

# Government Funding Costs Under Financial Repression

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# Motivation

- Financial repression has become increasingly relevant in the post-pandemic era, with many governments resorting to policies that keep interest rates artificially low to manage rising debt burdens.
- Historically, financial repression has been used extensively during periods of war and crisis.
- Need more theoretical work to understand its implications (Chari-Dovis-Kehoe, Jeanne).

## This Paper

- Develops a two-agent endowment economy model with monetary and fiscal dominance policy regimes in the presence of financial repression.
- Financial repression raises bond value and lowers the government's funding cost, while dampening the inflation response to unfunded fiscal expansions.
- However, there is no free lunch: bondholders ultimately bear the cost through lower future returns.

## Model

- Leeper (1991) model with heterogeneous agents: active asset traders and hand-to-mouth consumers.
- Government finances spending through taxes and issuing perpetual bonds.
- Financial repression: active asset traders' Euler equation for bonds is modified by a wedge  $\Omega_t$ :

$$\frac{1}{\Omega_t} = \mathbb{E}_t \left[ \frac{\beta u'(c_{t+1})}{u'(c_t)} r_{t+1} \right]$$

with the wedge exogenously determined as a linear function of government debt level:

$$\log \Omega_t = \omega_* + \omega_b b_t$$

# Result 1: Active Monetary and Fiscal Policies Can Coexist

- With sufficient financial repression, the government can simultaneously achieve active monetary and active fiscal policies.

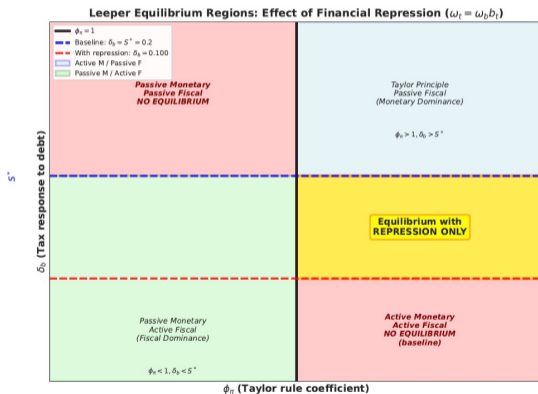


Fig. 1. Equilibrium Regions with Financial Repression

## Result 2: Financial Repression Lowers Government Funding Costs

- With passive monetary and active fiscal policies, financial repression
  - Reduces the inflation caused by an expansionary fiscal shock:  $\frac{\partial \pi_{\epsilon,n}}{\partial \omega_b} > 0$
  - Reduces the decrease in (real) total outstanding government debt caused by an expansionary fiscal shock:  $\frac{\partial b_{\epsilon,n}}{\partial \omega_b} < 0$
  - Reduces the decline in the price of government bonds caused by an expansionary fiscal shock:  $\frac{\partial q_{\epsilon,n}}{\partial \omega_b} < 0$
  - Reduces the fall in real government bond returns on impact of an expansionary fiscal shock, but lowers future real government bond returns:  $\frac{\partial r_{\epsilon,0}^{gr}}{\partial \omega_b} < 0, \frac{\partial r_{\epsilon,n}^{gr}}{\partial \omega_b} > 0$  for  $n > 1$

## Result 3: Welfare Implications of Financial Repression

*Corollary 1* (Utility with  $\rho_\pi < 1$ ). A financial repression rule that increases the value of government bonds during fiscal expansions ( $\omega_b < 0$ ):

1. Does not affect the response in asset holder utility to an expansionary fiscal shock if fiscal policy is exogenous ( $\delta_b = 0$ )
2. Reduces the decline in asset holders utility caused by an expansionary fiscal shock if repression leads to increased tax revenues ( $\delta_b > 0$ )
3. Increases the decline in asset holders utility caused by an expansionary fiscal shock if repression leads to decreased tax revenues ( $\delta_b < 0$ )

## Result 4: Persistent Repression is More Stable

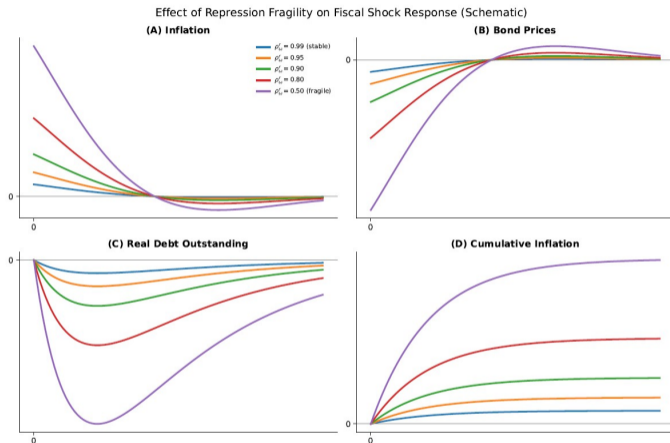


Fig. 10. Schematic Illustration: Effect of Repression Fragility

*Note:* Schematic impulse responses to a government spending shock for different values of the repression persistence parameter  $\rho_{\omega}^r$ . Lower persistence (more fragile repression) leads to larger inflation responses, illustrating Corollary 7. Axis scales are omitted to

## Comments

# 1. Distinguishing Different Types of Financial Repression

- The paper models financial repression as a wedge in the Euler equation that is a linear function of government debt.
- However, financial repression can take many forms, such as capital controls, directed lending, or interest rate caps.
- Do they have different implications for government funding costs and welfare, especially when we are thinking about a heterogeneous agent setting?

# 1. Distinguishing Different Types of Financial Repression

- For example, I can think of the following forms of financial repression:
  - ▶ **QE and similar purchases of Treasury securities** influence the yield curve while still putting investors on their Euler equations. These investors can freely trade the assets, while facing a different supply curve.
  - ▶ **Regulatory constraints** may force investors off their Euler equations. For example, changes in asset risk weights may put Treasury at an advantage relative to other assets, either by imputing a convenience yield on Treasury or by imputing an inconvenience yield on other assets.
  - ▶ **Forced Treasury purchases** are even more extreme. In case 2, agents may still be able to trade-off between different assets on the margin, even though it comes with additional wedges. But in case 3, Treasury and other asset markets may become even more segmented and less substitutable, which has direct implications on the conventional portfolio rebalancing way of thinking about QE.

# 1. Distinguishing Different Types of Financial Repression

- My hunch is that these different forms of financial repression may have different implications.
- For example, if we explicitly consider banks in the model, on which margins do banks adjust in response? Do they make fewer loans, or do they adjust their deposit rates, or do they adjust on their equity side?
- More narrowly in the model of this paper, the exogenously specified linear rule for the Euler wedge may be different for different types of financial repression, in terms of magnitude, cyclicalities, persistence, etc.
- As little is known in the literature, it would be interesting to explore the implications of different types of financial repression.

## 2. Taking It to the Data

THE U.S. PUBLIC DEBT VALUATION PUZZLE

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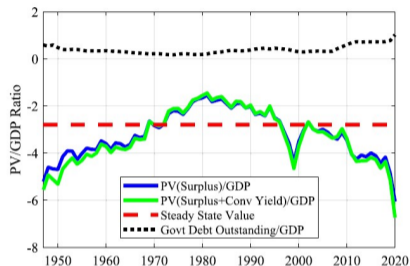


FIGURE 9.—Present Value of Government Surpluses and Market Value of Government Debt. The figure plots the present values of government surpluses and the market value of government debt. Both time series are scaled by the current U.S. GDP. We also estimate a model that incorporates bond convenience yields as in Section 5.4 and report the present value of government surpluses and seigniorage revenues.

- Time-varying relationship between market value of government debt and fiscal backing (Jiang, Lustig, van Nieuwerburgh, Xiaolan 2024).
- Can we demarcate the periods of financial repression from patterns of responses of bond value and inflation to identified fiscal shocks?

### 3. Domestic vs. External Financial Repression?

- Ding and Jiang 2024: in an open economy, in addition to monetary and fiscal dominance regimes, a third possibility arises.
  - ▶ A (hegemon) country can run active monetary and fiscal policies domestically, provided the foreign country accommodates by running passive monetary and fiscal policies.
- Similar to financial repression, this creates additional policy space for domestic policies.
- However, there is a key difference:
  - ▶ Domestic financial repression does not create new resources, hence the no-free-lunch result.
  - ▶ Ding-Jiang's international dominance is made possible by a resource transfer from foreign to home country via terms-of-trade adjustments, which can free up current fiscal space for the home country without sacrificing future fiscal space.
  - ▶ Might be useful to make this international transfer point explicit. A *thermodynamic* law for financial repression: no free lunch without external resource transfer?

## Conclusion

- Elegant framework to model financial repression and its fiscal implications.
- No easy free lunch: while financial repression can lower government funding costs, it ultimately imposes costs on bondholders through lower future returns.
- Keynes, An open letter to the French Minister of Finance:

*There are two methods of attaining the desired equilibrium. You can increase the burdens on the taxpayer, or you can diminish the claims of the rentier...*

*to consider coolly how best to reduce the claims of the rentier. Three methods offer themselves: first, a general capital levy; second, a forced reduction of the rate of interest on the public debt; third, a rise of prices which would reduce the real value of the rentier's money claims.*

*What are the arguments against these courses? They are entirely political.*