

Financial Repression

Financial repression refers to the notion that a set of government regulations, laws, and other non-market restrictions prevent the financial intermediaries of an economy from functioning at their full capacity. The policies that cause financial repression include interest rate ceilings, liquidity ratio requirements, high bank reserve requirements, capital controls, restrictions on market entry into the financial sector, credit ceilings or restrictions on directions of credit allocation, and government ownership or domination of banks. Economists have commonly argued that financial repression prevents the efficient allocation of capital and thereby impairs economic growth.

Ronald McKinnon (1973) and Edward Shaw (1973) were the first to explicate the notion of financial repression. While theoretically an economy with an efficient financial system can achieve growth and development through efficient capital allocation, McKinnon and Shaw argue that historically, many countries, including developed ones but especially developing ones, have restricted competition in the financial sector with government interventions and regulations. According to their argument, a repressed financial sector discourages both saving and investment because the rates of return are lower than what could be obtained in a competitive market. In such a system, financial intermediaries do not

function at their full capacity and fail to channel saving into investment efficiently, thereby impeding the development of the overall economic system.

Rationale for and types of financial repression

The key reason for the government to implement financially repressive policies is to control fiscal resources. By having a direct control over the financial system, the government can funnel funds to itself without going through legislative procedures and more cheaply than it could when it resorts to market financing. More specifically, by restricting the behavior of existing and potential participants of the financial markets, the government can create monopoly or captive rents for the existing banks and also tax some of these rents so as to finance its overall budget. Existing banks may try to collude with each other and to interrupt possible liberalization policies as long as they are guaranteed their collective monopoly position in the domestic market.

Typical policies that constitute financial repression and that are motivated by the government's fiscal needs include high reserve requirements, liquidity ratio requirements, interest ceilings, and government directives on the directions of credit.

In some countries, governments require banks to meet high rates of the reserve ratios, and use the reserves as a method to generate revenues. Because reserves earn no interest, reserve requirements function as an implicit tax on banks and also restrict banks from allocating a certain portion of their portfolios to productive investments and loans. When high reserve ratios are required, the lending and borrowing rate spread must widen to incorporate the amount of no-interest reserves, which can reduce the amount of funds available in the financial market (also see Money supply). If high reserve requirements are combined with interest ceilings and protective government directives for certain borrowers, savers who are usually unaware of the requirement policy become the main taxpayers because they face reduced rates of interest on their savings. Inflation can aggravate the reserve tax because it reduces the real rates of interest. Thus, high reserves requirements make the best use of the government's monopolistic power to generate seigniorage revenue as well as to regulate reserve requirements (see Seigniorage). A variant of this policy includes required liquidity ratios – banks are required to allocate a certain fraction of their deposits to holding government securities that usually yield a return lower than could be obtained in the market.

Governments often impose a ceiling on the interest rate banks can offer to depositors. Interest ceilings function in the same way as price controls, and thereby provide banks with

economic rents. Like high required reserve ratios, those rents benefit incumbent banks and provide tax sources for the government, paid for by savers and by borrowers or would-be-borrowers. The rents borne by the interest ceiling reduce the number of loans available in the market – the real interest rates on loans and deposits are higher and lower, respectively, thereby discouraging both saving and investment. In return for allowing incumbent banks to reap rents, the government often require banks to make subsidized loans to certain borrowers for the purpose of implementing industrial policy (or simply achieving some political goals). Interest ceilings in high inflation countries can victimize savers because high inflation can make the real interest rates of return negative.

Financial repression also takes the form of government directives for banks to allocate credit at subsidized rates to specific firms and industries to implement industrial policy. Forcing banks to allocate credit to industries that are perceived to be strategically important for industrial policy ensures stable provision of capital rather than leaving it to decisions of disinterested banks or to efficient securities markets. It is also more cost effective than going through the public sector's budgetary process. Government directives and guidance sometimes include detailed orders and instructions on managerial issues of financial institutions to ensure that their behavior and business is in line with industrial policy or other

government policies. The Japanese Ministry of Finance (MOF) is a typical example of government's micromanagement of financial industry. The extreme example of direct state control of banks is nationalization of banks as was observed in Mexico in the 1980s, when the government nationalized all the banks to secure public savings.

Capital controls are restrictions on the inflows and outflows of capital and are also financially repressive policy (see Capital controls and Convertibility). Despite their virtues, the use of capital controls can involve costs. Because of their uncompetitive nature, capital controls increases the cost of capital by creating financial autarky; limits both domestic and foreign investors' ability to diversify portfolios; and helps inefficient financial institutions survive.

Impacts of Financial Repression

Because financial repression leads to inefficient allocation of capital, high costs of financial intermediation, and lower rates of return to savers, it is theoretically clear that financial repression inhibits growth (Roubini and Sala-i-Martin, 1992). The empirical findings on the effect of removing financial repression, i.e., financial liberalization on growth supports

this view, but various channels through which liberalization spurs growth have been evidenced.

The possible negative effect of financial repression on economic growth does not automatically mean that countries should adopt a laissez-faire stance on financial development and remove all regulations and controls that create financial repression. Many developing countries that liberalized their financial markets experienced crises partly because of the external shocks that financial liberalization introduces or amplifies. Financial liberalization can create short-term volatility despite its long-term gains (Kaminsky and Schmukler, 2002). Also, because of market imperfections and information asymmetries, removing all public financial regulations may not yield an optimal environment for financial development (see Asymmetric information). An alternative to a financially repressive administration would be a new set of regulations to ensure market competition as well as prudential regulation and supervision

See also: Asymmetric information, Banking crisis, Capital controls, Capital management techniques, Convertibility, Financial liberalization, International regulatory cods and standards, Money supply, Seigniorage.

Further Reading

Ariyoshi, Akira, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Iván Canales-Kriljenko, and Andrei Kirilenko, 2000, “Capital Controls: Country Experiences with Their Use and Liberalization,” IMF Occasional Paper 190 (May).

This paper presents an overview of capital controls by discussing the role of capital controls and the current trend of capital account liberalization. The counter-competitive roles of capital controls are well-presented while referring to actual cases of capital controls policies in the world.

Beim, David, and Charles W. Calomiris, 2001, *Emerging Financial Markets*, New York: McGraw Hill.

This book discusses the factors that contribute to the development of financial markets, especially those in emerging market countries. One of the chapters discusses the effect of financial repression in well-organized fashion.

Claessens, Stijin, 2005, “Finance and Volatility,” Aizenman, J. and B. Pinto Ed. *Managing Economic Volatility and Crises: A Practitioner’s Guide*, Boston: Cambridge University Press.

This paper reviews the academic literature on the determinants of financial markets; the role of financial markets in economic development; the potential impact of domestic financial deregulation; and the effect of financial volatility on the economy.

Kaminsky, Graciela, and Sergio Schmukler, 2002, “Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization,” World Bank Working Paper No. 2912.

This paper empirically examines the short- and long-run effects of financial liberalization on capital markets and finds financial liberalization can lead to pronounced boom-bust cycles in the short run, but more stable markets in the long run.

McKinnon, Ronald I. (1973). *Money and Capital in Economic Development*, Washington, DC: Brookings Institution.

This book is a seminal work along with Shaw (1973) in which the author defines financial repression and identifies it in the development of financial markets in countries.

Montiel, Peter, 2003, *Macroeconomics in Emerging Markets*, Boston: Cambridge University Press.

This textbook provides macroeconomic theories and models especially for emerging market countries. A few chapters in the book present academic discussions about financial repression and the impact of financial liberalization.

Roubini, N. and X. Sala-i-Martin, 1992, "Financial Repression and Economic Growth,"

Journal of Development Economics 39, p. 5 – 30.

This paper is one of the first papers that empirically find analysis negative effects of financial repression on economic growth.

Shaw, Edward (1973). *Financial Deepening in Economic Development* (New York: Oxford University Press).

Along with McKinnon (1973), this book is a seminal work that defines financial repression and examines the effect of financial development on economic development.

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