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by Kenneth J. DeWoskin and Ian J. Stones

CORRUPTION IN CHINA has again risen to the top of many corporate agendas. This is partly in response to the growing size of MNCs in China, the growing importance of their China revenue and the growing intensity of competition for market share. But it is also a response to widespread media reports of significant fines levied by the U.S. for violations of the Foreign Corrupt Practices Act, as well as a recent OECD report expressing discontent over the poor enforcement of its multinational anticorruption covenants. Pre-emptory actions by some large corporations to purge their China organizations following internal investigations have helped move corruption up the corporate agenda. However, it is both interesting and troubling that no consensus has emerged on how to deal with the overlay of informal transactions in China's economic life.

China's central authorities appear to be stepping up their efforts. In February, Wu Guanzheng, secretary of the Party's disciplinary department, announced a campaign to step up investigations into Party officials' behavior as well as commercial business cases. Ouyang Song, deputy of the organization department within the Communist Party of China (CPC), held a press conference in July, ending an 18-month, three-phase internal education program involving 70 million Party members—the largest such program in CPC history. Even the Party's public statements make clear that this fight is not only about what kind of party they want, but their continued viability and dominance.

China's long hot summer has not been pleasant for many officials. To name just a few celebrity expulsions: On June 9 Beijing Vice Governor Liu Zhihua, in charge of lucrative Olympic construction, was removed; last month, Wang Shouye, former deputy commander of naval forces in the Chinese People's Liberation Army (PLA), was expelled from the national legislature for economic crimes; and Liu Zhixiang,

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Family members react to the guilty verdict for reporter Yang Xiaoqing, convicted in June this year for exposing official corruption.

former deputy director of the Wuhan Railway Bureau and brother of the current Minister of Railways, Liu Zhijun, was given a suspended death sentence for corruption-related crimes. Another vice mayor, and the executive vice president of the Beijing Organizing Committee for the Olympic Games (BOCOG), Liu Jingming, along with the heads of 23 BOCOG departments, signed a pledge to combat corruption within days of the sacking.

Commercial crime is being addressed with increased urgency. In June of this year, an audit of the Agricultural Bank uncovered $6.45 billion in irregularities, leading to the firing of 64 employees and disciplinary action against 1,300 more. More than $1 billion was involved in serious criminal cases and $3.5 billion in irregular loans. The banking sector is the epicenter of large scale commercial corruption. As a result of the disclosures at the Agricultural Bank, the Chinese Banking Regulatory Commission announced measures to fight corruption and fraud in banks, co-operative credit units, trust firms and asset management companies.

In May, the Central Commission for Discipline Inspection for the first time released figures on its work since it launched an interdepartmental team to tackle bribery in February. It reported receiving leads in more than 9,000 cases of commercial bribery, opened probes into 4,367 of them, is preparing indictments on 1,195 cases and has passed more than 674 cases to the courts. The PLA has been very public this year as well about newly invigorated investigations into procurement and business corruption within its ranks.

Measures to protect minority shareholders' interests are being introduced by China's stock exchanges. In an unprecedented move, the Shanghai and Shenzhen exchanges in June published a list of 189 publicly traded companies with a total of $4.2 billion misappropriated by big shareholders and affiliates. The list came two days after the China Securities Regulatory Commission issued a notice ordering misappropriated money at publicly traded firms be repaid at a faster pace. Companies are put under market pressure and finding their credit reduced, while judicial measures are being considered by the Supreme People's Court to bring criminal charges against embezzlers of funds from publicly traded firms.

Judicial reform has been taking place alongside anticorruption drives. A basic flaw is that top court officials in every jurisdiction are mainly appointed by, and are responsible to, the local party and government. Because local economic interests are often at stake, serious interference by local officials in judicial proceedings has led to the appointment of Supreme Court judges to lower courts.

Corruption and the fight against it always engender political tensions between the central government and the provinces, as well as between the provinces and the locales. In China there is an historic sense of entitlement that goes with high office, and in this gray area the issue was primarily about proportion. Customs officials attracted punishment only when their expropriations became disproportionate to what they produced for the higher levels. The extent to which individual judgment determines every step of indictment, inves-

> *Foreign businesses operating in China are caught in a paradox, pitting ethics against potential growth.*

tigation and adjudication makes each of those steps very political.

Whether there is a genuine escalation of anticorruption activities by the Party or primarily an energetic campaign to publicize them is difficult to determine. And whether the campaign, if more significantly energized than previous campaigns, is really achieving its goals, is likewise hard to gauge. The CPC expelled 44,738 members in 2005 who "failed to meet Party requirements," slightly down from the 49,000 expelled in 2004. But an overarching theme is that stronger and more objective legal processes are now being installed. This indeed would be welcomed by domestic and foreign interests alike.

Viewed from the ground, one often finds sympathy for the cause of reducing corruption, but pessimism about the prospects. Some officials in private simply say that corruption is so deeply rooted in the fast-growing economy, and its fabric so tightly interwoven, that it is difficult to discern whether things are improving or degrading. Most agree that this is not a battle to be won in some definable time frame; rather, it is a very long march. It is clear in China that corruption is part of the marketization process, and some economists argue it is an important precursor to a more open marketplace. We understand that the growth of corruption and the fight against it are both entangled in the details of economic reform policy and practice.

At the top, the Party's efforts to curb corruption focus on the CPC's immediate interests, and these are, at the core, different from those of foreign investors. An important point, not to be lost, is this: Since reforms began, the biggest victims of corruption in China, after the people themselves, are the Party and the state, by almost any measure.

From the establishment of the Contract Responsibility System in the early 1980s to the recent surge in domestic mergers and acquisitions, no amount of ingenuity has been spared in devising ways to convert rural land and developed property, and divert industrial assets and their earnings, away from public ownership and into the hands of politically connected private parties.

The majority of the CPC disciplinary cases of the last several years focus on economic crimes related to asset conversion, especially property and land sales, involving collusion among local party officials, local developers, and local banking authorities. Although China's top auditor, Li Jinhua, has described these schemes, no one has put a number to these losses.

In fact, these ubiquitous practices contribute significantly to the twin crises of bad lending and overheated property investment, both driven by the promise of illicit private gain as well as real commercial potential. So their damage to the overall dynamics of quality growth in China is highly geared. The real cost of corrupt conversion in China is likely to be in the same ballpark as the aggregate cost of poor quality bank lending and NPL generation and overheated property development.

But irregular asset conversion is not the corruption plague that increasingly worries foreign investors. Their troubling issues focus on the domestic trading systems, not the conversion of capital assets. With the final phase-in of China's WTO commitments, foreign investors are taking advantage of new regulatory space to build capacity in sourcing, distribution, and sales. Deepening involvements in trade channels bring them face to face with pervasive corrupt trade practices.

In many cases, MNC brand owners operating in China feel the grip of a paradox, pitting necessary global business practices and ethics—not to mention legal obligations—against bountiful potential business growth in many of China's most enticing domestic markets. As foreign-invested business interests go downstream, this paradox will become increasingly intense.

For foreign investors, one thing that bears careful observation is the direction that impending remedies created by the CPC and the state might take. They have the potential to bring relief, but anticorruption reforms also have the potential to create new risks and market challenges. Nothing illustrates this better than the campaigns launched in early spring to rectify markets for medical equipment, supplies and pharmaceuticals.

Kickbacks for buying agents, mandated consultants, sales agents and distributors, as well as other forms of corruption have distorted China's healthcare markets for at least a decade. As a third-party payer, the state is also a victim here, but a genuine concern about the affordability of health care for private as well as publicly funded channels demands action. One media report estimate suggested that as much as 20% of capital equipment costs to hospitals represented kickbacks to procuring agents and hospital directors. That would be an overcharge of nearly $350 million on this year's projected equipment spending of $1.7 billion. The situation is even worse in the much larger pharmaceutical markets.

As part of the price regulation discussion, regulators are showing interest in the underlying cost of manufacturing and have views on what they consider acceptable margins. The problems for MNCs are obvious, not the least of which is a potentially intrusive examination of exclusive processes, exposing intellectual property, or accounting for the $1 billion-plus tab to bring a new drug to market in a deemed "manufacturing cost." In the medium and long term, these policies could turn major pharmaceutical companies away from China or have a potent simulative effect on the growth of legal and illegal generics.

While the details of the rectification campaign are being worked out, equipment manufacturers already report a sharp downturn in the market. New processes stall deals, and political risk for officials has now become a factor in approving purchases. The longer term impact could be positive or negative, depending now on the quality and integrity of individual provincial authorities, who could become unchecked players in equipment sales.

The real answer lies, at the moment, in an ideal not yet fully achieved in China but arguably within reach. That is a market dynamic in which quality, reliability, transparency, and fair pricing are decisive in winning business, and both the buyer and seller live by that dynamic.

From the standpoint of MNC brand owners, short-term underperformance can be offset with medium- and long-term benefits from effective development of high performance organizations with strong controls and clear value proposition to the market. A clean channel should also become a powerful factor. It is not premature to begin building that capability and reputation.

From the standpoint of the government, reform will have to progress at an accelerated pace. A larger measure of trust will have to be invested in market mechanisms, and more and more of the state's direct administrative controls over large enterprises will need to be relaxed. The separation of regulator and operator will need to advance and regulators will have to become more effectively shielded from an array of other pressure, economic and political. These are the critical reform issues where the interests of China's governing Party and foreign investors converge again. ■