Transparency and China’s Aspirations

BY HILTON L. ROOT

How can we tell if China is attracting as much capital as it needs from outside of greater China? One indication is the attempt by Taiwan to use its position as a major investor on the mainland to acquire political leverage. Strained relations with the P.R.C. have led officials in Taipei to request Taiwanese firms to defer investments on the mainland. Taipei anticipates that a credit boycott will lead mainland officials to negotiate terms for more stable and direct trade relations. Taiwan is banking on the expectation that the mainland will not easily find alternative sources of small- and medium-sized enterprise capital.

Mainland officials have a different view. They see the preferential treatment given to Taiwanese in the absence of other international investors as an irresistible lure to Taiwanese businesses. They expect that Taiwanese will continue to invest when others are driven away by the absence of rule-bound contracting. Taiwanese investors enjoy privileged access to the political and social order called guanxi. Inaccessible to non-Chinese investors, guanxi is often critical to success in business in China. Thus, while limiting the size of the market, guanxi grants Taiwanese investors advantages not enjoyed by others.

It doesn’t matter whether the mainland or the Taiwanese are proved right, the fundamental question is: Can China put in place the institutions that will encourage international investors to provide the large amounts of money needed to finance its modernization?

Recognizing the need to reduce dependence on guanxi, mainland authorities helped create futures and stock markets in the early 1990s. The markets, however, highlighted systematic weaknesses rather than solved them. The futures markets that sprung up throughout China did not operate effectively because the institutional fundamentals—creating low-cost methods of moving orders, providing information, and establishing the creditworthiness of players—were all lacking. Property rights conferred by the contracts were neither secure nor transferable, and legal remedies to cope with defaults were absent. Instead of providing a price mechanism or discovery function to reduce dependence on state planning, firm managers gained opportunities to parlay public assets into private profits.

The newly created stock markets have had similar impediments. Without the legal practice of responsible corporate behavior, managers may mislead investors and abuse funds. Legal recourse does not exist, even when managers sell company assets below market value to a sister company, without sharing the profits with shareholders. The market is crippled by the absence of legal remedies to prevent such opportunism. The experiment has taught Chinese officials that if stock markets are to contribute to financial depth, legally defined assets, liabilities and responsibilities must be established.

The government’s response to the malfunctions of the markets was to insist upon Communist Party control over risky financial initiatives. However, the inevitable politicization that accompanies party control was a source of the unpredictability in the first place. International investors, both individuals and institutions, require information to assess risks and monitor corporate performance. The experiments in futures and stock market formation reveal a basic weakness that bedevils all Chinese efforts to develop capital markets: barriers to transparency, or the free dissemination of information. Timely, reliable information at the firm-specific level is needed. Once an investment is made, reliable verification and disclosure mechanisms must be in place to constrain corporate management from opportunist behavior. Information should therefore be transparent—i.e., open to independent verification.

Private large-scale business organizations within China are handicapped by the same information disclosure issues that besiege foreign investors. An arbitrary legal environment, tenuous property rights, unpredictable levels of taxation, provincial officials that apply rules capriciously, and complex regulatory codes that invite bribery are all reasons why entrepreneurs must minimize exposure to external scrutiny. With limited means to verify company or public debt, investors will hesitate.

The sudden fall this year of Mou Qizhong, China’s most famous entrepreneur and head of one of China’s largest privately owned corporations reveals how difficult it is to estimate the assets and liabilities of Chinese firms. This weakness in information disclosure makes it difficult for strong, independent, professionally managed private firms to emerge in China.

By monopolizing the information upon which private investment depends, the state will prevent the development of independent large-scale economic organizations that can undertake complex manufacturing or long-range research. State-run companies have information and authority to engage other state-run entities and government agencies, whereas private firms cannot compete with government entities that have access to cheap credit and are supported by the state’s coercive authority. Without the institutional capacity to support strong private firms, China’s only alternative to an omniscient state will be dependence on direct investment by foreign multinationals in complex manufacturing or technology-intensive production. That approach is fine for Singapore, but China’s very size and ambitions dictate the need to find a path toward large, professionally managed indigenous corporations.

So long as economic data is controlled by government, the flow of information can be subjected to political considerations, which adds political risks to ordinary business risks. Erecting boundaries between party and government administration is, then, also critical and China is in the process of clarifying those boundaries. One important step toward separating politics from public administration is under way. A bureaucracy that will be appointed by examination and can act as neutral referee is being set up.

More publicly available information would support capital-market development and allow the emergence of professionally managed firms that do not depend on an owner’s political connections. International bodies can help build up institutional capacity. For example, although they will supply but a fraction of the capital that China needs for infrastructure, the multilateral development banks can assist by supporting the development of audit and accounting systems, legal systems, and most importantly, they can help to establish international guidelines of corporate accountability.

The choice for Chinese officials is complex. Will the gains from improved monitoring by external bodies be worth the costs of increased interdependence on these international bodies? With limited interdependence, capital markets will underperform. China can always fall back on traditional ties to the state-controlled economy, but as the escalation of tensions with Taipei underscores, that dependence cramps growth. Real industrial prowess will require the strengthening of monitoring institutions.

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