

COMMENT

Wilful blindness will no longer do: SAMUEL PORTEOUS.

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801 words

24 September 2004

[Financial Times](#)

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Deng Xiaoping, the wily architect of China's economic transformation, recognised early on the risks inherent in opening China to the magic of market forces. Assessing the preliminary results in 1982, he proclaimed: "We need two hands - one to persist with the open-door policy and domestic economic reform, the other to fight resolutely against economic crimes."

More than 20 years later it looks like China could do with more hands. According to a recent report, tens of thousands of corrupt Chinese Communist party (CCP) members and officials fled China or "went missing" last year, taking with them hundreds of millions - if not billions - of dollars in ill-gotten gains and fuelling one of the world's worst capital flight problems. Scandals involving officials fleeing on false passports with more than Dollars 100m and little chance of ever being brought to justice have become routine. Meanwhile, more than 100,000 less mobile officials were punished for corruption in 2003.

The economic consequences are severe. Corruption has rightly been blamed for much of the resource misallocation that has crippled both China's government-controlled banks and the state-owned enterprises that they have so recklessly funded. But the CCP's leaders are well aware that the risks presented by endemic corruption are more than financial. The legitimacy of the CCP's claim to rule, and thus the stability of the country itself, may lie in the balance. The Tiananmen protest of 1989 was, after all, as much about corruption as a call for democracy.

Hu Jintao, China's president, and Wen Jiabao, the premier, have taken the challenge to heart, describing it as a "life and death" struggle for the party. Academics, the media and some vocal government auditors are engaged in what for China is a surprisingly robust national discussion on corruption. It is certainly one that would have been unthinkable a few years ago.

In response to this mounting concern - and to China's World Trade Organisation commitments in the areas of law and governmental transparency - the CCP is working on a number of reforms. These focus mainly on the relationship between government officials and the temptation-laden state-owned and private sectors. In May, for example, the CCP declared that party officials would no longer be allowed to work at state-owned enterprises. Though there are significant loopholes in the policy, it is a start. It should go some way to reassuring foreign investors who may have been deterred from investing in state-owned enterprise assets after recent scandals.

The party has also recognised the role family members in China and overseas play in corruption. In response, it is creating registries of information on party members' relatives, including where they live and what assets they hold. At the same time, foreign governments have been approached to assist in extraditing corrupt officials. In spring, George W. Bush's administration promised to bar fugitive party officials from entering the US.

Caught in the middle of all this are increasingly confused western businesses, with their intricate relations with various commercial entities that have greater or lesser links with officialdom. They are having to wake up to the fact that the days are gone when simply hiring former high-ranking officials or their relatives guaranteed carefree progress within China. More than one multinational has recently seen a once-prized Chinese catch for a seat on their board or role as a key business partner end up in custody.

The increased focus on corruption leaves practitioners of the "wilful blindness" strategy - where foreign companies leave their China operations in the hands of locals, perhaps directed by a studiously uninquisitive expat - in some disarray. Add to this pressure from home-country anti-fraud initiatives and business as usual in China becomes an increasingly risky proposition. Wilful blindness towards certain mainland Chinese clients is also becoming more difficult for western financial institutions operating outside China, as Beijing urges foreign governments to help it repatriate stolen capital by cracking down on suspicious transactions.

Beyond the new regulatory environment, more and more companies are recognising that there are fundamental commercial rationales for rooting out shady practices. Corrupt supply chains and kickbacks cost money and distort the decision-making process. Businesses - both Chinese and foreign - that avoid these practices are beginning to prosper.

In many ways, western investors and the more enlightened elements of the Chinese government are being driven to the same conclusion. Deng's famous remark that it does not matter what colour a cat is so long as it catches mice was incorrect: even in a market economy with Chinese characteristics, there is a wrong way to pursue wealth accumulation and creation.