Terms You Should Know: Financial Repression and Fiscal Dominance

August 11, 2020

There are two financial terms that explain what is happening right now. Most investors don't know these terms, but they are common knowledge among central bankers.

The Bank of International Settlements, also known as “the central bank for central banks,” has even published white papers discussing them. The terms are “Financial Repression” and “Fiscal Dominance.”

Financial Repression is about what the Federal Reserve is doing now.

Fiscal Dominance, meanwhile, covers the factors that force the Fed to engage in Financial Repression in the first place.

To begin, the term “Financial Repression” was coined by two Stanford economists, Edward Shaw and Ronald McKinnon, in 1973. Back in the early 1970s, Shaw and McKinnon were describing the behavior patterns of dysfunctional emerging markets. They likely had no idea financial repression would one day dominate the West.

Financial repression is a term for policies that create deliberately low interest rates, and, in particular, low nominal rates that fall below the cost of inflation. To put it another way, financial repression is a policy of deliberately making real yields negative. When real yields are negative, meaning the nominal yield is less than the cost of inflation, that state of affairs does multiple things.

First, financial repression incentivizes savers to buy risky assets with their cash. When the value of cash is falling, it makes sense to get rid of cash and buy paper assets (like stocks) instead.

Second, financial repression makes it easier for public and private entities to keep on borrowing money at artificially low rates. In the midst of the pandemic, U.S. corporations have gone on another wild debt bender. Their ability to do this was enabled by financial repression, that is to say, the Fed keeping interest rates low while backstopping credit markets, and even promising to buy corporate debt.

Third — and we have discussed this before — financial repression is a means of inflating away the value of outstanding debt.

When interest rates are below the cost of inflation, and the central bank keeps them there, government debt is gradually losing value in real terms. That is the outcome the central bank wants to generate. A lighter debt load, in real terms, means less of a weight on future growth prospects.

The second term, Fiscal Dominance, describes the backdrop that leads to Financial Repression.

Fiscal dominance occurs when fiscal policy — the borrowing and spending habits of a sovereign government — gets so out of control that fiscal policy "dominates" monetary policy. When this happens, the central bank has to devote its effort to managing the government debt burden, and helping to finance new government purchases, rather than its normal mandate of fighting inflation and keeping prices stable.

Here is the Cato Institute describing how fiscal dominance led to hyperinflation in various Latin American countries:

Most populist experiences in Latin America, including the best-known ones — Peru (1985–90), Argentina (2003–17), and Venezuela (2002–present) — have been characterized by "fiscal dominance." Monetary policy is dominated by fiscal policy, and the central bank finances (very) large increases in public expenditures. The central bank purchases national and subnational debt (municipalities and provinces) and provides loans to state-owned enterprises.

In this way, it finances large transfers to the lower and middle classes, provides funds to huge public investment projects, and helps pay for the nationalization of large firms.

Fiscal dominance has been behind the explosion of inflation in the vast majority of Latin American populist episodes. Peru under President Alan García ended up with hyperinflation of 7,000% in 1990, and Venezuela is on its way to 1,000,000%. Argentina under the Kirchners avoided hyperinflation, but in 2016, the last full year of President Cristina Fernández de Kirchner in office, the consumer price index increased at an annual rate of 41%.

What the Cato Institute describes above is more or less where the United States is headed. And between the two terms, financial repression and fiscal dominance, we have a reasonably full picture of what the Federal Reserve is doing and why.

Via financial repression, they are keeping interest rates low (and real yields negative) to force savers into risky assets, make it easy for entities to borrow, and inflate away the value of the debt. And via fiscal dominance, the Federal Reserve is paving the way for ever greater expenditures on the government side, as the central bank monetizes newly issued debt by adding it to its balance sheet.

Meanwhile the near-vertical recent upward movement in the gold price, the silver price, and the Bitcoin price is a recognition of this phenomenon, and a reflection of growing awareness on the part of investors.

It looks like financial repression and fiscal dominance will stick around for years, as the balance sheet numbers grow larger. Barring some miracle of super-productive real economic growth, there is no way off this path.