

Institutional Foundations of Finance and Growth

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Can the Chinese economy continue to grow at the current pace for another two decades? High growth of Asian economies is almost all followed by major economic or financial crisis. The decade-long stagnation in Japan and the Asian financial crisis are two cases in point. Is this accidental or inevitable? What's the logic behind the pattern? Can China escape the fate? Is China truly a miracle? When people use the word "miracle" to describe China, I feel uneasy and even somewhat frightened.

I do not have answers to these questions, not even a hypothesis. As an economist, I tried very hard to search for evidence to convince myself that China is indeed different, but remained skeptical till today. While impressed by the spectacular economic growth like all outsider observers, I saw the other side of the story, that is the accumulation of bad assets in the financial sector. Non-performing loans of the banking system was estimated at 30 to 50% before the recent capital injection of the central government. More than half of the securities firms either went under or on the brink of bankruptcy. State-owned insurance companies could not have got listed in Hong Kong and New York without writing off billions of dollars bad assets by the government. Chinese financial institutions failed to function as a risk screening mechanism and failed to impose market disciplines on enterprises. They simply provided cheap capital to fuel fast expansion of the economy, too often at the cost of efficiency. Like in every exciting-then-disappointing story of the Asian growth model, the financial industry has always played a key role, unfortunately, as a cause of the problem as well as a victim. Consequently, today's international financial markets are dominated by American and European firms, with Asian players being marginalized, if not driven entirely out of competition. The once mighty Japanese banks and insurance companies are still struggling today to get back on their feet.

Asian countries fell one after another into the Solow's curse, suffered from diminishing returns on capital.

Asian countries emerged in the post-war era as manufacturing giants, from Japan, Korea to China. But are they doomed to be a dwarf in finance? If so, why? Again, I do not have answers to the question, but some rough ideas on the direction of research in this area. Perhaps, a starting point is to understand what makes finance different from manufacturing.

In light of the transaction cost theory by Ronald Coase, maybe weak institutional foundations in Asian countries are the key to explain these countries' poor performance in domestic and international financial markets. Information asymmetry is more severe in financial markets than in markets of goods and services. Transaction costs are much higher as a result. We need to establish and develop various types of

institutions in order to reduce transactions costs.

According to Oliver Williamson, there are four layers of institutions. On the top are informal institutions including social norms, ideology, religion, customs, culture and so on. The core of formal institutions consists of constitution, polity, and laws with a focus on property rights and contracts. Below the layer of formal institutions is governance that ensures contracts to be executed smoothly. The market cannot allocate resources efficiently without solid institutional foundations. Skyscrapers cannot be built on sand.

Based Williamson's criteria, I speculate here that China would remain to be a third world country in fiancé in years to come. The underdevelopment of the financial industry would eventually claim its tolls in the real economy. Economic growth may slow down, as it happened in other parts of Asia.

What we need to do to avoid that gloomy scenario? Credit culture and shareholder value is one thing. Independent legal system and law enforcement are another, and finally effective corporate governance. That would in turn require a mass cultural movement to change the millennium-long tradition of China. Legal and political reforms are necessary to free regulation of financial markets and financial institutions from government intervention. Privatization and deregulation seem to be prerequisites to improve corporate governance.

Formidable as the tasks may well sound. But I am afraid we have no choice. Time is running out. Economists in this country are now working very hard to shed some lights on these issues. By doing so, we hope we can raise the level of social consciousness and pave the way for further reforms. We also try to offer some policy recommendations so that China will not follow the footsteps of other Asian countries. On all these fronts we need your help. I cannot promise any academic rewards or investment returns at this point. However, I am pretty sure your time and energy devoted to these issues will not be wasted, but will contribute tremendously to the literature of economics and finance, and to the well-being of the 1.3 billion Chinese people.

Thank you very much.

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