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# Financial repression: what does it mean for savers and investors?

## Abstract of the Edinburgh Discussion

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This abstract relates to the following paper: Paul Fulcher, Richard Boardman, Ian Collier, Hans-Christof Gasser, Rod Price, Paul Shelley and Sarah Softley. Financial repression: what does it mean for savers and investors? *British Actuarial Journal*, doi:10.1017/S1357321714000154.

**The Chairman (Mr D. Anderson, F.I.A.):** This evening is going to be a presentation, rather than a formal paper, on the subject of financial repression. It is my pleasure to introduce Paul Fulcher, who is going to deliver the presentation.

**Mr P. Fulcher, F.I.A. (presenting the session):** Firstly, we have posted the large slide presentation on the Institute and Faculty website. This presentation uses a shorter version of those slides. Add in edit of Mr Fulcher's written presentation.

**Mr P. O. J. Kelliher, F.I.A. (opening the discussion):** Financial repression is not due to a conspiracy. There are reasons why people might buy assets with negative real yields. For long-term index linked gilts it seems a bit perverse. However, in terms of savers leaving money on deposit when they are getting negative real yields, there was an interesting article by Gillian Tett of the FT in 2012. She said there were two reasons people put money on deposit. One is to get a return in the form of interest and the other is security of capital. The point that she was making was that with the financial crisis causing a loss of confidence in banks, some people decide to invest in say German bonds, which have negative normal yields, because they believe their capital will be preserved.

It is easy to overstate the impact of QE. In Japan, from 1990 up to about 2003, the M0 narrow measure of money supply almost trebled. There was 180% growth in M0, but only about 30%–40% growth in the broader M3 measure of money supply: bank assets were stagnant in that period.

The big driver of inflation is not QE but broader money. If we have a balance sheet recession we will not see M3 growth or inflation, we will instead have the potential of prices falling.

There is another aspect of government policy which works in the opposite way to QE and that is increased capital and regulatory constraints. Basel III is being introduced. This is partly in response to demand from governments for better regulation. The Basel committee is driving Basel III and higher capital requirements and higher liquidity ratios. That is why there is an increased demand for gilts.

Mervyn King, in his final act, imposed the 3% leverage ratio ahead of schedule on UK banks. On the one hand, the government have policies which are supposed to be boosting demand like QE; but, at



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the same time, they are taking a lot of wind out of the economy through the higher capital requirements.

This could end in a situation like that in Japan. It is interesting that in the last 20 years in Japan there has been deflation and a transfer of wealth from the young to the old.

**Mr Fulcher (responding):** I largely agree. Japan tried to create negative real yields and failed, although they may now have just about achieved it. Japan, however, has a slightly different issue from the UK because the Japanese economy, taken as a whole, is owed money by the rest of the world. People always look at the high debt to GDP ratios in Japan and assume they have trouble financing themselves. They do not because the problem is less acute on a consolidated balance sheet basis. If the government is just seen as the collective liabilities of the population Japan is the only major economy which is owed money by the rest of the world rather than the other way round.

You raised the issue of the Bank of England taking with one hand and giving with the other. In a way they have given to the government with both. Firstly, they did QE, which is supposed to boost the economy, but still creates demand for gilts because the Bank is buying them. It has the additional pro-cyclical effect that as yields fall insurance companies and pension funds want to buy more, not less, which would not be the actions of a rational investor. Secondly, they imposed the higher capital requirements and leverage ratios, which create demand for gilts. There is £100 billion of gilts sitting on bank balance sheets that was previously not there. All of the measures seem to be pushing in one direction, even if it is only by confusion.

Your point about savers came up quite a lot when it was debated at the Momentum Conference in December, when Mr Gasser gave more detail on this. There is the interesting question as to why people should actually bother saving if real yields are negative. We are used to a world where the whole point of saving is "I can consume an apple today, but if I save, I can consume a nicer apple or more apples tomorrow". A negative real yield implies I have an apple today or a more rotten apple in 5 years' time. This does not make sense, and is creating a world which is a big challenge for us as a profession and as a financial services saving industry.

**Mr H.-C. Gasser:** The question should be what is the character of interest rates? They are seen most of the time as providing an advantage for deferring consumption. With negative real rates consumption potential in future becomes less. From this perspective you could say it does not make sense to save money but on the other hand, you need to live from something when you retire.

Overall, a majority of people at the Momentum Conference presentation said they would save even if real rates were negative. I would be very curious how many people in this room would, if they imagine they are now 25, still save for their pension and for their retirement. Please raise your hands. It seems here also that the majority would be prepared to pay this kind of levy for transferring wealth from today to the future. It is clear that financial repression can work, as people are prepared to accept it.

This also links to the topic of demographics. If you consider an ageing population, with the percentage of people in the working population decreasing, then the people that work want to have more for doing the work than those not working. There is a supply and demand issue. In future there will be a reduction in some services from the decreasing population that is actually providing these services.



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**Mr M. A. Potter, F.I.A.:** Another side effect of the credit crisis was a point when credit spreads were going up and IAS19 deficits were shrinking and company balance sheets, an economic measure of those liabilities and deficits, were actually going up substantially. The government was probably doing things in its own interests and the corporates might have accidentally benefited, as in the example of IAS19 deficits. I wondered whether corporates might have other outlets by which they could mitigate the effect of the financial crisis.

Did the working party consider whether something that may accompany a situation of financial repression is that real wage growth may be negative? I do not know whether the measure of real wage deflation would be close to the 7% in GDP that you mentioned earlier. There, however, are many people who are feeling the pinch. Perhaps, rather than QE, this is a factor that might be causing people to be saving a little bit less today.

**Mr Fulcher (responding):** We did not consider that factor but it is an important one. The issue of negative real wage "growth" is becoming a hot political topic, because clearly people are becoming worse off, which will inevitably feed through into the wider economy and savings.

If anything, wages have been the dog that has not barked in this crisis. It is one of the reasons inflation has stayed under control so far. That links into the forward guidance topic.

The Bank of England has now linked maintenance of the low base rate to forward guidance, which is based on unemployment. The logic behind this strengthens your observations as they are trying to link rises in interest rates to the point when real wage growth returns again. They are trying to keep rates low, and are therefore penalising savers, to try to bring real wages back up again to sensible levels, but trying to avoid wage inflation getting out of control.

The Bank of England has given a lot of thought to forward guidance, which ultimately is all about spare capacity. The secular stagnation story that I spoke about earlier was the idea that we might never have full capacity and wage pressure again and therefore we might be in the world of sustained falling prices and wages, because there is not the demand.

So, the whole set of factors is linked in a way even wider than we considered on the working party.

**The Chairman:** One might speculate that George Osborne's announcement about an increase to the minimum wage last week might be linked to approaching too close to the 7% unemployment threshold and the implications for keeping interest rates at a low level.

**Mr Fulcher:** Real wage growth has become such a political issue that the minimum wage increase is a clever thing to do politically. There is a suggestion that the Bank of England might decide to alter the 7% unemployment threshold. It is certainly clear that this target is being reached too early, before the economy feels like it has truly recovered and therefore they may need to amend their Forward Guidance in some way.

**Mr H.-C. Gasser:** It is my opinion that real wages will grow in the long term. What we are seeing is that workers in the developed world are competing with workers in the emerging markets, where, for example, in China, wages are already beginning to grow there.

On a global level, wages are actually growing, and in the very long term, we can imagine that wages will outperform the level of inflation. There is the demographic argument again. The part of the



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population that is actually working is decreasing and will demand more for working instead of being retired, in education, or enjoying their leisure time.

**Mr A. N. Walton, F.F.A.:** By blaming the government are we trying to shift the blame from ourselves? What we are suffering from is a form of crowd psychology. People save in banks because they are scared of losing jobs or losing money.

We as a profession tell our pension schemes, in particular, "You must de-risk". Not for any reason other than it is conventional wisdom. That helps to create the consequences we have seen.

**Mr Fulcher:** I have to declare an interest. I have been one of the people telling pension schemes to de-risk down the years. Regarding pensions there has been significant changes in the nature of the promise. There is quite a difference between the Imperial Tobacco pension fund, as it was in the 1950s, with very long-term time horizons, and a strong sponsor and no regulation, and where that pension fund is today, with a much weaker sponsor relative to the size of the pension fund, with contractual promises to provide inflation and regulation that requires them effectively to top up their pension scheme at relatively frequent intervals.

Which came first, the regulation or the conventional wisdom, is a debatable point. There is definitely an argument that maybe fashion leads these things.

I would also make the point that the government is trying to push back on these changes because they realise the damage to the wider economy.

Has it done harm? Pension schemes would be in a worse position if they had not have hedged their liabilities. It has probably done harm to the wider economy in terms of sucking out productive wealth from corporate balance sheets onto the government balance sheet.

This is fine if the government then turns round and invests in the wider economy, which is why we come back to this point about the government having a role as the "borrower of last resort". It is not necessarily a bad thing if governments borrow lots of money in these sort of economic conditions, as long as they are using it to do productive things that the private sector is not doing.

**Mr H.-C. Gasser:** The situation regarding pension schemes might be reinforced by trends in the corporate world to focus on core competencies. Fewer and fewer companies want to bother the boards with the pension scheme. They want to outsource these things and essentially do not want any more calls to put more money into the fund.

**Mr A. C. Martin, F.F.A.:** I challenge the figure of 90% for the ratio of debt to GDP that was mentioned and speculate that a figure times 10 that amount would be better. This is because that headline figure does not take into account future pension promises.

These pension promises cover everybody in respect of the new basic state pension and also pension promises for public servants who are not currently in funded schemes such as those in local government, central government and health service employees, and so on.

There was an Office of National Statistics paper on the subject a few years ago, which suggested an increase by a factor of 10. The pension position throughout the world is equally scary, with the Japanese in the worst position.



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A better estimate of the true debt position would be 900% of GDP: the future taxpayers' ability to service that debt is inextricably linked to the underlying financial assumptions that go into the contribution rate calculations and our ability to pay. The public-sector discount rate changed almost 3 years ago by Steve Webb, following Lord Hutton's report on public-sector pensions. That was the biggest change in public financing for almost a century.

Looking at inflation/deflation, etc., we should also look at our ability to fulfil the underlying assumption of that discount rate, and that flows from growth in the economy. Growth can be muddled with immigration, and so on, but the underlying efficiency of the economy is probably a much bigger factor, particularly given global competition.

**Mr Fulcher:** I agree with most of these points. You could also consider the various other off-balance sheet promises, like the PFI scheme, and the UK pledge to effectively guarantee large amounts of infrastructure borrowing. These are all part of the government's balance sheet but are not apparent, so the true debt to GDP ratio is growing. I come back, however, to the point that maybe that is not a bad thing, particularly when the borrowing is used to finance infrastructure.

The public pensions sector is a bigger problem. It is a promise on which the government may default. Those pensions are unsustainable and the government can implicitly default on those promises by changing the rules. There is an argument that at some point the classic Left/Right political divide is going to be replaced by an age divide. Whether we can afford to pay pensions from the working population to the older population is going to become a big political issue over the coming 20 years, if it is not already.

**Mr C. I. Black, F.F.A.:** The comparison between the cost of financial repression to UK savers and the bank levy in Cyprus is not correct. The key difference is that in Cyprus the cost was largely incurred by foreign depositors who could take their money away so the Cypriots had to go for a one-off immediate levy.

I am perplexed about the lack of comment on the figures which show the fall in gross government debt as a percentage of GDP during the financial repression era. The other side to that was rising private-sector debt.

You covered the pre-war defaults. Post-war there have been a number of crises and recessions, and generally the response to these has been some form of bail out, and to pile further debt on the private sector.

You can characterise the reason for debt as having two potential forms. It can be investment or it can be accelerated consumption. Maybe that and the link to the baby boom, and the demographic factors, are more significant than we realise.

**Mr Fulcher:** You always have to look at overall national balance sheets to see the full picture. The figures have to add up in that for every borrower there has to be a lender. Recently, we have been seeing a trend for private-sector debt to be turned into public-sector debt.

If anything, the problem currently is that not enough people in the private or personal sector are prepared to borrow, which is why the government debt is rising, possibly with some justification.

**The Chairman:** We have had a lot of people arguing that our current situation of financial repression is due to confusion rather than some kind of conspiracy.



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As a former civil servant, I am of the view that our policymakers would have to be extremely clever to come up with a conspiracy in our terribly siloed world.

It strikes me that there are examples of things going on which are anti-financial repression, which have not been discussed. Auto-enrolment is anti-financial repression. The money is largely going into the equity market rather than the gilt market.

The removal of compulsory annuitisation of pension assets is again anti-financial repression, on your definition. In addition, the removal of compulsory indexation of benefits under DB pension schemes, to the extent that may be possible, could be anti-financial repression.

**Mr Fulcher:** We did acknowledge that the more recent legislative changes are in the opposite direction. That is truer of the pensions sector than of the insurance sector. The insurance sector is still very much incentivised to invest in "risk-free" assets, Solvency II relaxations notwithstanding these assets are still mortgages and government debt, the two things that policymakers want you to invest in.

In regards to pensions, I suppose the only counterpoint is that most of the relaxations are only around new money. My company's gilt analyst is always asked: "what do these changes mean for the demand for index linked gilts"? The answer is not a lot for the trillion of liabilities that are not particularly affected by the changes, that is, it makes a difference to the new money being invested, but not the massive back book. The bigger impact will be over time. If they scrapped a lot of the legislation referred to with retrospective effect, that would make a very big difference.

Some of this could be applied retrospectively to accrued liabilities, but this is unlikely. Legislation does change promises retrospectively, but only it seems to make them more onerous.

Overall, in respect of pensions, there is not much evidence that the government is doing anything deliberately to encourage financial repression. As a working party our basic view was that the situation is caused by the accidental impact of regulations that were put in place in the past for different reasons. It has had the nice effect of financing the government debt today at quite cheap rates. Had it not been there, maybe the government would have had to do something deliberately. The work has been done for them by the choices of the past. With hindsight, Robert Maxwell did today's Government a very large favour 25 years ago.

**Mr H.-C. Gasser:** It is hard for governments to implement measures to cause financial repression. Within a democratic system, where there are a lot of checks and balances in place and a number of entities have responsibility for different features of the economy, financial repression is obviously harder to implement than in authoritarian states.

**Mr B. J. Duffin, F.F.A.:** It was worthwhile introducing a few thoughts on the power of the market. We have not really gone into that in any great depth. A free market is normally a better allocator of resources to demand than a centrally controlled market.

In many ways regulation obliges organisations, whether they are bank or insurance companies, to behave in a very similar manner, and it rather destroys the power of the market.

We do this in all sorts of ways. We do it in our own profession by setting technical standards which have to be observed. So, it does not really matter who you use to provide the certificate for your



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insurance company or your pension funds. Thus, we destroy the power of competition within our profession. Accountants do it with auditing certificates. When did you ever hear of a company boast: "We are very proud that we have the best firm of accountants auditing our accounts? You can trust us more than other people because we have the best firm of accountants". It does not happen.

It is unclear we should therefore be trusting "Mr Market" again and throwing ourselves on his mercy, because the financial systems we have are very interlinked.

If the consequences of trusting ourselves to the market and reducing regulation were that we suffered sporadic failures but we were able to pick ourselves up and move on, that would not be a problem. Unfortunately, we tend to have massive failures when the system goes wrong. The linkages between organisations are so strong that if one goes down, another is affected. The disruptive effects on people are and can be enormous.

So, although we might criticise politicians for intervening in the market they may not be wrong because the consequences of having a prolonged period of depression, such as the 1930s, is absolutely horrible for people. It is not an easy balance to set.

Another area where the power of the market has an effect is in demographics. Age structure need not be such a problem because in many cases the reason people are living longer is because they are healthier.

As long as there is flexibility, which allows people to work longer and to move within the workplace, market forces will take care of the allocation of resources between labour and demand.

Even the size of population takes account of the economic allocation in that successful economies tend to attract people. Unsuccessful economies do not tend to retain people. Overall, I would not be quite as concerned about demographics as some of the other points.

**Mr R. E. Andrew, F.F.A.:** When considering how much debt the British government currently has, and if the Bank of England is sitting on much of it, was consideration given to scope for them to let the Treasury off a little bit?

I know some might say a permanent increase in the money supply might be inflationary. But could they not test that out, make a small increase and see what happens? It seems if the government owes itself money, why is it such a huge problem?

**Mr Fulcher:** Cancelling the debt is often discussed. Some people think that it would be a complete disaster, people would take fright, and it would end in a collapse for sterling. The Bank of England's current approach seems to be to let the existing bonds they hold run off. Even if you strip out the debt that is owed by the Bank of England, the debt to GDP is still at very high levels. As a working party we would not claim to be experts on the exact mechanics of QE but this is an interesting point probably worthy of further research.

I very much agreed with the previous speaker. These points relate to the paper we referred to "Goodbye financial repression, hello market crash" – the two things are clearly linked.

The world moves in cycles. We had a crash so let us make the legislation very tight. In 10–20 years' time, we will have the next Glass-Steagall Act and the next Big Bang, and then 10–20 years after that we will have the next crash.



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On the demographic point, interestingly, you can have demographic repression as well. In other words, will market forces prevail on demographic trends or will governments intervene? I can see two examples of demographic repression. The first is government controls on immigration. The entire population of Romania was apparently going to move to the UK on 1 January 2014. The second is government pension policies. Governments have a lot of ability to control the demographics. If they pay people generous pensions, they will retire early. If they up the state retirement age very rapidly, they can have the opposite effect.

Perhaps demographic repression should be the next working party. You cannot avoid the issue of government interference and public policy on demographics. Not least because the man or woman on the street cares much more about demographics, pensions and immigration, than they care about or understand the functioning of long-dated interest rates and QE. It is an even more political area.

**The Chairman:** There would be unanimity on that point. Thank you very much for everybody's contribution to such an active discussion. I am tempted to take a straw poll about who believes financial repression is the result of confusion as opposed to conspiracy. Who is for confusion?

The overwhelming majority here believe in confusion and not conspiracy.

Thanks again, Mr Fulcher and Mr Gasser, for an excellent presentation. I am sure that given the wealth of questions here there will be many interested readers when the presentation is set out in paper form.



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