'Great Wall' stands in the way of China's economic ascent

Institutional inadequacies could prevent China from achieving its full economic potential despite its breathtaking growth in the past decade.

Unless Beijing succeeds in making “deep structural reforms” of its “relatively poor quality” institutions, income per capita in China might not break a ‘Great Wall’ barrier of US$12,000, warns Ilian Mihov, INSEAD Professor of Economics.

Mihov, who co-authored a note with Professor Antonio Fatás on this topic in the March edition of the Harvard Business Review, says China has managed to sustain high growth rates in recent years despite the poor quality of its institutions. That’s because institutional quality might not be the bottleneck in achieving high growth at the early stages of development.

Mihov’s article was based on a data constructed by the World Bank in 2007, which measured institutional quality using six governance indicators - government effectiveness, regulatory quality, rule of law, control of corruption, political stability and absence of violence, and voice and accountability. The article linked these measures of institutional quality to income per capita.

For economies to break through the US$12,000 barrier, the HBR note argues that “complex organisation of production” is needed and that this is possible only with the presence of good institutions.

“If you look at the institutional quality and you then try to link it to income per capita – that is how rich a country is – we find that countries that don’t have good institutions, don’t have rule of law, have too much corruption, they can only grow about US$12,000 (in terms of income per capita),” Mihov told INSEAD Knowledge. “Before that, they can grow very fast (even if the institutional quality is not that high).”

Indeed, China’s gross national income per capita surged to US$5,370 in 2007 from US$2,340 in 2000. During this period, annual gross domestic product (GDP) tripled to US$3,280 billion from US$1,198 billion, according to the World Bank.

Mihov notes that even countries that have “command” or centrally planned economies and...
have income per capita of less than US$12,000, can grow rapidly if they implement the right policies.

For instance, totalitarian countries such as the Soviet Union and various Eastern European countries, had been growing at between five and 10 per cent a year in the 1950s and 1960s – similar to China’s economic growth in recent years.

But economic growth in the Soviet Union began to stagnate in the 1980s when its per capita income reached US$12,000 in today’s currency, says Mihov. He noted that the Soviet Union collapsed after it hit the ‘Great Wall’ due to its raft of economic problems.

Another example is Venezuela – South America’s top oil exporter – which could have been much richer today if not for its wanting institutions.

“From 1960 until 2007, Venezuela has been fluctuating between US$8,000 and US$12,000 (in terms of income per capita), obviously depending on the price of oil,” says Mihov.

“But they have never been able to grow above this level. If Venezuela had the right institutions, if Venezuela were growing like Chile, today Venezuela would have been richer than France, Germany – richer than most European countries. But instead it has income per capita of only US$11,000.”

“Right now China is at US$5,000. With the current growth rates, they will reach the wall in about seven to 10 years,” says Mihov. “At that time, if there have been no reforms, then history at least teaches us that China will stop growing. It will stagnate at these levels of US$10,000-US$12,000.”

But Mihov says he is optimistic that Beijing will undertake the necessary institutional reforms, given China’s history of surmounting challenges and the government’s political will for making the necessary reforms.

Case in point: Beijing recently took decisive action to address the current global economic recession, rolling out a 4 trillion yuan (US$585 billion) fiscal stimulus package and introducing measures to revitalise 10 key industrial sectors.

“It’s actually ironic that Western economies and policymakers probably know the lessons of the Great Depression and the need for fast policy action better than anyone else, but so far the only government that has (taken) aggressive action (has been) the government of China that announced the fiscal package … of about US$600 billion,” says Mihov.

“And now they (China) are talking about a second fiscal policy package. So in some sense the reaction in China might be, at the end of the day, the fastest and the most appropriate one compared to all the Western economies.”

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