Financial Repression and Structural Transformation

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This paper analyzes the relationship between financial repression and structural change. We present a simple theoretical model of structural transformation in which the impact of financial repression on unbalanced growth is studied. The model suggests that governments may choose to repress the financial sector to allow for continued development of the industry sector while inhibiting growth in the domestic service sector. We then present empirical evidence of financial repression having a significant negative effect on structural transformation. In countries with higher levels of financial repression, the development of the service sector is held back in favor of continued expansion of the industry sector. The results are robust to different country sample compositions, alternative measures of sectoral structure, and different measures of financial repression. The analysis suggests that financial repression may be an important driver of structural imbalances, especially in countries with heavy state intervention and where the government strongly favors industrial expansion. The findings have direct and important policy implications for governments that are experiencing rapid economic transformation due to high economic growth and that also use financial repression to achieve a long-run industrial output growth.

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