Journal of Asian Economics 21 (2010) 66–75

Contents lists available at ScienceDirect

Journal of Asian Economics

Globalization, transparency and economic growth: The vulnerability of Chinese firms to macroeconomic shocks

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ARTICLE INFO

Article history:
Received 17 September 2008
Received in revised form 23 May 2009
Accepted 24 May 2009

JEL classification:
E22
E32
E44
F15
F23
F37
G18
G32
L25
M21
M48

Keywords:
International Financial Reporting Standards
Transparency
Economic growth
Macroeconomic impact
Globalization

ABSTRACT

The process of globalization encompasses economic and financial integration. The abolition of capital controls and the dismantling of barriers of different kinds will expose previously sheltered companies to shocks originating in the global economic arena. Policy-makers in already globalized countries have learned that market participants should be prepared in due time to meet the new exposure to fluctuating rates of exchange, interest and inflation. China has recently adopted a version of the International Financial Reporting Standards (IFRS) in an effort to improve the quality of information available for risk management and for pricing of risk. This paper analyzes the gains in transparency from the implementation of IFRS in Europe as of January 2005 and reports no improvements in regard to the macroeconomic impact on firms. Based on this experience, improvements for Chinese adoption are suggested. The paper presents a framework for how to understand and measure the impact of different scenarios on corporate performance. It also elaborates on how to communicate the macroeconomic effects to external stakeholders of the firm in a way that should foster further economic growth in China.

1. Introduction

Globalization involves economic and financial integration. The abolition of capital controls and the dismantling of barriers have exposed previously sheltered Chinese companies to global economic shocks. These firms' first taste of globalization will materialize in the aftermath of fluctuating rates of exchange, interest and inflation. Policy-makers in globalized countries, however, have already learned that market participants should be prepared to meet the new exposure to macroeconomic variables in due time, prior to the dismantling of capital controls (Oxelheim, 1996). Some market actors will require education and guidance in order to weather the new situation. The quality of the information available for assessment and pricing of risk should be improved. Uncertainty about the impact of macroeconomic fluctuations on

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doi:10.1016/j.asieco.2009.05.004

corporate performance will leave managers, investors and politicians confused. The price of this confusion is an increased cost of capital and a lower level of investment on a national level than it would otherwise obtain (Oxelheim, 2006).

China has recently adopted a version of the International Financial Reporting Standards (IFRS) in an effort to improve the quality of information available for the management and pricing of risk. Yet not enough time has passed to make an empirical analysis of its success. In order to gain some guidance as to the potential success of China's recent adoption of the IFRS, however, this paper analyzes the implementation of IFRS in Europe as of January 2005. Based on a reported lack of success, and keeping in mind China's current phase of transition, we claim that Chinese implementation will necessitate harsher requirements on disclosure within the IFRS framework. We present a new framework for how to understand and measure the impact of different scenarios on corporate performance. We also elaborate on how to communicate the macroeconomic effects to external stakeholders of the firm in order to increase transparency and foster further economic growth in China. While the analysis will focus on corporate transparency, the issue of the transparency of local and national policies is discussed as policy-makers form the macroeconomic playing field.

Although the terms *transparency* and *economic growth* occur frequently in any discussion of political economy, research on the link between these two phenomena is limited to only a few published studies. Interest in economic growth has a long history, while the concept of transparency has only recently appeared in both public debate and research. As an example of the increasing scientific interest in transparency, only 32 instances of the word appeared in working papers published by the National Bureau of Economic Research during 1974–2005, the first only occurring in 1993 and most appearing in working papers published after 2000 (Forssbaeck & Oxelheim, 2006). Usage increased in tandem with the development of information technology.

While the meaning of the word can vary from one situation to the next, this lack of transparency involves an information asymmetry that is pervasive. In the political context, this asymmetry often entails a difficulty in understanding current policy and an uncertainty as to what the next step may be. The price for this lack of transparency occurs as a political risk premium, which can be translated quantitatively into unrealized growth. Consequently, increased transparency in policy-making results in reduced political risk, a lower risk premium as part of the cost of capital, higher investment and increased economic growth for society as a whole (Oxelheim, 1996). Here, political risk is viewed as a macroeconomic phenomenon that affects all parties, although vulnerability may vary from one enterprise to the next.

Yet in exposure to political risk – not only vulnerability but also the risk itself – can be firm-specific. This exposure occurs when politicians intervene with programs tailored to the specific needs of enterprises, aimed for instance at attracting a specific enterprise to the country. The politicians' conduct generates an uncertainty among competitors as to who is next in line to receive such treatment, resulting in potentially radical changes in a company's competitive circumstances (Oxelheim, 2008).

In the business world, lack of transparency often transpires in communications between those who hold special insight into a company's dealings (insiders) and those who have interests at stake in a company but otherwise lack insight (outsiders). The theory on the supply and demand for company-specific information, however, is weak (Bushman, Piotroski, & Smith, 2004), and this criticism applies to an even greater degree when supply and demand are linked to economic growth (Oxelheim, 2006). Basically, access to information is regarded as a central determinant in effective decisions on resource allocation and growth (Levine, 1997).

The cost of the lack of corporate transparency appears as an agency cost and risk premium that result in a lower valuation of the company, a higher cost of capital and lower investment than it would otherwise obtain. Individual companies use various methods – including international cross-listing and/or internationalization of the board of directors – to improve their transparency relative to their competitors and lower their global cost of capital in the process (Oxelheim, 2001; Oxelheim & Randöy, 2003; Reese & Weisbach, 2002). Small and medium-size enterprises (SMEs) in developed countries as well as most enterprises in developing countries often cannot work in this manner. Politicians have therefore an interest in reducing information asymmetry at both the national and the regional level. They can work to improve transparency through the national or regional regulatory framework; if other aspects do not change, this will in turn lead to higher growth. The introduction of International Financial Reporting Standards in the EU in 2005 and in China in 2007 has been such an attempt. As a step towards improved transparency, all listed consolidated companies (with very few exceptions) in the EU and China had to change their accounting practices to conform to IFRS.

This paper analyzes optimal transparency for companies in transitional countries in general and in China in particular. The combination of the current financial crisis with the opening up of China's capital account within the context of its new economic role makes Chinese development essential for global prosperity. Like most politicians in transitional countries, Chinese politicians are assumed to be inexperienced in "reading" corporate vulnerability to macro policy changes under changing institutional settings. Indeed, this is why transparency is so important. To what extent can the current Chinese IFRS improve transparency, thereby lowering costs due to information asymmetry, improving costs of capital, increasing investment and, in turn, spurring higher economic growth? The full and immediate implementation of IFRS in China is exceptional, deviating from a deregulation process that has been experimental in design and gradual in terms of its sequencing (following the old Chinese proverb "for unfamiliar rivers, touching the stone at the river bed is the best strategy to cross the river", Child, 2001). Yet, since there is currently no information regarding the success of the IFRS implementation in China, an empirical analysis of China is not possible; hence, a second-best strategy is to undertake an analogous study of the EU's implementation. The paper focuses on a specific phenomenon, that is, the degree to which a company's performance is intrinsic rather than the result of macroeconomic fluctuations during an accounting period. Apart from the many different