



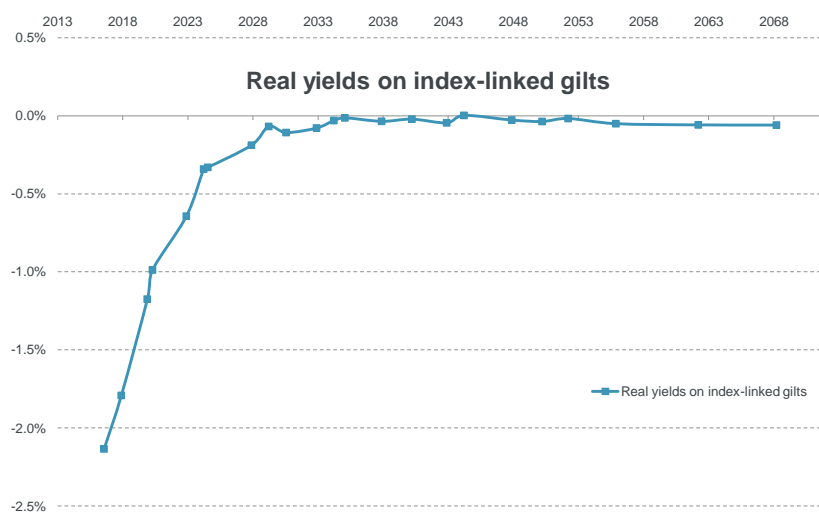
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Financial repression

Financial repression working party of the
Finance & Investment Board



Financial repression in action...



Financial repression in action...

Savers 'condemned to £33bn loss' by Bank of England

Daily Telegraph, August 2013

The £170bn secret raid on your savings: How keeping rates at a record low is a government ploy to pay off its debts

thisismoney.co.uk, August 2013

The elderly must suffer low rates so the young can pay down their debts

Daily Telegraph, July 2013

3

What is Financial Repression?

Shaw and McKinnon (1973)

- Distortion by government of domestic capital markets
- Particularly to channel funds to themselves, that, in a deregulated market, would go elsewhere

Reinhart and Sbrancia (2011)

- Explicit or indirect caps or ceilings on interest rates
- Direct lending to govt. from captive domestic audience
- Regulation of cross-border capital
- Tighter connections between governments and banks

4

What is Financial Repression?

- **Implemented by:** Macro-prudential regulation
 - “Goodbye financial repression, hello market crash”
- **Evidenced by:** Negative real yields
- **Impact:** A tax on savers
 - Paid to borrowers – including government



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How can debt to GDP be reduced

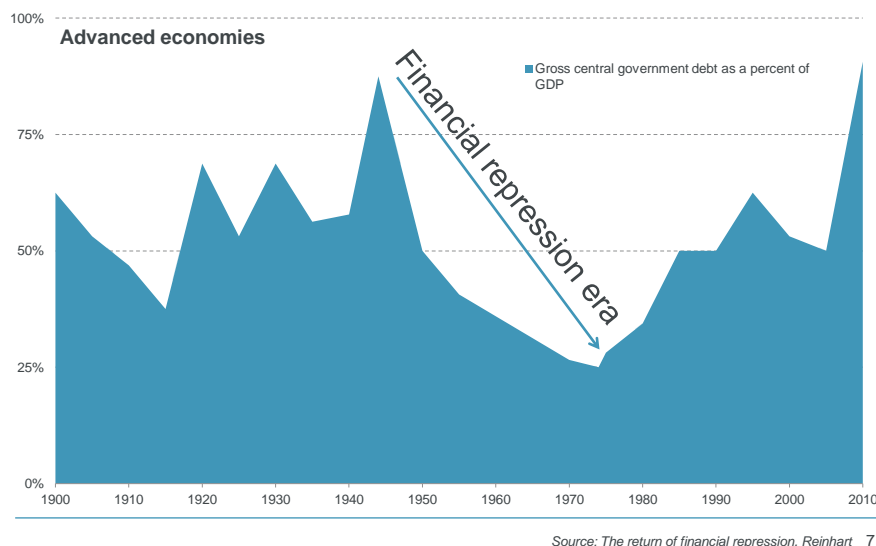
1. Economic growth
2. Austerity and fiscal adjustment
3. Outright defaults or restructuring
4. Surprise burst in inflation
5. Steady dose of financial repression + steady inflation



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Gross government debt as a % of GDP

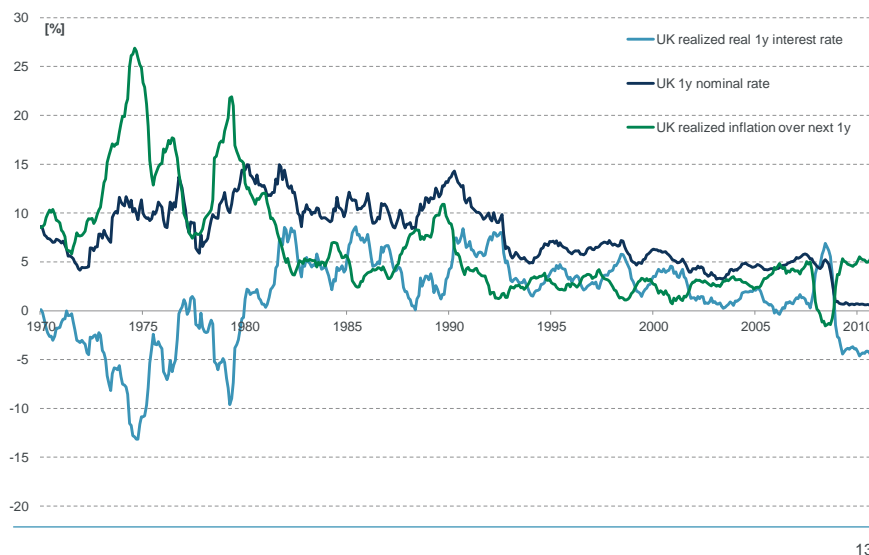


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Low interest rates

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Real interest rates in the UK (1y)



13

Impact of QE on gilt yields

- QE reduces yields
 - “QE has caused the price of gilts to rise and yields to fall” and “The results... around 100bps fall” Bank of England, July 2011
 - “One of the effects of QE is to push up the market price of government bonds and consequently to push down the yield they give investors.” BBC article, March 2012
 - “...the very low gilt yields which are partly, though not exclusively, the result of QE.” NAPF, *Exceptional times, exceptional measures*, March 2012
- But then again...
 - “UK gilt yields have declined only marginally more than comparable government bond yields in countries where there had been no QE.” Towers Watson, October 2012
 - “There are several ways in which large-scale central bank purchases of government bonds can put upward pressure on their yields.” Capital Economics, April 2013
 - “Far from being expansionary, QE is actually contractionary and deflationary.” Ken Fisher, Chief Executive of Fisher Investments, FT article, April 2013

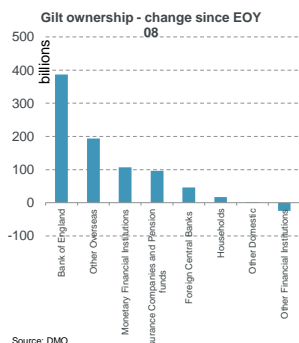


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16

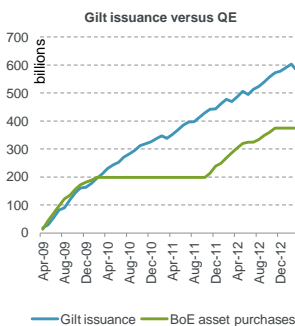
Impact of QE on gilt yields

- The BoE has been the largest buyer
- ...but other buyers are larger in aggregate



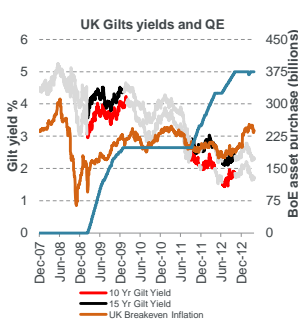
- Pension schemes and insurance companies saw GBP100bn increase
- Has risen at 3x the rate of pre-crisis
- Overseas buyers not deterred by low yields

- QE at times equivalent to new issuance
- ...but not more



- Little evidence of crowding out
- Long periods without QE

- Gilt yields have risen during periods of QE
- QE seems to raise inflation expectations



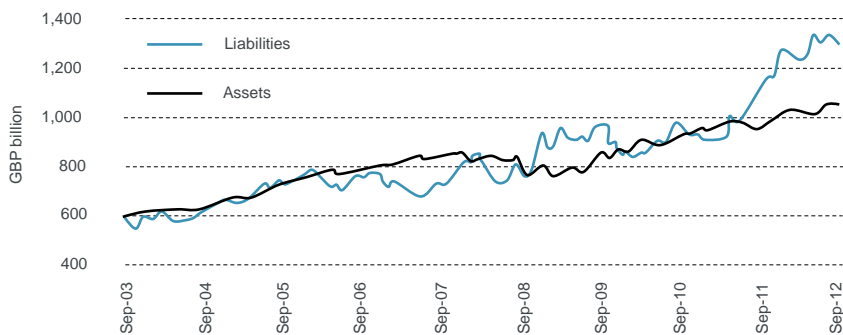
- BoE analysis based only on the few days after announcements
- Choosing the data to fit their conclusion?
- Also, yields moved on US QE2 when BoE did none

17

Impact of low rates on insurers and pension funds

The insurance industry and pension providers have as their first concern the return of the economy to health; however...

Defined Benefit Scheme Assets and Liabilities



Liabilities are measured on a s179 basis.



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Source: The Purple Book 2012 PPF/The Pensions Regulator 20



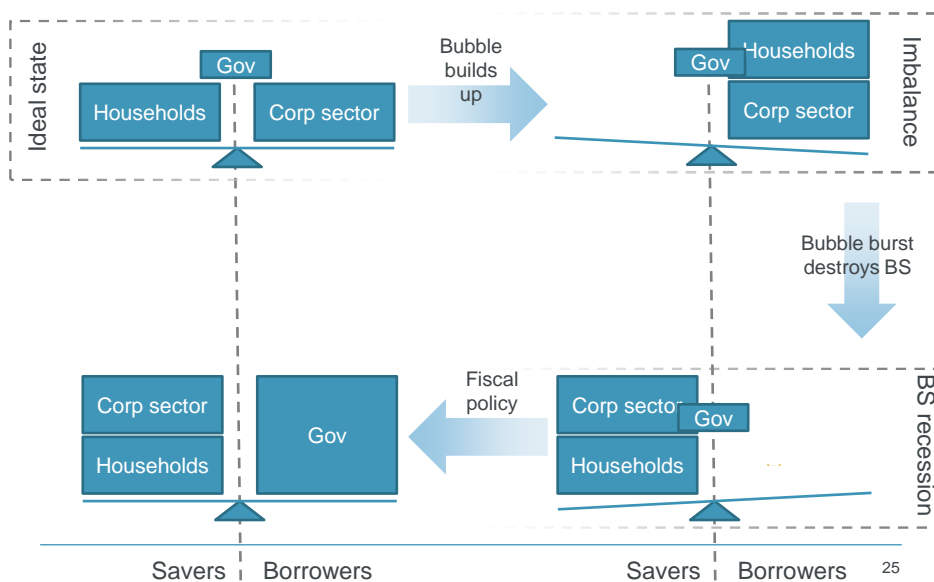
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Balance sheet recessions

Lessons from Japan

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Balance sheet recession – what is that?





The Ying and Yang economy

	Phenomenon	Fundamental driver	Corporate financial condition	Behavioural principle	Monetary policy	Fiscal policy	Prices	Interest rates	Savings
Yang	Textbook economy	Adam Smith's "invisible hand"	Assets > Liabilities	Profit maximization	Effective	Counter-productive (crowding-out)	Inflation	Normal	Virtue
Yin	Balance sheet recession	Fallacy of composition	Assets < Liabilities	Debt minimization	Ineffective (liquidity trap)	Effective	Deflation	Very low	Vice



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28

Source: The holy grail of Macroeconomics, Richard Koo

Secular stagnation

"... prior to the crisis... many people believe that monetary policy was too easy. Everybody agrees that there was a vast amount of imprudent lending going on"

"Was there a great boom? Capacity utilisation wasn't under any great pressure; unemployment wasn't under any remarkably low level; inflation was entirely quiescent, so somehow even a great bubble wasn't enough to produce any excess in aggregate demand."

Larry Summers

"I wonder if a set of older ideas...'secular stagnation'...may not be without relevance to America's experience."

"Back in the day, Hansen stressed demographic factors: he thought slowing population growth would mean low investment demand. Then came the baby boom."

Paul Krugman



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Unconventional²

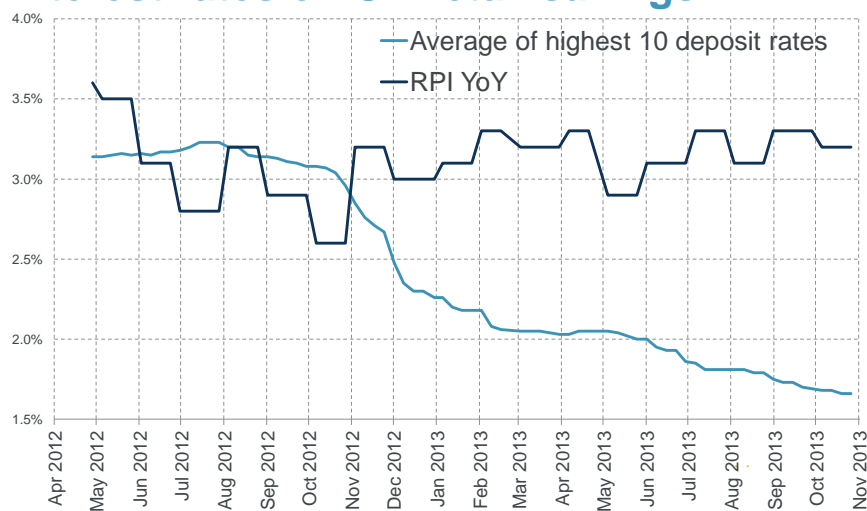
Financially “repressive” schemes

There are other schemes which reduce private sector investment options and effectively encourages investors towards repressive negative “real yield” investment:

- Funding for Lending Scheme
- Help to Buy Scheme
- Business Finance Partnership
- Government underwriting of Housing Association bonds

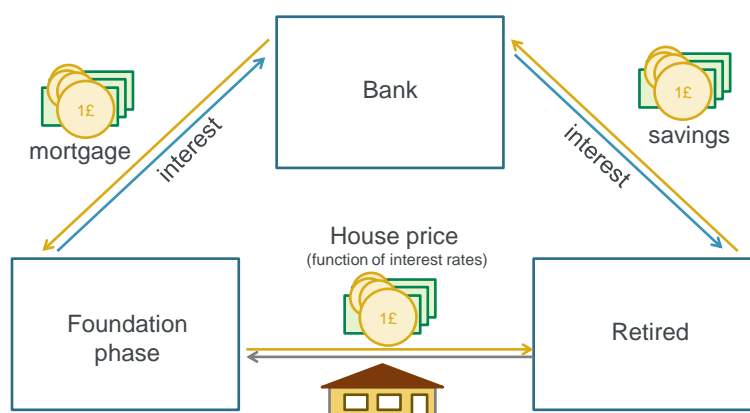
Each of these schemes reduces options for savers and investors as government is providing cheap finance.

Interest rates on UK retail savings



Source: Investec 35

The money cycle



What does the Bank of England say

“That led to a transfer of wealth to the older generation, which took the form of the younger generation taking out a lot of debt and the older generation having a lot of liquid assets that they got from the proceeds of selling houses.”

Mervyn King, Treasury Select Committee testimony, June 2013

“I have tremendous sympathy for [savers]. But raising interest rates now is not the answer – instead what savers need is a stronger economy. That will mean higher asset prices ... [and] is in all of our interests, as it will deliver better job prospects for our friends, neighbours, children and grandchildren.”

Mark Carney speech on Forward Guidance, August 2013

37



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A captive audience

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Creating and maintaining a captive domestic audience

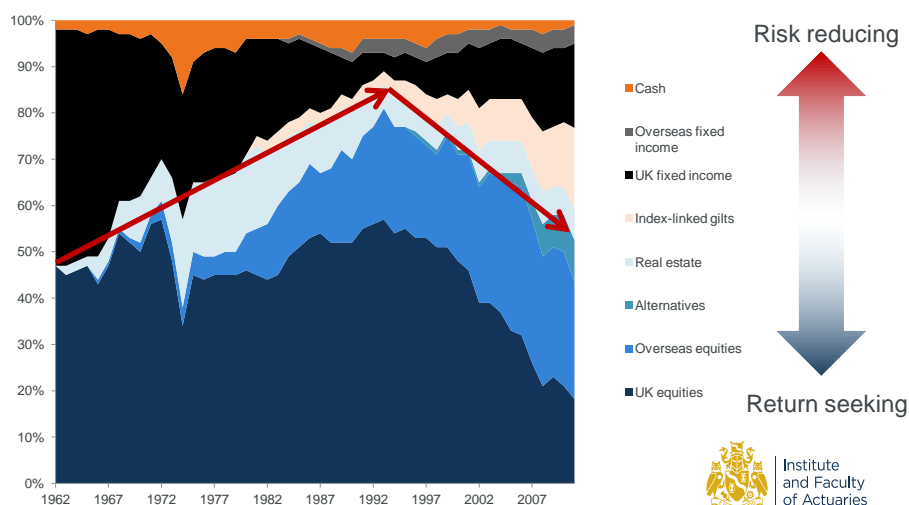
- Prudential regulatory measures
- Exchange controls
- High reserve or liquidity requirements (tax levy on banks)
- Transaction taxes
- Prohibition of gold transactions



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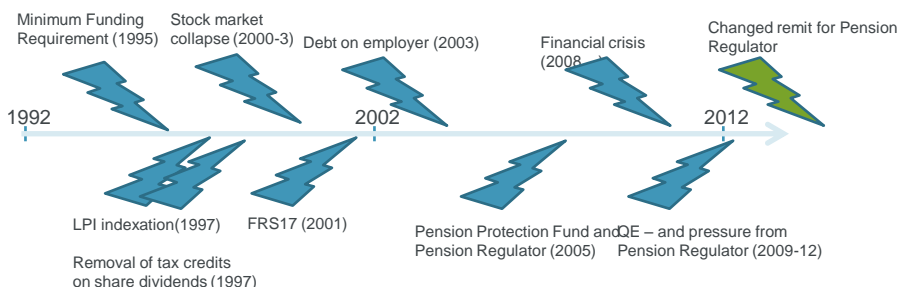
39

The rise and fall of the cult of the equity



Source: UBS Pension Fund Indicators 2012 41

Drivers of the reversal



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42

Discussion points ...

- What's the lesser evil: financial repression or market crashes?
- Why would anyone buy assets with negative real yields - are pension funds and insurers overly influenced by regulation?
- Has the main impact of unconventional monetary policies, such been to repress retail savings – and is this a good thing?
- Are savers unfairly paying for the past excesses of borrowers? Or are low interest rates necessary to redistribute the baby-boomer's wealth to a younger generation?
- Cock-up or conspiracy – is this a deliberate strategy, or the result of an accidental interaction of monetary policy and regulation?



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46



Questions



Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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47

Working party members

- *Paul Fulcher (chairman)*
- *Richard Boardman*
- *Ian Collier*
- *Hans-Christof Gasser*
- *Rod Price*
- *Paul Shelley*
- *Sarah Softley*



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49

Recommended further reading

- **The Liquidation of Government Debt**
Reinhart and Sbrancia; 2011; National Bureau of Economic Research
<http://www.nber.org/papers/w16893>
- **The Return of Financial Repression**
Reinhart; 2012; Centre for Economic Policy Research
<http://www.cepr.org/pubs/dps/DP8947.asp>
- **The world in balance sheet recession: causes, cure and politics**
Richard Koo; 2011; Nomura Research Institute
<http://rwer.wordpress.com/2011/12/12/rwer-issue-58-richard-koo/>
- **Investment Practice – Full Circle?**
Alastair Ross Goobey; 2005; The Pension Institute
<http://www.pensions-institute.org/workingpapers/wp0510.pdf>



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