Financial Repression and the Finance-Growth Nexus: Evidence From China

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Abstract

This paper presents an empirical analysis of the finance-growth nexus under the condition of financial repression. In this paper, I scrutinize the hypothesis that financial repression leads to political distortion in terms of bank lending to state-owned but low productivity firms and thereby reduces growth. Using disaggregated data from the firm and regional levels in China, one of the countries characterized by significant financial repression, I find the hypothesis to be correct. The endogeneity between finance and growth is addressed in this paper according to the Rajan-Zingales approach. Using this approach, I show that industries with a relatively greater need for external finance grow disproportionately slower in highly financially repressed regions, while the positive interaction effect between financial development and external finance needs on the industry growth rate decreases with financial repression levels. These findings suggest that financial repression interrupts the theoretical mechanism through which financial development fosters economic growth, and so decreases the positive relationship between finance and growth. Further, the robustness check shows that these results are not driven by region-level omitted variables or outliers.

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