highlights five cases with quasi-fiscal characteristics.
<table>
<thead>
<tr>
<th>European legislative measures/proposals</th>
<th>Privileged treatment of governments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Common financial transaction tax (to be introduced by 11 euro area countries in 2014)</td>
<td>A possible exemption or lower tax rate for trade in government securities would create a cost advantage over transactions in private financial instruments</td>
</tr>
<tr>
<td>2. New EU bank regulation tightens capital requirements and introduces new liquidity rules based on the Basel III standards (to be phased in from January 2014)</td>
<td>Central government securities are deemed to be zero-risk, high-quality and liquid assets, which supports the banking sector’s demand for sovereign bonds</td>
</tr>
<tr>
<td>3a. New EU restrictions on credit rating agencies (to enter into force in 2nd half of 2013)</td>
<td>Places time and scrutiny restrictions on issuing sovereign ratings and rating outlooks</td>
</tr>
<tr>
<td>3b. New EU restrictions on uncovered short selling and ban on uncovered sovereign credit default swaps (in force since November 2012)</td>
<td>Pushes the more speculative traders out of the market and curbs market pressure on governments</td>
</tr>
<tr>
<td>4a. Capital export restrictions against tax evasion in euro area countries under financial strain (rejected European Parliament proposal of June 2012)</td>
<td>Creates a captive domestic investor base</td>
</tr>
<tr>
<td>4b. National protective measures against market turmoil in euro area countries under financial strain (accepted European Parliament proposal of June 2012, entered into force on 30 May 2013)</td>
<td>Promotes a captive domestic investor base</td>
</tr>
<tr>
<td>5. New permanent euro area rescue fund: European Stability Mechanism (operational since October 2012) could give support for access to government bond markets</td>
<td>Might be used to suppress unsustainable secondary market yields below their “fair value”; policy conditions may be less strict or less effective than warranted</td>
</tr>
</tbody>
</table>

Source: van Riet (2013).

First, following a proposal from the European Commission (2013), 11 euro area countries (including Belgium, Germany, Estonia, Greece, Spain, France, Italy, Austria, Portugal, Slovenia and Slovakia) plan to introduce in 2014 a common financial transaction tax under the so-called “enhanced cooperation procedure”. This would be comparable to imposing a “Tobin tax” on speculative foreign exchange flows. The main objectives of the financial transaction tax are to curb destabilising short-term speculative trading in secondary markets for shares, bonds and derivatives and to ensure that the financial industry makes a fair contribution to tax revenues and the fiscal costs of the crisis. Harmonising the basic features
of the tax across the participating countries should help to avoid tax evasion and tax arbitrage, as well as double or non-taxation of certain trades, as much as possible. Assuming that the financial transaction tax will be effective in meeting its stated public policy goals, it could be regarded as a legitimate market intervention. However, some participating euro area countries have indicated that they would like to exclude transactions in government securities from the scope of the tax. The European Parliament favoured to limit the tax rate on government bond transactions to only half of the standard rate until 1 January 2017, and to apply that reduced tax rate also temporarily to all financial trades by pension funds, which typically invest a large part of their reserves in government paper. This would create an arbitrary cost advantage for secondary market purchases of public sector debt compared with alternative financial instruments and is a typical example of financial repression to favour governments.

Second, the EU Treaty explicitly allows governments to have privileged access to financial institutions based on prudential considerations. This privilege has already been in force for many years in EU banking regulation (Kopf, 2011), which in many respects considers government securities as safe assets by definition. The transposition of the new Basel III standards into EU banking law gives national regulatory authorities, as before, the discretion to apply a zero-risk weight to banks’ exposure to EU central government bonds denominated and funded in domestic currency. This implies that capital adequacy rules continue to be misaligned with market-based sovereign credit risk. Moreover, marketable securities backed by governments are always deemed to be of high quality and liquid, irrespective of the actual market situation, and thus count in full towards meeting the new liquidity requirement for banks. Hence, government securities receive preferential treatment over private debt, encouraging banks to hold relatively more sovereign debt, including more risky but higher yielding bonds. The financial connection between governments and domestic banks will therefore be even closer than it is currently, thereby increasing systemic risks, especially in the event of new financial and fiscal crises in Europe. EU banking law, in this respect, relies heavily on the controls to be put in place to address concentration risks arising from high public sector exposures. While tighter prudential regulation in Europe is in the public interest,

---

3 The EU supervisory rules for the capital adequacy of insurance funds (Solvency I and II) entail a similar preferential treatment of sovereign bonds. This government privilege was to be extended to proposed new capital requirements for pension funds as part of a revision of the Institutions for Occupational Retirement Provision (IORP) Directive, which already allows Member States to put aside diversification requirements for investments in government bonds. However, the plan to require pension funds to hold more capital was shelved.
the new rules also contain repressive elements that work towards easing government funding constraints.

Third, European financial sector legislation has been tightened in several other areas, also to the benefit of stressed governments. Although the purpose of the two EU regulations discussed below is to enhance market stability in the public interest, they also show attempts to “shoot the messenger” so that the voice of concern about fiscal developments is no longer heard.

Credit rating agencies have come under strong criticism for downgrading governments, even after they had just committed to serious policy adjustments which should improve their fundamental outlook. Following stricter supervision and authorisation requirements, further EU legislation will make credit rating agencies subject to civil liability for damages caused intentionally or due to gross negligence, set a fixed calendar for issuing sovereign ratings and rating outlooks and enhance the transparency of the assumptions on which they are based. Governments will also be given more time to react to a change in their credit rating before this is made public, so that they can verify the underlying data. It was also suggested that sovereign ratings could be suspended in exceptional circumstances to prevent market instability. This repressive action was, however, not considered realistic and hence rejected.

As another case in point, a new EU regulation harmonised with effect from 1 November 2012 the rules for short selling and certain aspects of credit default swaps. The common regulatory framework, among other things, restricts the uncovered short selling of shares and debt instruments and prohibits uncovered sovereign credit default swap positions in view of their speculative nature. A safeguard clause allows the competent authorities to suspend the regulation temporarily if the restrictions on sovereign credit default swaps are found to lead to a significant decline in the liquidity of the sovereign debt market. Market-makers and primary dealers are exempted from the new requirements. Already in the run-up to the date of introduction of the new EU regulation, the unwinding of short-selling positions reportedly contributed to a decline in government bond yields. Similarly, the phasing out of all uncovered positions in European sovereign credit default swaps coincided with a decline in spreads and reduced market liquidity, although other factors may also have played a role (IMF, 2013). As a result, more speculative traders are likely to turn to unrestricted proxy markets to place their bets on European sovereigns.
Fourth, financial repression could take the form of financial protectionism benefiting governments under strain. For example, EU law allows for capital controls for narrowly defined public policy purposes or as a safeguard in exceptional circumstances when the proper functioning of EMU is under threat. This exception was invoked by the European Parliament (2012) during the debate on a new EU regulation on enhanced surveillance of euro area countries facing financial stability risks, which entered into force on 30 May 2013. Their proposal was to authorise distressed euro area countries to introduce restrictions on capital movements to support their fight against tax evasion. However, this would entail an infringement of the free movement of capital, which would hardly qualify as a defendable exception to the rule. While it was agreed that countries must take measures to safeguard tax revenues, the suggestion to restrict capital outflows for this purpose was therefore rejected.

The European Parliament also argued that a government under financial stress could take all necessary measures to encourage private investors to maintain their overall exposure on a voluntary basis. In addition, it proposed to allow the countries concerned to initiate measures aimed at stabilising markets and preserving the good functioning of their financial sector. As these proposals were adopted, the new EU regulation could in principle legitimise national regulatory actions and moral suasion in support of government debt financing.

Fifth, a small adjustment was made to the EU Treaty to allow euro area countries to establish a permanent euro area stability mechanism to safeguard the stability of the euro area as a whole. Any financial assistance to be granted was made subject to strict conditionality. This new provision was used to create the European Stability Mechanism (ESM) as a fiscal backstop for solvent euro area members facing financial strain, assuming the tasks of the temporary European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). The lending capacity of the ESM amounts to €500 billion and can be used to provide conditional financial assistance to distressed member countries.

The ESM can also support euro area countries in maintaining or restoring access to primary or secondary government bond markets (using the ECB as its operational agent). The interventions in the primary market will, as a rule, be conducted at the market price and complement the participation of private investors in government bond issues up to a maximum of 50%. This appropriately preserves market discipline. The conditional ESM purchases in the secondary market are intended to address exceptional circumstances when the lack of liquidity could push sovereign bond yields to unsustainable levels and threaten
financial stability. Activation depends on an ECB assessment of whether there are indeed exceptional market circumstances that constitute a risk to financial stability. However, this does not fully exclude the possibility that the ESM might use its secondary market interventions to suppress unsustainable yields below their “fair value” and to constrain market discipline on sovereigns. In addition, the policy conditions accompanying ESM support could be less strict than warranted and actual compliance could be weaker than envisaged (Buiter and Rahbari, 2012).

Overall, the European legislative measures to correct market failures and improper incentives in the financial industry are taken in the public interest. However, some of the interventions also appear to benefit public finances in the sense that they unduly curtail the market pressure on sovereigns and privilege governments, in particular in times of fiscal stress. This could create moral hazard and undermine incentives to implement reforms. The fiscal authorities are likely to become complacent when knowing that they are shielded from market-induced discipline in the case of unsound national policies. Even the conditionality attached to the market access support of the ESM may turn out to be less strict or less effective than is required to offset the negative incentives for governments to undertake unavoidable structural adjustments.

6. Financial repression associated with the European Central Bank?

Some observers have argued that the ECB’s monetary policy actions to support financial stability and preserve the euro have also created privileges for vulnerable governments and weak banks (see, for example, Buiter and Rahbari, 2012; Eijffinger and Hoogduin, 2012). The ECB indeed faced challenging times in the independent conduct of monetary policy. The scope of its actions from mid-2007 to mid-2013 could only be justified by the threats to price stability stemming from the exceptional nature of the EMU crisis and its intensification over time. Five main episodes may be distinguished, corresponding to the nature of the crisis the ECB was confronted with (for more details see Drudi et al., 2012; Cour-Thimann and Winkler, 2012).

During the first phase, the Eurosystem had to address the impact of the financial turmoil which started in August 2007 and then turned into a financial crisis in September 2008 with the collapse of Lehman Brothers. Right from the start it took decisive action to contain the risks to credit supply when banks – which account for some 80% of financial intermediation in the euro area – faced great uncertainty over their access to money-market funding. From
early October 2008 onwards the ECB swiftly reduced its key interest rates to an exceptionally low level, at or close to the zero lower bound (Graph 5). In addition, the Eurosystem applied a range of non-standard monetary policy tools as lender of last resort for liquidity-constrained banks and as market-maker of last resort to address dysfunctional financial markets (see Eser et al., 2012). This included conducting refinancing operations as fixed rate tenders with full allotment, the provision of liquidity at longer maturities as well as in foreign currencies, a relaxation of requirements for eligible collateral, the acceptance of a wider range of financial instruments as collateral, and two covered bond purchase programmes.

**Graph 5 – ECB key interest rates and the euro overnight interest rate (EONIA)**
(daily data from January 2007 to May 2013, percentages per annum)

![Graph showing ECB key interest rates and the euro overnight interest rate](image)

Source: ECB.

The second stage of the crisis started in May 2010 when, after months of increasing market tension, the Greek government had to call on other euro area countries and the International Monetary Fund (IMF) for financial assistance. This triggered significant negative contagion effects leading to a seizing up of sovereign bond markets in vulnerable countries with an additional adverse impact on financing conditions for banks, corporates and households (ECB, 2010). As the growing fragmentation of financial markets in EMU impaired the monetary transmission mechanism, the Eurosystem undertook temporary and limited interventions in the affected secondary markets for medium- to long-term government bonds under its Securities Markets Programme (SMP). This instrument was applied when needed between May 2010 and March 2012 and helped to stabilise and reduce sovereign bond yields of Greece, Portugal, Ireland, Spain and Italy, albeit usually only for a short period. The
government bonds purchased are held until they mature and their impact on liquidity is fully sterilised. The ECB thereby took note of the commitments taken by the countries concerned to accelerate fiscal consolidation, implement structural reforms and ensure the sustainability of their public finances. This allowed the ECB to relax the minimum sovereign credit rating requirement, thereby enabling the banks in these countries to continue pledging the marketable debt securities issued or guaranteed by their respective governments as collateral in the Eurosystem’s refinancing operations.4

In the third episode of the crisis, from the summer of 2011 onwards, the negative feedback loop between distressed governments and fragile domestic banks intensified. After cutting its interest rates again, the ECB responded in December 2011 by offering two longer-term refinancing operations with an extended maturity of three years and the possibility of repayment after one year. At the same time, a wider range of collateral eligible for use in the Eurosystem’s refinancing operations was accepted, this time also including bank loans. A reduction in the banks’ required reserve ratio, from 2% to 1%, also released collateral. Taken together, these measures gave credit institutions the opportunity to secure a substantial amount of their liquidity needs over the medium term. This, in turn, enabled them to sustain their credit lines while being able to repay bank bonds that were falling due.

As mentioned in Section 5, in some countries the recipient banks parked a considerable part of this liquidity in sovereign bonds which, subsequently, could be used for collateral purposes. Although the collateral accepted by the Eurosystem included marketable securities and bank loans from countries receiving EU/IMF financial assistance, stronger risk provisions and substantial haircuts kept the attendant credit risks within prudent limits. At the same time, troubled banks which had no eligible collateral and/or did not meet minimum capital requirements, especially in distressed countries, had no access to Eurosystem funds. They could only resort to emergency liquidity assistance from their national central bank, the repayment of which was secured by government guarantees in view of the exceptional risks involved. This non-standard liquidity provision was only a temporary solution, awaiting the recapitalisation of these troubled banks.

4 The ECB temporarily suspended the collateral eligibility of marketable debt instruments issued or guaranteed by Greece and Cyprus at the time when credit rating agencies judged these countries to be in default.
As a result of these extensive monetary policy interventions, the Eurosystem’s balance sheet almost tripled in size from the start of 2007 to mid-2012 (Graph 6). This reflected the role of the ECB as a trustworthy intermediary in a segmented money market and as a reliable counterparty in distorted securities markets. This way, the ECB countered the threat of a credit crunch and a major economic slowdown with downward risks to price stability.

During the fourth period of the crisis, from spring 2012 onwards, the tensions in sovereign bond markets intensified again and, in order to calm the markets, in July 2012 the ECB expressed its willingness “to do whatever it takes to preserve the euro”, within its mandate (Draghi, 2012). To make this commitment concrete, in September 2012 the ECB announced that it stood ready to undertake unlimited Outright Monetary Transactions (OMTs) in secondary government bond markets, focused on shorter maturities, whereby the liquidity injected will be fully sterilised. The ECB made clear that it will consider OMTs only if they are warranted to safeguard a homogeneous transmission of monetary policy and to address the severe distortions in sovereign bond yields originating from market fears of an involuntary break-up of the euro (ECB, 2012). The use of this monetary backstop is also conditional on the strict and effective compliance with a full macroeconomic adjustment programme that comes with the activation of EFSF/ESM lending, or with the enhanced policy conditions of a precautionary credit line from the EFSF/ESM. The agreed support must include the possibility of primary market purchases of sovereign debt by the EFSF/ESM. The involvement of the IMF will be sought for the design and monitoring of the country-specific conditionality.

With the commitment to undertake OMTs it established a credible monetary backstop for malfunctioning sovereign bond markets that were impairing the monetary transmission mechanism. Following the announcement of OMTs as a new instrument in the ECB’s toolbox, government bond yields in troubled euro area countries declined significantly (Graph 3). Markets evidently expected that stressed governments will apply for EFSF/ESM support and accept its policy conditions and that, in turn, the ECB will intervene in their secondary bond markets if warranted to safeguard the monetary cohesion of the euro area. The mere existence of OMTs thus had a self-fulfilling downward effect on government bond yields, offsetting the previous default expectations in the interest rates of distressed countries which could have become self-fulfilling and represented a potentially catastrophic “tail risk” for the euro area (Draghi, 2013). This market stabilisation furthermore reflected progress
made by many euro area countries to place their economies on sounder footings. A key factor was also the decision taken at the June 2012 summit of euro area leaders to break the negative feedback loop between sovereigns and banks in their jurisdiction. This was to be achieved by the establishment of a Single Supervisory Mechanism at the ECB, as a first step towards a banking union, after which the ESM could also be allowed to recapitalise troubled banks directly subject to appropriate conditionality.

**Graph 6 – Assets on the Eurosystem’s balance sheet**  
(weekly data from January 2007 to May 2013, EUR billion)

This calming down of financial markets, from the autumn of 2012 onwards, characterised the fifth episode of the crisis. Confidence among euro area investors gradually returned and they began to increase their exposure to the vulnerable euro area countries again, while many companies took the opportunity to issue bonds in these more favourable market conditions. To also foster the availability of credit for small and medium-sized enterprises the ECB started in spring 2013 consultations with the European Investment Bank on how to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations. The easier funding conditions also enabled banks to start repaying, from early 2013 onwards, the loans they had acquired a year earlier from the Eurosystem as part of the two longer-term refinancing operations with a three-year maturity. As the fragmentation in financial markets subsided, while still remaining high in some segments (ECB, 2013), the size of the Eurosystem’s balance sheet began to shrink again (Graph 6). At the same time, the ECB clarified that it would maintain its accommodative monetary stance for as long as
necessary. This was underpinned in July 2013 by the forward guidance that it expected its key interest rates to remain low for an extended period of time, as long as the inflation outlook would stay subdued over the medium term.

The scope of these monetary policy actions triggered intense debate inside the Governing Council of the ECB and, as regards the OMT, even before the German Federal Constitutional Court, on what was necessary and legitimate to address the EMU crisis without engaging in monetary financing of governments. As pointed out by Yiagou et al. (2013, p.229), politicians exercised pressure on the ECB to provide vulnerable governments with sufficient liquidity and stabilise sovereign bond markets. Eijffinger and Hoogduin (2012, p.35) argue in this respect that “the ECB became hostage to governments that counted on it to intervene in markets when pressures mounted due to a lack of action on their part”. According to Buiter and Rahbari (2012, p.7) the ECB was forced to assume this quasi-fiscal role because of the reluctance of the eurozone political leadership to establish the European institutions with full fiscal backing for dealing with distressed sovereigns and banks.

This discussion shows the complex political and institutional environment in which the ECB had to operate as the single monetary authority vis-à-vis 17 euro area member countries and the only eurozone institution capable of averting destructive scenarios. This made it necessary for the ECB to counter perceptions that it was acting under pressure of the public authorities and to push for deeper euro area integration as the appropriate response to the EMU crisis that also threatened its independence (Yiangou et al. 2013). The central bank thereby emerged as a strategic political player that focused on the sustainability of EMU as its foremost, albeit implicit, objective (Torres, 2013). In this respect, the ECB emphasised that its interventions were always motivated by monetary policy considerations in conjunction with its additional mandate to contribute to safeguarding financial stability. The unprecedented monetary policy actions were designed to be transitory and phased out semi-automatically as the market stress receded. Hence, they only bought time for both governments and banks under financial strain to undertake the structural adjustments that were necessary to underpin the stability and unity of the eurozone. To set the right incentives for removing the root causes of the EMU crisis, the ECB consistently made three points clear in its communication (Trichet, 2013, p.238): first, the credit institutions had to complete their recapitalisation and balance sheet repair process as quickly as possible; second, the countries concerned had to pursue ambitious fiscal consolidation and economic reforms to restore
confidence in their sovereign signature; and third, European authorities would need to significantly improve EU economic governance and take steps towards strengthening the architecture of EMU.

Graph 7 – Inflation expectations in the euro area
(survey- and market-based measures for January 2004 to May 2013, percentages per annum)

The option to use OMTs was explicitly tied to concurrent policy actions by the beneficiary country, as agreed by the euro area membership, in order to create a fully effective monetary backstop (Cœuré, 2012). Compliance in this regard is assessed independently by the ECB. The focus on just eliminating “tail risks” in malfunctioning secondary government bond markets thereby leaves ample room for market participants to exercise discipline over sovereigns on the basis of genuine credit risks. The ECB also accepted the same (pari passu) treatment as other creditors with respect to its government bond purchases under the OMTs, and thus the associated sovereign credit risks – even though it could never accept losses in the event of a public debt restructuring, as this would amount to monetary financing. Furthermore, as part of its accommodative monetary policy, the ECB supported lending to the economy by improving both bank funding and market conditions. At the same time, it
avoided directly allocating credit to politically favoured sectors or small and medium-sized enterprises, since assessing the creditworthiness of borrowers was the task of financial intermediaries.

On balance, the ECB pursued its mandate in an independent manner and with a credible focus on maintaining medium-term price stability, while safeguarding financial stability and the monetary cohesion of the euro area and standing ready “to do whatever it takes to preserve the euro”. Given that euro area inflation expectations remained well anchored, monetary stability continued to prevail in the euro area (Graph 7). This notwithstanding, the ECB will need to continuously guard its political independence and urge euro area governments to address the root causes of the EMU crisis.

7. Low interest rates in the eurozone: evidence of financial repression?

Quite a few observers have pointed to the environment of persistently negative real interest rates as evidence of financial repression, both globally and in the euro area (see, for example, Kirkegaard and Reinhart, 2012; Eijffinger and Mujagic, 2012). However, with regard to the euro area this observation must be qualified. Many factors affect interest rates in the euro area. While financial repression to ease fiscal stress could be among them, its contribution is difficult to detect and isolate.

First, as discussed in Section 6, the ECB’s monetary policy has been exceptionally expansionary during the crisis, both in terms of standard and non-standard instruments. This explains why short-term interest rates have fallen close to the zero bound in the euro area and have been negative in real terms since the onset of the financial crisis, as they have in other major currency areas. Given the ECB’s continued focus on maintaining medium-term price stability, also when it gave forward guidance on its key interest rates, the argument that the conduct of monetary policy deliberately engineers favourable bond market conditions for highly indebted governments is unfounded. As the central bank has no target for the euro exchange rate, and only looks at the impact of changes in the effective exchange rate on the outlook for growth and price stability, its accommodative monetary policy stance can also not be connected with efforts to steer the external value of the currency. At the same time, it is attentive to the possible distortions arising from maintaining negative real interest rates as well as extensive bank and market support over a long horizon. This is apparent from the fact that, in late 2009, the ECB initiated a phasing-out of non-standard measures, although this
action soon had to be reversed as market volatility rose again when the sovereign debt crisis broke out. Moreover, in the light of growing upside risks to price stability, the ECB temporarily raised its key interest rates in April and July 2011 (see Graph 5).

Second, the decline in (real) interest rates signals investor fear rather than financial repression, since it is a natural response to the shrinking global supply of safe assets at a time when the demand for safety increases dramatically (Gourinchas and Jeanne, 2012). This process is also visible within the euro area. While euro area average sovereign bond yields have fallen to a very low level, the spreads of Greece, Ireland, Portugal, Spain and Italy relative to Germany and other stable countries rose to unsustainable levels (Graph 3), throwing these countries into a sovereign debt crisis. Many investors responded by reallocating funds away from distressed countries to safe haven nations, both inside and outside the euro area. They were looking to preserve liquidity and capital in the face of volatile securities markets and elevated credit risk. Moreover, they sought to align assets and liabilities on their balance sheets in preparation for a potential break-up of the euro. Creditors thus willingly accepted a negative real rate of return. Not all these safe haven capital flows were truly voluntary. As noted in Section 5, several national supervisors temporarily promoted a “home bias” in bank exposure. This had the effect of reversing earlier cross-border capital movements and may have contributed to the widening of sovereign bond spreads within the euro area (Battistini et al., 2013).

Third, in the face of a prolonged balance sheet correction in sectors of the economy with high debt-to-income ratios, the growth prospects of many euro area countries are more subdued than in the past. Most governments are on a course of fiscal consolidation, the banking industry is strengthening its buffers in response to tighter capital and liquidity requirements, while in several countries the non-financial private sector is also being forced to repair its balance sheet (Cour-Thimann and Winkler, 2012). This necessary deleveraging process, in combination with the rebalancing of current account positions within the euro area, constrains output growth in the short to medium term. Moreover, population ageing has a dampening impact on long-term productivity growth. As the positive impact of ongoing structural reforms on potential growth takes some time to materialise, the mediocre growth outlook translates into very low nominal long-term interest rates. This fundamental factor has no obvious link to repressive activity favouring the public sector.
Taking these explanatory factors together, very low interest rates in the euro area are in line with the ECB’s exceptional but necessary monetary easing over an extended period of time, the flight to safety in the capital market and the (for the time being) more subdued medium-term growth outlook. By contrast, distressed euro area countries were confronted with rising sovereign bond yields, and their use of repressive measures showed little success if any in reversing that upward trend.

8. Conclusions

The fiscal legacy of the financial crisis that erupted in September 2008 raised serious market concerns about the sustainability of public finances in advanced economies. As a consequence, “policy-makers for some time to come will be preoccupied with debt reduction, debt management, and, in general, efforts to keep debt servicing costs manageable” (Kirkegaard and Reinhart, 2012). They may also attempt to revive two age-old tactics of financial repression: curtailing financial markets and calling on the central bank to ease fiscal stress.

As regards the eurozone, there is ample evidence that financial repression is reappearing and that policy-makers are trying to turn back the clock on the freedom of financial markets as one way to cope with the sovereign debt crisis. The financial turbulence exposed the vulnerability of those member countries which, since opening up their capital markets and joining EMU, had allowed economic imbalances to accumulate to unsustainable levels, throwing them into a sovereign debt and banking crisis. Under rising market pressure, troubled euro area countries pursued debt stabilisation policies in order to regain confidence. At the same time, they applied coercive tools to ensure debt financing and ease their fiscal predicament, while two countries addressed a public debt overhang by imposing a ‘voluntary’ debt restructuring upon private creditors. These repressive measures were deemed necessary to survive the episode of volatile bond markets and funding stress, secure alternative private sources of funding when market access was lost, or to reduce public debt to a sustainable level. Taking a longer term view, savers and investors are likely to hedge against such financial repression tactics. This could require governments to intervene even more forcefully in order to maintain captive markets and affordable interest rates.

By contrast, euro area (and non-euro area) countries perceived as safe havens strongly benefited from a high demand for their bonds and exceptionally low interest rates. Apart from
sound fundamentals, this was mostly a reflection of capital flight, both within the euro area (leading to substantial market fragmentation) as well as away from the euro area (leading to some downward pressure on the euro exchange rate). This reversal of earlier cross-border capital flows was mostly associated with investor fear rather than financial repression designed to ease fiscal stress. However, some national bank regulators temporarily also promoted a “home bias” for prudential reasons; if maintained over time, this would restrain the efficiency of markets in allocating capital across EMU.

The financial crisis and its adverse consequences for governments, banks, economies, and the stability of the euro also led to a range of interventions by European legislators. Apart from addressing excessive market volatility, they reflect the fact that the financial crisis has triggered a reassessment of the economic benefits of a fast-growing financial sector. The initiatives of European policy-makers to correct market failures and improper incentives in the financial industry are well intentioned. From a public finance perspective, however, it will be important to preserve the role of markets as a disciplinary force against unsound national policies in the euro area. Otherwise, the reinforced EU governance framework for economic and fiscal policy surveillance could be overburdened with the task of countering the risk of moral hazard on the part of governments.

In addition, the ECB’s exceptional but necessary monetary easing kept interest rates at bay, consistent with the subdued growth outlook and low underlying price pressures over the medium term. The extraordinary monetary policy interventions, which also supported financial stability and the singleness of the euro area, in practice have also worked to the benefit of governments, both directly and indirectly. This side effect was subject to intense debate, calling into question the necessity and legitimacy of those measures. The ECB indeed had to operate in a complex political and institutional environment. The central bank’s decisions were, nevertheless, taken in accordance with its mandate and designed to preserve its political independence by creating the right incentives for policy-makers to tackle the root causes of the EMU crisis. Because the ECB stayed credible in its focus on maintaining medium-term price stability and euro area inflation expectations remained well anchored, monetary stability continued to prevail in the euro area. At the same time, the ECB will need to continuously counter perceptions that as guardian of the euro it might be forced to follow the political guidance from euro area governments.
References


European Parliament, 2012. Amendments to the Commission proposal for a Regulation of the European Parliament and of the Council on the strengthening of economic and budgetary surveillance of Member States experiencing or threatened with serious difficulties with respect to their financial stability in the euro area. 13 June.


Turner, A., 2013. Debt, money and Mephistopheles; how do we get out of this mess? Lecture at Cass Business School, 6 February.


