

Systemic Irregularity and Spontaneous Property Transformation in the Chinese Financial System*

X.L. Ding

Although the Chinese leadership and international observers disagree on many things about China, they share at least one assessment: corruption has penetrated China's public sector, and the state financial system is among the worst examples. In Transparency International's *Corruption Perception Index* released annually since the early 1990s, China has been placed either into the bottom group ("the most corrupt") or at the lower tier ("more corrupt than the majority").¹ During the Asian financial crisis *The Economist* even called the Chinese state banks "the worst banking system in Asia."² The Communist Party leader Jiang Zemin, when addressing a 1996 general meeting on Party discipline, marked several domains as the "major problem area" where big corruption and crime cases concentrated, and the financial sector topped the list.³ The Prosecutor General, in his 1998 work report, urged law enforcers to pay special attention to the abuses of power by financial officials.⁴

This article explores the main forms of corruption in the state banking system by focusing on how the bank management surreptitiously transform bank assets into their private wealth. Some methods are unambiguously illegal, but many are in the grey area ranging from informal to illicit. That is why "irregularity" instead of "illegality" is used in the title. "The bank management" refers primarily to those working within financial bodies but also includes some government officials overseeing them.

The bank management's spontaneous and irregular asset transformation requires scrutiny because it has been pervasive, threatening the state banks' financial health and undermining their regulatory capacities. The main findings are that bank insiders' pervasive asset abuse and looting during the 1980s and 1990s have been the joint effect of poor institution-building and opportunist behaviour encouraged by it. Under rapidly changing economic conditions, inadequate institutions, systemic irregularity and managerial corruption reinforce each other, forming a symbiotic relation.

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1. For details visit < <http://www.transparency.de/documents/cpi/index.html> > .

2. 2 May 1998, p. 2.

3. Zhongjiwei Yanjiushi (ed.), *Liuzhongquanhui zhuanji (Documents of the Sixth Plenary Meeting)* (Beijing: Zhongguo fangzheng chubanshe, 1996), p. 5.

4. *Renmin ribao (People's Daily)*, 24 March 1998, p. 3.

Here the difference between formal and actual institution formation should be noted. In political-economy literature there are two competing views of institutions. One can be called “the rules view,” in which “social or economic institutions are seen as sets of rules that constrain individual behaviour and define the social outcomes that result from individual action.” The other one, “the behavioural view,” interprets “social institutions not as sets of predesigned rules, but rather as unplanned and unintended regularities of social behaviour (social conventions) that emerge ‘organically’ ... The rules are not as important as the behavioural regularities that players establish given the rules.”⁵ As this study investigates a family of problems arising from the contradiction between an outdated regulatory framework and the fast-marketizing Chinese economy, it adopts the dynamic perspective that “institutions are complex bundles of formal and informal rules.”⁶ Attention is primarily paid to the dialectical interaction between rules and managerial misconduct.

Data

This article is mainly based on three case collections obtained through fieldwork during 1997–99. The first two contain 289 (summarized in Table 1) and 120 (Table 2) cases respectively. They were supplied to the Supreme People’s Procurate (SPP) in 1996 by the nation-wide procuratory system, because economic crime had risen rapidly with many forms being unfamiliar to judicial personnel. It was necessary to provide them with a body of concluded cases to serve as judicial precedent, despite the fact that the Chinese legal system was not exactly in the common law tradition. The case compiling started in 1994, with every provincial procurate taking part. The two collections were selected by the SPP from a pool of 4,000 cases, based on the criterion that the chosen ones must be “complete and representative.”⁷ The information covers the late 1970s to 1993.

The SPP’s data appear biased. Cases involving senior officials or huge funds were almost absent, perhaps because they were politically too sensitive. The third collection (summarized in Table 3) compiled by this researcher was intended to compensate for these omissions. About 30 Chinese periodicals on Party discipline and law enforcement were surveyed. These publications, mainly serving cadre training at the central and provincial level, regularly included details of corruption and economic crime cases, including significant ones, in which the financial system was highly noticeable. Because of the immense number of such

5. Andrew Schotter, “The evolution of rules,” in Richard Langlois (ed.), *Economics as A Process* (New York: Cambridge University Press, 1986), pp. 117–18.

6. William Riker and David Weimer, “The political economy of transformation,” in Jeffrey Banks and Eric Hanushek (eds.), *Modern Political Economy* (New York: Cambridge University Press, 1995), p. 99.

7. Luo Ji (ed.), *Tanwu zui (The Crime of Embezzlement)* (Beijing: Zhongguo jiancha chubanshe, 1996), pp. 1–7; Ye Huilun and Yu Bin (eds.), *Nuoyong gongkuan zui (The Crime of “Temporarily Misappropriating” Public Funds)* (Beijing: Zhongguo jiancha chubanshe, 1996), pp. 1–2.

cases, it was decided that the entry level for a theft case in Table 3 was 100,000 *yuan*, equal to the total of 80 urban employees' average annual salaries in the mid-1980s and the total of 30 in the mid-1990s. The entry level for a case in unauthorized use of bank funds in Table 3 was 500,000 *yuan*. Overall 172 cases were compiled, and the information covers from 1984, the beginning of urban reforms, to 1997, the end of the Deng era, but concentrates on the 1990s. Recently exposed major financial irregularities indicate that Beijing is far from stopping bank insiders' illicit asset capture. So the analysis remains largely applicable to the immediate post-Deng period.

Terminological Distinctions

There are two basic patterns of irregular privatization of financial assets, *nuoyong* and *tanwu*, upon which numerous variations have flourished. Although in English both are generally rendered into "embezzlement," in Chinese laws and regulations they have substantive differences, reflecting meaningful disparity between property-rights protection in mature market systems and that in a transitional system.

In brief, *nuoyong* is legally defined as an act which temporarily diverts a public financial asset from its formally designated use into a different destination, with demonstrable evidence that the perpetrator plans to return the asset to its lawful position shortly. In contrast, *tanwu* is defined as an act which decisively alters the ownership status of a financial asset from public to private. While the former is, as far as the Chinese authorities see it, temporary illegitimate utilization, the latter is plain theft.⁸ Based on these considerations, this article retains "embezzlement" as the translation for *tanwu* but renders *nuoyong* as "temporary misappropriation."

A caveat: the restrictive word "temporary" is somewhat tricky in the current context, for virtually all perpetrators claim, understandably, that they never intended to misappropriate public funds for long and that they failed to retribute them simply because conditions went beyond their control. Thus, how to define "temporariness" and consequently how to tell "temporary misappropriation" from outright theft is a tough legal question, and provides a main source of institutional ambiguity and irregularity. For this reason, the translation "temporary misappropriation" will be kept in quotation marks when used.

Embezzlement: From Sporadic to Systemic

Stealing public property is not new to China or any society with a sizeable public-sector economy.⁹ What makes the financial system out-

8. See discussions in Luo Ji, *Embezzlement*, pp. 16–50; Ye Huilun and Yu Bin, *Misappropriating*, pp. 1–46.

9. Cf. Gregory Grossman, "Sub-rosa privatization and marketization in the USSR," *Annals of The American Academy*, Vol. 507 (1990), pp. 44–52.

standing among all Chinese state industries is the magnitude with which the purloining of public property has occurred. By the mid-1990s, embezzlement had almost become a systemic feature of the financial sector, a fact even Beijing is inclined to admit.¹⁰ Investigations reveal that in 1989, the average monetary value per embezzlement case in one of the four big state banks was 14 times the national average.¹¹ The Jiangsu Legal Institute in late 1996 examined all the 362 funds-capture cases in the province's financial system filed from 1993 to June 1996. The average amount per case was 154,000 *yuan* in 1993, 348,000 *yuan* in 1994, 453,000 *yuan* in 1995 and 718,000 *yuan* in the first half of 1996, a 466 per cent increase over the period.¹² The sectorial distribution of the embezzlement cases in Table 1 shows that within the top two categories on the right, where a single case involved 100,000–500,000 *yuan* or more, the financial sector was well represented, with a dominant position in the biggest-amount category. This pattern becomes more conspicuous when the data of Table 3 are incorporated.

Of embezzlement devices, insider-outsider conspiracies have been the most effective method of siphoning off massive bank funds. Most big schemes owed their success to the insiders' exploitation of the primitive asset-control regime long practised by the banks. For instance, in the four separate operations that seized 30 million *yuan*,¹³ a common core component was that the staff asked artisans to counterfeit the chops of a public-sector body which had a large deposit in the bank. Financial papers stamped by those chops are the essential proof for making transactions in the organization's account. But manufacturing them is technically simple, and one can make an order by paying a moderate fee of, say, 800 *yuan* to artisans who are widely available on the streets.¹⁴ Of course, it is not easy for a stranger to transfer a large sum away from a corporate account, as the bank staff can ask for supporting documents of identity in addition to the chops, plus making verification calls to the corporate depositor. But when the agent is the bank's employee, a key to the security chain is broken. All the bank insider needs to complete the operation is a payee's bank account, which ought to be a corporate body's. (In the above-mentioned four cases, the insider-agents were all

10. See a conference report on China's financial risks, *Banyuetan (Semi-monthly Comments)*, No. 2 (1999), pp. 21–23.

11. Bai Jianjun, *Jinrong qizha ji yufang (Financial Fraud and Prevention)* (Beijing: Zhongguo fazhi chubanshe, 1994), p. 1.

12. Zhongjiwei yanjiushi (ed.), *Ziliaoku 1995–1996 (Material Collections 1995–1996)* (Beijing: Zhongguo fangzheng chubanshe, 1997), pp. 155–160.

13. Cases 17, 25, 28 and 47 in Table 3. All the cases so marked in the article are from the author's collection summarized in the table. It is impossible to detail the cases' sources here, but they are available upon request. A few cases are presented below with the necessary details to illustrate typical patterns of irregular property transformation.

14. Under government regulations, a licensed chop-maker must see a written authorization by a local government office when taking an order for organizations' chops. But since the mid-1980s many private operations, mostly run by a single artisan, have entered the chop-making business. They can make a good income largely by providing services to dubious customers. Chinese journalists informed the author that in south-east cities like Shenzhen and Haikou, one can even purchase sham chops of ministries at the price of 2,000–3,000 *yuan* per piece. The quality of these shams varies considerably.

Table 1: Summary of the SPP's Data on Embezzlement in China, 1978–1993

	<i>Case distribution by sector</i>	<i>Cases 50,000 yuan or less</i>	<i>Cases 50,000– 100,000 yuan</i>	<i>Cases 100,000– 50,000 yuan</i>	<i>Cases over 500,000 yuan</i>
State financial institutions	70 (100%)	22 (31.4%)	14 (20.0%)	21 (30.0%)	13 (18.6%)
State and collective enterprises	145 (100%)	75 (51.7%)	19 (13.1%)	38 (26.2%)	13 (9.0%)
Government organs	33 (100%)	21 (63.6%)	5 (15.2%)	6 (18.2%)	1 (3.0%)
Total	248 (100%)	118 (47.6%)	38 (15.3%)	65 (26.2%)	27 (10.9%)

Source:

Luo Ji (ed.), *Tanwu zui (The Crime of Embezzlement)* (Beijing: Zhongguo jiancha chubanshe, 1996). The table omits 41 cases in the collection that were dropped after court deliberation, were not of an embezzlement nature or occurred before 1978.

Table 2: Breakdown of the SPP's Data on "Temporary Misappropriation" in China, 1979–1993

<i>Cases each involving</i>	<i>Case distribution by volume</i>	<i>State financial institutions</i>	<i>State and collective enterprises</i>	<i>Government organs</i>
500,000 <i>yuan</i> or more	15 (100%)	13 (86.7%)	2 (13.3%)	0 (0%)
100,000 to 500,000 <i>yuan</i>	36 (100%)	18 (50.0%)	15 (41.7%)	3 (8.3%)
100,000 <i>yuan</i> or less	51 (100%)	16 (31.4%)	27 (52.9%)	8 (15.7%)
Total	102 (100%)			

Source:

Ye Huilun and Yu Bin (eds.), *Nuoyong gongkuan zui (The Crime of "Temporarily Misappropriating" Public Funds)* (Beijing: Zhongguo jiancha chubanshe, 1996). The table omits 18 cases in the collection that were dropped after court deliberation.

Table 3: Breakdown of the Author's Data on Embezzlement and "Temporary Misappropriation" in the Chinese Financial System, 1984–1997

<i>Case distribution (%)</i>		
<i>By bank</i>	<i>By region</i>	<i>Total</i>
Industrial & Commercial Bank: 20.9	Southern: 33.1	Cases: 172 (100%)
Construction Bank: 16.9	Central: 22.7	Volume: 7.7 billion yuan (100%)
Agricultural Bank: 16.3	Eastern: 19.8	Volume shared by embezzlement: 10%
Bank of China: 11.6	Northern: 9.3	Volume shared by "temporary misappropriation": 90%
Central Bank: 7.6	Western: 9.3	
Bank of Communications: 2.9	North-eastern: 5.8	
Other financial institutions: 23.8		

Note:

"Other financial institutions" refer to the state banks' spin-offs such as trust and investment companies, securities firms, insurance corporations, and credit societies.

Source:

Author's fieldwork.

successfully assisted by their conspirators' corporate accounts.) Sometimes, the bank insiders even helped outside swindlers to fake their own bank's chops, making repeated illegal transactions easy. In a recently substantiated case, the perpetrator, a deputy director of the Bank of China's branch in Yingyang, Henan province, provided the branch's chops for a businessman to make imitations. From 1995 to 1997, the two swindled 360 million *yuan* from several bank branches (Case 1).¹⁵

For the insiders planning to siphon off large sums from state banks, inter-bank or inter-branch transfers across vast regions are a fertile source of funds, because the outdated procedures and techniques in the banking system make detection slow, giving the agents enough time to finish the job. To carry out the plans, an insider must have all these in hand: the bank cheques specially used for inter-bank or inter-branch transfers, access to the bank's chops validating the cheques, and knowledge of the secret code verifying a large payment by a bank cheque. According to the regulations, these items must be kept separately by different staff in a bank branch. But as numerous cases demonstrate (for example Cases 6, 19 and 63), the bank insiders could obtain these either by acting as a syndicate or by stealing. In these three cases, the bank employees siphoned off 76 million *yuan*, with some managing to repeat operations over ten months before being noticed, signifying the quality of the internal asset-control regime.

The problem with that regime is not merely that its set-up is primitive, but that even its outdated prescriptions are not always complied with. In Case 6, a staff member of the Industrial & Commercial Bank's branch in Haikou, in his capacity as the keeper of the bank cheques for inter-branch transfers, diverted the proceeds of 29 of the cheques between February and October 1992 and delivered 33 million *yuan* to his crime partners. The branch had not been aware of any unauthorized cheque clearances until it received a verifying call from an overseas business; within the bank branch no one had ever checked the bank cheques during the nine months.

Routine inspections, however, do not necessarily mean effectual detection. For example, a manager of the Construction Bank's branch in Huhehot, Inner Mongolia, helped his colleagues steal 2.5 million *yuan* bank funds in 1992. The scheme was later exposed because the police were investigating another crime. When asked why their repeated operations over seven months had not been discovered by regular superior-level inspections, the manager explained: "The inspectors always informed us of their visits in advance; so every time I showed them the correct accounts and hid those with big problems. Then we took them to fancy restaurants to get them drunk. Afterwards, they only wanted to sleep: no more questions would be asked about the accounts" (Case 159).

Habitual irregularity in the enforcement of primitive control procedures

15. For more details, see Ju Bin (ed.), *Fantan gonggao (Anti-corruption Files)* (Beijing: Economic Daily Publishers, 1999), pp. 287–306; cf. "No haven for China's crooks," *Washington Post*, 16 October 1998, p. A29.

gives the bank management many opportunities to transport public funds into their pockets unlawfully. In Case 24, a junior manager at the Haikou Credit Society took 7 million *yuan* from the institution over eight months by falsifying account sheets 24 times. It would have been impossible for him to repeat these rudimentary thefts for so long if there had been a minimum level of rule-enforcement within the office. This was his confession: "It's so easy to seize public money. You waste your chance if you don't do it."

In major embezzlement cases, there is often a special kind of outsider co-operation giving assistance to bank employees to move abroad after the success of their "joint venture" in stealing bank funds. These outsider partners are mostly ethnic Chinese, hold foreign passports (real or fake), and have a base in overseas Chinese communities in Asia or the Americas.¹⁶ Of the 101 financial fraud cases compiled by Beijing University Centre for Banking Laws, which covered up to the early 1990s, at least 28 had overseas co-operation.¹⁷ Some of the outsider partners are ex-employees of the Chinese state banks, and their overseas identities (acquired later) are instrumental in switching bank funds into their hands.¹⁸

Costs to Public, Profits to Private

"Temporary misappropriation" in the state banks has been executed in various styles. The most forgivable kind, from the perpetrator's standpoint, is when the earmarked public funds get diverted into a different public-sector body's project from the formally specified one, such as moving from a transportation project to a local government-owned hotel business. It is less forgivable when, for example, the managers of a bank branch shift funds earmarked for modernizing inter-regional infrastructure to the building of public housing in the area where the bank staff live. It becomes punishable if bank managers use public funds to finance their private business secretly without paying the government proper interest. Most "temporary misappropriation" cases documented in Chinese legal files after 1978 lie in this last category, because the first two types are not regarded as punishable conduct unless grave financial loss is incurred by the government.¹⁹ For example, the Hebei provincial branch of the central bank was short of funds to construct new office

16. For comparable developments in China and Russia, see X.L. Ding, "Informal privatization through internalization," *British Journal of Political Science*, Vol. 30, Part 1 (2000), pp. 121–146, and Vladimir Tikhomirov, "Capital flight from post-Soviet Russia," *Europe-Asia Studies*, Vol. 49, No. 4 (1997), pp. 591–615.

17. Based on Bai Jianjun, *Financial Fraud*; the frequency is calculated by this researcher.

18. In Case 3, which incurred a loss of 400 million *yuan* to the Bank of China's branch in Zhongshan, Guangdong province, one of the two Macau partners was an ex-staff member of the bank branch and remained a close friend of its managers after she had settled in Macau. The other Macau partner ran a property company linked to the Zhongshan city government. The two absconded with the money in April 1995, and the branch managers tried to shift all the responsibility to the fugitives. Here again we observe the parallel between state bank managements in China and in Russia; see "Just follow the money," *Newsweek*, 29 March 1999, pp. 40–41.

19. Ye Huilun and Yu Bin, *Misappropriating*, pp. 17–19.

buildings and staff dormitories. The management decided in October 1992 to switch 100 million *yuan* bank funds secretly to coastal areas for the property venture, which, a retained property agency promised, could bring a return of 50 million *yuan* in one year's time, sufficient to supplement the construction expenditure. However, this operation was exposed in April 1993, and the central government imposed an "administrative demotion" on the branch president. Despite the magnitude of the diverted funds, the discipline was very gentle, because the act was seen by the higher authorities as "benefiting the bank branch as a whole" rather than individual managers;²⁰ that is, it was "temporary misappropriation" of either the second or the first type, not the third.

Ways of organizing "temporary misappropriation." There are basically three ways in which the agents organize themselves: a bank staff member carries out a programme alone; the management of a financial institution acts as a whole; or something in between, namely, part of the management acts in close co-operation. The first type is like any ordinary crime, and both its advantages and disadvantages are obvious. The perpetrator can keep all the returns on the underhanded investment made with bank funds, but will run into trouble if the operation is discovered by colleagues, who are excluded from the endeavour and thus motivated to report on it. This "individualistic" way of "temporary misappropriation" is more suitable for bank staff such as accountants, heads of small branches and computer programming personnel, for they control a relatively enclosed area of banking.

The second type of "temporary misappropriation" reveals more about the systemic problems in the financial sector. In the numerous instances recorded in Table 3, the bank managers utilized public funds to generate private profits in a way similar to their conduct of official business. They held meetings over the investment proposals, discussed implementation details, designed the division of labour among themselves and arranged for the distribution of profits. The main things distinguishing the scheme from official business are that they did not record the transaction details on formal accounting sheets, and they did not hand over the earnings to the state banks but split them among themselves.

Compared with the individualistic way of "temporary misappropriation," the syndicate way has an obvious disadvantage: the gains have to be collectively shared. But the advantages are greater, and chief among them is that the perpetrators can mobilize organizational muscle for their self-protection. During the execution of a "temporary misappropriation" programme they can cover it up under the façade of an official body. If exposed, they can either diffuse the responsibility within complex hierarchies or collectively take the blame, thus significantly reducing the severity of punishment for each individual. Chinese laws and Party discipline have not developed sufficiently, at least up to 1999, to cope

20. Li Xueqin (ed.), *Xin Zhongguo fanfubai tongjian (History of Anti-Corruption in New China)* (Tianjin: Renmin chubanshe, 1993), pp. 732–33.

with “temporary misappropriation” programmes carried out by an official organization as a whole, a phenomenon labelled *jiti weiji* (“the collective as an offender”) or *danwei fanfa* (“a unit’s breach of law”).²¹ The benefit of so acting is tremendous. For example, the management of the Bank of China’s branch in Puqi, Hubei province, were engaged in syndicated diverting and stealing of public funds. A bank employee disagreed with the managers but was suddenly removed from a key position permitting him to learn about the operations; the situation quickly got under control. From 1988 the branch had even enjoyed the “model work-unit” status, until early 1995, when 10 million *yuan* that had been illegally switched to Hainan could not be restituted (Case 94).

The third way of organizing “temporary misappropriation” displays features of both individualistic and syndicate approaches, but resembles more the latter. When a fraction of a bank branch’s staff is switching public funds into private investment, close co-operation between a senior manager and an accountant is typical, as confirmed by a 1995 legal survey,²² for the former is empowered with administrative discretion and the latter provides technical assistance.

Principal investment spheres. Personnel of financial bodies rarely use diverted bank funds to finance production activities; their private investments concentrate on the stock market, real estate and grey-market trade, plus some underground economic activities. All are, in the Chinese business environment during most of the 1980s and 1990s, wildly speculative and volatile. Several interrelated factors explain this investment pattern. For the bank staff who have moved big bank funds from here to there without going through the legitimate procedures, the duration for underhand utilization is uncertain. Investing funds in manufacturing industries would involve time-consuming production circles. But funds put in the above-mentioned tertiary businesses could be pulled out quickly when necessary. More importantly, most trust and investment companies, securities and futures trading firms have been organized by and linked to the state banks. Hence, the banks’ staff enjoy monopolistic advantage such as privileged information and inside trading when playing on the markets.²³

But all these factors would be much less meaningful to the bank management if the following reason did not exist. This is, as a popular Chinese saying satirizes it, *Guojia fukui, yinhang fuzhai, jingli fuying*, meaning “the state takes care of losses, the bank takes care of debts, and the manager takes care of profits.” It is chiefly this mechanism that disproportionately distributes risks and gains between the owner-state and the managers of state financial institutions, which means that the latter are motivated to invest boldly in extremely speculative and volatile ventures.

21. See legal discussions summarized in *Yanjiu wengao* (*Draft Research Reports*, hereafter *DRR*), No. 15 (1994), pp. 12–15; *Chinese Youth Daily*, 27 July 1999, p. 2.

22. *Renmin ribao*, 21 December 1995, p. 2.

23. *Jingji yantao cankao* (*Economic Research Sources*, hereafter *ERS*), No. 44 (1995), pp. 40–41; *Jingjixuejia xuexiziliao* (*Economists’ Study Material*), No. 55 (1993), pp. 2–26.

Paul Krugman remarks that in the Asian countries recently in financial crisis, “too many people seem to have been granted privilege without responsibility, allowing them to play a game of ‘Heads I win, tails somebody else loses.’”²⁴ Too many Chinese financial officials are truly masters of this game.

Topping Chinese bank staff’s list of investment priorities is the stock market. About 30 per cent of the “temporary misappropriation” cases in Table 3 were in this domain. During January–October 1994, 93 cases were detected at the Shanghai Stock Exchange, and overall more than 150 million *yuan* of public funds were found to have been “temporarily misappropriated” to generate private profits.²⁵ But record-breaking news in this domain keeps flowing in. In a single scheme uncovered in 1999, two bank managers in Zhengzhou city, Henan province, had “temporarily misappropriated” some 200 million *yuan* to trade stocks in 1997–98.²⁶

Despite these impressive figures, what has been exposed is merely a tiny corner of the big black box, because bank staff seldom get punished if they win on the stock market and can quickly return the secretly mobilized funds. They get caught only when they have lost so much for so long that the hole they have made in the public-funds account becomes impossible to cover up.²⁷ For instance, in 1994, a divisional head of the Construction Bank’s branch in Nanjing city secretly transferred huge bank funds to trade in stocks and futures. He made 15 million *yuan* of profits and kept all as personal income. He would have been trouble-free had not later his colleagues issued loans to a Hong Kong swindler and failed to claim them back. This scandal further exposed 144 personnel in the municipal financial system (including the divisional head), who all had “temporarily misappropriated” bank funds for futures trading (Case 20). More revealing is the confession of a manager of the Agricultural Bank’s securities company in Shanghai. She “temporarily misappropriated” 10 million *yuan* bank funds to trade in stocks and bonds, incurred 1 million *yuan* losses in early 1994 and thus was caught. When questioned why she had done it, she responded: “I would not have done it if I knew the legal consequences. It’s so common in the securities industry; I just did what others had been doing every day” (Case 126).

Real estate is another main sphere for the bank management to make vast profits with diverted bank assets. It gained momentum especially in the early 1990s, when several factors spurred property speculating. These included the scheduled handover of Hong Kong and Macau to China; the expected opening of direct transport lines between Fujian and Taiwan; rumours about Beijing’s move to make Hainan island a free port; and the implementation of industrial park projects (the largest being Pudong, Shanghai). So, funds moved to these regions from all over China. Earlier, the banking sector was estimated to have mobilized some 50 billion *yuan*

24. Quoted from *Fortune*, 2 March 1998, p. 21.

25. *Tequ fazhi* (*Special Zones’ Judicature*), No. 7 (1995), p. 2.

26. *Huasheng bao Electronic Edition* (hereafter *HBEE*), 1 April 1999.

27. See a seven-province conference briefing in *Renmin jiancha* (*People’s Procurator*), No. 5 (1994), pp. 36–37.

for off-plan ventures on the property markets from 1991 to April 1993.²⁸ But later investigations proved that during that period Hainan-based financial bodies alone issued some 90 billion *yuan* credits for property and stock speculation.²⁹

In the boom time of 1992–93, average returns to property ventures could be as high as 120–150 per cent, and profit rates of 50–80 per cent were considered “acceptable” in places like Hainan.³⁰ State financial bodies entered property speculation either by organizing wholly self-owned developers (often hiding their corporate identity behind a puppet management), or by forming consortia with developers run by local governments or foreign interests. An alternative to these direct engagements was bank managers simply issuing undercover short-term loans (usually for less than 12 months to evade yearly inspections) to property agencies and demanding a dividend, ranging from 30 per cent per annum to 15 per cent per month (according to the cases in Table 3). Of course, most of those usurious profits were kept by the bank management in private.

Trade is also an important investment sphere. Bank funds so used are typically for a single deal or a brief operation. Although the majority of such cases in Tables 1 and 3 were related to grey-market trading of scarce goods, evidence also shows that some bank staff used diverted funds to finance smuggling and the sex business.

Techniques of “temporary misappropriation.” Why is it possible for the bank management to put bank funds into irregular uses so systematically, so often and on such a large scale? Undoubtedly, the key is the lack of effective, sophisticated monitoring mechanisms within and around the state banks. To begin with, it must be borne in mind that banking in China is a government monopoly, which goes a long way towards explaining many strange relationships between the financial sector and the rest of the economy if viewed from normal market economics. The irregular banking practices in many Asian economies exposed during the 1997–98 crisis make it easier to comprehend the Chinese story. In most parts of the banking sector, the situation in China has been indubitably worse.

Falsifying the borrower’s identity is bank staff’s basic scheme for “temporary misappropriation.” In this respect, China shares much with other transitional economies, where fraudulent insider lending is commonplace.³¹ When the actual borrower is a bank manager himself or his kin and the lending violates the rules, he can get around this by persuading a state firm or a governmental agency to act as the ostensible borrower, or by using a public-sector body’s title without informing it, or even by making up a business name as the debtor. Those organizations

28. *ERS*, No. 133 (1995), p. 22 and No. 93 (1996), pp. 29–31; *DRR*, No. 20 (1994), p. 12.

29. *Xinshiji (New Century)*, No. 9 (1998), pp. 2–4.

30. Interviews in Haikou, November 1995.

31. Sweder Wijinbergen, “Enterprise reform in Eastern Europe,” *Economics of Transition*, Vol. 1, No. 1 (1993), pp. 31–33.

whose names are so abused rarely dare offend the bank manager if the abuses do not cause substantial trouble for them. In any event, they can expect to be treated favourably by the bank manager in return.

“Temporarily misappropriated” funds may come from business earnings a bank branch has hidden from superior levels. Management of financial bodies have been widely engaged in under-reporting earnings and subsequently use these to support illegitimate consumption and investment. Bank assets may also be “temporarily misappropriated” from an investment fund a bank branch designs for its portfolio operations. Under this situation the fund manager uses it regularly for a dual purpose: the same money is simultaneously injected into capital markets for the branch and the manager himself. When there is a positive return on the investment, the manager claims a handsome portion; when the result is negative, he bears no cost at all. To do this, the manager needs to register his personal investment account under a false name, thereby routinely altering the transaction records.³²

From the late 1980s, bank management began setting up countless spin-offs to increase channels for “temporary misappropriation.” Those spin-offs have extensively spread in financial services, futures trading, jewellery and the gold trade, and so on, and concentrated in loosely regulated regions such as Hainan and Shenzhen.³³ Where the state bank itself is bound by government regulations, the managers first inject bank funds into the affiliates and then use them freely. An illustrative example is the president of the Shanghai Bank of Communications’ regional headquarters in Suzhou city, Jiangsu province. He and his assistant registered a financial service company in Hainan and arranged their relatives to run it. From 1990 to July 1993, they provided 170 million *yuan* of abnormally underpriced credits to the company, which in turn lent them to outsiders at remarkably higher rates. Moreover, the president and his senior colleagues diverted 1.36 billion *yuan* bank funds into six bogus corporate accounts to finance their partners’ property speculating. Most of the gains, over 40 million *yuan*, were split among the bank managers themselves, but the bank itself eventually suffered a total loss of 840 million *yuan* (Case 2).

Dubious branching out is not limited to local levels of the banking system. The Industrial & Commercial Bank had 29 provincial branches, and 15 senior managers were on the boards of directors of the companies erected by the bank.³⁴ When the famous Guangdong International Trust and Investment Corporation (Gitic) was going into liquidation in late 1998, the top managers could not even provide an accurate number of its spin-offs to external auditors: there were only 36 in its official documents, but there turned out to be 240 after investigations. Registered in various parts of China and abroad, these had been convenient tools for Gitic

32. Based on interviews in Guangdong and the Zhang Qiong case in *Yangcheng Evening News* (electronic edition, hereafter *YENEE*), 5 May 1999.

33. See an investigation in *Chinese Business Times*, 30 July 1996, p. 3.

34. See a disciplinary report in *Renmin ribao*, 25 August 1994, p. 1.

officers to cheat the central government and serve their private operations.³⁵

Arbitrarily delaying payments in order to keep the funds for the bank staff's private investment is another standard technique. Transfers between a state bank and a non-bank corporation, between two banks or two branches of the same bank can all be deliberately postponed. Delays are typically for days or weeks, but can be much longer, even around two years, as revealed by inspections in Shanxi and Henan provinces in the early 1990s.³⁶ If one takes into account the aggregate size of such postponed payments – tens of millions of *yuan* on the county level and at least several billions of *yuan* nation-wide on a daily basis during the early to mid-1990s³⁷ – one will be impressed by how much these free or almost free credits could contribute to the personal welfare of the bank staff. They normally do not pay any interest for briefly delayed payments, let alone punitive fines.

Overall Estimates

The exploratory nature of this study necessitates some overall estimates, which help give a rough sense of the magnitude of the problems. First is on the scope of embezzlement. The banking authorities reported that over the three years 1988–90, the financial sector recorded about 15,000 cases of grave wrongdoing (mostly embezzlement and kickbacks), involving at least 900 million *yuan* bank funds. This exceeds the total of bank funds captured by insider crime from 1949 to 1987. In January–September 1991, the amount jumped to 300 million *yuan*, a 33 per cent increase on a yearly basis from the 1988–90 period.³⁸

To date, the sector-wide data for the later years have not been published, but 1992–94 were notorious for rampant financial irregularities. If the economy-wide growth rates in the illegal capturing of public property by private hands³⁹ are applied to the financial sector, which is obviously an underestimate for the situation therein is universally admitted as much worse, then it can be safely said that in 1991–97 about 5.5 billion *yuan* bank funds were illegally channelled into the bank management's pockets. The sums for 1988–97, the last decade of the Deng era, could reach 14.5 billion *yuan*.

The sums of “temporarily misappropriated” bank funds for the same decade are extremely difficult to estimate, because most of such spon-

35. Gitic's 15 billion *yuan* of debt was largely caused by dubious branching out; see *Zhongguo jianbao (China Digest)*, 30 March 1999, p. 12.

36. *ERS*, No. 4 (1995), pp. 26–27.

37. The survey was in *Renmin ribao*, 9 October 1995, p. 9; and *New Century*, No. 4 (1995), pp. 5–6.

38. The figures were released by a discipline-inspector in late 1993; quoted from Li Hanlin (ed.), *Guoyouzichan da liushi (The Massive Vanishing of State Assets)* (Gansu: Lanzhou University Press, 1994), pp. 51–53.

39. The growth rates, as compared with the year before, are 110.7% for 1993, 173.9% for 1994, 115.9% for 1995 and 109.9% for 1996. They are released annually by the SPP and the Supreme People's Court in *Renmin ribao* (pp. 2–3) during late March.

taneous diversions, even if discovered, have never been reported to law enforcers. The SPP did not list “temporary misappropriation” as a separate category in its annual reports prior to March 1994. Its 1997 report (releasing data on 1996) has been the only one so far that contains some concrete information on the issue. According to the 1994–97 reports, the law enforcers each year handled about 14,000 serious cases of “temporary misappropriation” nation-wide in the early to mid-1990s. In 1996, the 857 big operations out of the 14,000 or so cases illegally diverted some 4 billion *yuan* in public funds. The majority of these operations lay in the financial sector. It seems a reasonable “guesstimate” that during 1988–97, sums of “temporary misappropriation” in the financial sector reached 40–50 billion *yuan*.⁴⁰

Needless to say, in the domain of irregularity, what is revealed is always much less than what has actually occurred. The real sizes of embezzled and misappropriated bank funds in 1988–97 could be several times the estimates.

The trend. Since the mid-1990s when Beijing made financial regulation a top priority, there have been many legal and administrative efforts to strengthen banking surveillance. How effective are these measures? They seem to have some effect in several respects: the state banks and many of their spin-offs are being disconnected; the banks are doing more feasibility studies before issuing loans; fewer fresh funds have been put into property speculating (partly attributable to the burst of bubbles earlier). But there is little evidence to indicate that the trend of irregular insider privatization has been significantly curbed. According to the most recent SPP statistics, major economic crimes in 1998 rose 16.7 per cent from 1996. And in January–August 1999, 51,000 economic crimes were registered by the police, involving 84 billion *yuan* – increases of 23.4 and 390 per cent respectively over the same period of 1998.⁴¹ In February 1999, the Construction Bank’s and the Agricultural Bank’s branches in Kunming city, Yunnan province, experienced the largest embezzlement schemes in the PRC’s history: a group of employees stole 370 million *yuan* and disappeared.⁴² In April 1999, a securities company in Fuzhou city, Fujian province, reported the largest “temporary misappropriation” operation by a single agent in the PRC’s history, in which its deputy manager diverted 916 million *yuan* of company funds to speculate in stocks and lost 17.5 million *yuan*.⁴³ These astonishing occurrences suggest that there remains much room for insiders to abuse and capture bank assets.

40. Zhongjiwei yanjiushi, *Collections 1995–1996*, pp. 427–430.

41. *Renmin ribao*, 21 March 1999, p. 2; *South China Morning Post*, 14 October 1999, p. 12.

42. *YENEE*, 5 September 1999; *Ming bao*, 3 September 1999, p. A20.

43. *YENEE*, 29 October 1999.

Static Definition of Property Rights in a Rapidly Marketizing Economy

Under the Chinese legal circumstances the bank management's irregular privatization of bank assets has been better served by *nuoyong* than by embezzlement because the former is a much safer and more powerful instrument.⁴⁴ For the insiders, plain theft of bank assets is a clearly defined crime, and the punishment is generally severe under the 1979 criminal law and its 1988 supplements (Table 4), together in force for almost the entire 1980s and 1990s. But official policies on how to handle *nuoyong* are much less clear, leaving a vast grey area for discretion in enforcement. This has manifested in the state's conceptual and practical treatment of unauthorized utilization of public funds vis-à-vis plain theft. Not until January 1988 did the Chinese legislature define *nuoyong* as a legal offence; previously, it had been a violation of financial discipline, and the perpetrator had been punishable only in accordance with the code of conduct of public-sector employees. The code stipulated four punitive levels: warning, demerit, demotion and dismissal; a perpetrator could be dismissed only under very rare circumstances.

In January 1988, the legislature, on the basis of earlier provisional measures, made for the first time *nuoyong* a category in China's criminal law, but noticeable flaws remain. Under the 1988 legislation, public-sector employees are subject to criminal charges of *nuoyong* if all these conditions simultaneously exist: that their unauthorized utilization of public funds is directly linked to their official posts; that such use is committed by a private person for a private profit-making programme; that the diverted public funds are a relatively large amount; and that the public funds have not been restored after three months of their initial diversion.⁴⁵

It is not hard to find plentiful opportunities for diverting public funds despite the legislation.⁴⁶ If the management of a bank branch act in the name of a public institution (their own or another) rather than in that of private individuals, then they are unlikely to be subject to *nuoyong* charges. Criminal charges are also unlikely to be brought against them if the managerial teams of separate financial institutions do not freely use the funds under their direct administration to finance their private ventures but exchange such uses between them. More convenient is the time

44. For the convenience of textual interpretation, this section mostly uses the word *nuoyong*. It is based on the summary of legal discussions in Ye Huilun and Bin Yu, *Misappropriating*, pp. 1–66; and Lang Sheng (ed.), “*Jueding*” *shiyi* (*Interpreting the “Resolutions”*) (Beijing: Zhongguo jihua chubanshe, 1995), pp. 170–180.

45. See especially Ye Huilun and Yu Bin, *Misappropriating*, pp. 20 and 6–9. The legislation also states that if the diverted public funds serve a programme which is a crime in itself (e.g. smuggling), Conditions 3 and 4 are not necessary for indicting the perpetrator for *nuoyong*. In 1988, the top judicial bodies also decided to keep the previously set tentative quantification in effect; that is, “a relatively large amount” starts from 5,000–10,000 *yuan*, “a large amount” starts from 50,000 *yuan*, and “a particularly large amount” starts from 100,000–200,000 *yuan*. But these figures quickly became irrelevant to the administration of law after the early 1990s, as numerous cases involved many millions of *yuan*.

46. In February 1995, this legislation was extended to cover corporations with mixed ownership. Its fundamentals were further preserved in the 1997 amended criminal law (Lang Sheng, *Interpreting*, p. 288; *Renmin ribao*, 15 March 1997, pp. 1–2).

Table 4: Quantitative Aspects of Embezzlement and Its Punishment in the Chinese Laws, 1979–1997

<i>Value of theft (yuan)</i>	<i>Under very serious circumstances</i>	<i>Under ordinary circumstances</i>
50,000 or more	Death sentence	Over 10 years to life in gaol
10,000 to less than 50,000	Life in gaol	Over 5 years gaol
2,000 to less than 10,000	Over 7 to below 10 years gaol	Over 1 to below 7 years gaol
Below 2,000	Below 2 years gaol	Administrative discipline

Note:

Capital punishment has been more prudently used in economically booming areas, where embezzlement cases easily involve millions of *yuan*.

Sources:

Li Xueqin (ed.), *Xin Zhongguo fanfubai tongjian (History of Anti-corruption in New China)* (Tianjin: Renmin chubanshe, 1993), pp. 801–833; Ye Huilun and Yu Bin, *Misappropriating*, pp. 1–3.

threshold: if they can manage to return the bank funds before being caught by periodic inspections or falsify the in-use records as below three months, they may never be punished. (During the pre-1988 provisional period, the time threshold was set as six months.) Anyone who has learnt some financial-market economics knows that investment in stock markets, currency trading, the futures exchange or even property speculating does not have to be longer than three months. By gambling in these markets with huge bank funds but paying no interest, the bank management can bring quick returns to themselves in private.

As mentioned above, much of the institutional ambiguity and irregularity in public-funds control is related to how to define “temporariness” implied in the term *nuoyong* and consequently how to tell “temporary misappropriation” from outright theft or embezzlement. Although the “period of grace” for public-funds diversion was reduced from six to three months by the 1988 legislation, the time frame of “temporary misappropriation” is kept loose. The law states that a perpetrator is punishable for the crime of embezzlement instead of *nuoyong* if he privately diverted “a relatively large amount of public money and has not restituted it because of unwillingness or insolvency” by the time the case is formally registered by the law-enforcer.⁴⁷ In other words, the span of time for a “temporary misappropriation” is extendable from the first day after the “period of grace” to an unspecified day when the full restitution is not made and therefore the police file the case. This explains why the anti-*nuoyong* law in reality has been a vague reference rather than an enforceable, strict regulatory framework. Numerous misappropriations have lasted for years but are still treated as “temporary.”

In short, in the course of rapid marketization, China’s regulations on *nuoyong* remain designed basically to serve an economy in which opportunities for private investment were almost non-existent; accordingly, the real value (and the risk) of a financial asset changed little, if at all, over a short time. Thus, when someone spontaneously used public money, the owner-state would not suffer materially as soon as the money was fully restored.⁴⁸ Yet, accelerated reforms since the mid-1980s have altered the key parameters of China’s economic setting; there now co-exist the state-sector economy, which has been fading away, and the semi-private and private sectors, which are both vigorous. All hunger for fresh capital funds, but the government has very limited capacity in monitoring widely dispersed public funds. As new sectorial markets continue opening up to provide investment opportunities, money now can yield profits quickly, and the rights to the use of public funds and to the returns yielded thereon have gained increasing importance vis-à-vis the right to the static nominal possession of those funds. What does it mean for “state ownership” when the management of a state financial body return the public funds while

47. Ye Huilun and Yu Bin, *Misappropriating*, pp. 61–62.

48. Prior to the early 1980s, it was quite common for cadres to keep public funds for personal (but not commercial) use for as long as several years. Once the wrongdoing was revealed and restitution was fully made, they might be disciplined slightly but were not required to pay interest to the funds account (fieldwork).

retaining the two-digit interest earned from the underhand lending? From early 1991 to April 1993 the state banking sector was estimated to have mobilized at least 192 billion *yuan* for off-plan investments. Who was the residual claimant of the profits? In most cases, it was not the owner, the state treasury, but the personnel running state-owned banks.⁴⁹ When reporting big *nuoyong* cases in April 1999, *Southern Weekend*, the most popular newspaper in today's China, stated:

Nuoyong earmarked public funds has been spreading for years, but few perpetrators get punished. Why? The most difficult thing is that the rules on handling *nuoyong* are unclear. Is it a breach of law, or merely a breach of work discipline? ... It seems a norm that the perpetrator would not be legally punished if he did not cause a substantial monetary loss to the government account. What the hell is *nuoyong*?⁵⁰

In mature market economies, the rights of ownership of an asset have been interpreted, correctly, as consisting of the right to use it, the right to change its form or substance, the right to transfer its parts or entirety, and the right to appropriate returns from the asset. The legal institution has developed in agreement with this complex definition of property rights.⁵¹ But in transitional China, institution-building by the state in this domain has lagged far behind the real economic life process. Because of the increasingly complex property-rights situation, public funds are exposed to unprecedented exploitation, as the bank management can mobilize huge financial resources for various sorts of speculating for weeks, months or even years. They make the owner-state take the bitter results of the volatile markets and make themselves take the sweet ones. As a Chinese phrase puts it, "Capitalism with Chinese characteristics – profits to the private and losses to the public."

Why is the Chinese legal system so lenient on *nuoyong*? Why was the law not changed until 1988 and has been kept relatively mild since? A critical reason is that the law makers do not want to change the situation too much because essentially they represent the interests of the cadres who want to retain the flexibility of diverting public funds into a variety of alternative uses. The bureaucrats, both the law makers and the bank management, do not want to be seriously penalized for doing things the way they have always done.⁵²

49. *DRR*, No. 20 (1994), p. 12; *ERS*, No. 133 (1995), p. 22.

50. *Nanfang zhoumo*, 9 April 1999, p. 1.

51. Eirik Furubotn and Svetozar Pejovich, "Property rights and economic theory," *Journal of Economic Literature* Vol. 10 (1972), pp. 1137–62; Oliver Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985), pp. 26–27.

52. There is strong evidence to back this explanation. In 1998, the State General Anti-Corruption Bureau was convicted of diverting confiscated crime funds for its staff. In June 1999, the Ministry of Water Resources was found to have diverted more than 3 billion *yuan* of flood-control funds into speculating (*Renmin ribao*, 21 March 1999, p. 3; *HBEE*, 16 August 1999).

Conclusion

In his address to the Chinese intellectual and policy establishments, Joseph Stiglitz underscored the banking sector's crucial role in market transition: in a command economy the state bureaucracy decides where factors of production should go, while in advanced market economies banks are the key decision makers in resource allocation. As reform is shifting substantial economic power from the state apparatus to the bank management, it is crucial that a transitional economy create an appropriate banking regulatory structure that does not "give rise either to incentives for excessive risk-taking or looting."⁵³

Since the mid-1980s Beijing has given the state banks more autonomy in managing the nation's financial assets – public property of the most floating and manipulatable kind. Yet, the government has not developed corresponding regulatory and monitoring mechanisms within and surrounding the banking system. This fragile agency structure has resulted in aggressive wealth transfer from the hands of the state to those of the bank management. As property-rights analyses have predicted, "the more one sees grants of autonomy allowing managers to pursue private goals, the less effective the agency relation between owner and manager, and the more one might justifiably speak of *de facto* privatization."⁵⁴

This study stresses that the aggressive wealth transfer owes its success more to *nuoyong* than to embezzlement. A main characteristic of informal property transformation under the transitional conditions is that the insider-agents rely more on the dubious exercise of the utilization and the return rights than on the alienation right. This is because the governance of public assets in China is still largely based on the old, simpler forms of property rights, focusing on nominal ownership rather than on who are in effective control of resources.⁵⁵ The bank management are thus inspired to erode state property to enrich themselves by routinely abusing bank assets, or *wan guozi* as a popular expression characterizes, since there is asymmetry in bearing responsibilities and taking gains. This has become a key method of national wealth redistribution.

Transition involves institutional design, which includes introducing new rules, and institutionalization, which includes making new regulations effective. But this is not just a matter of people becoming accustomed to the new rules. There is a moral hazard problem: people see that the new rules (or the old rules in new circumstances) simply do not adequately cover the subject matter, and they start to profit from the gaps in the system of regulations. Because the personal return is high, individuals devise evasion strategies.⁵⁶

53. Joseph Stiglitz, "Second-generation strategies for reform for China," <http://www.worldbank.org/html/extdr/extme/jssp072098.htm> (1998), pp. 8–9.

54. Louis Putterman, "The role of ownership and property rights in China's economic transition," *The China Quarterly*, No. 144 (1995), p. 1051.

55. See contrast of the two in Armen Alchian, "The basis of some recent advances in the theory of management of the firm," *Journal of Industrial Economics*, Vol. 14 (December 1965), pp. 30–41; Williamson, *Economic Institutions*, pp. 8–9.

56. The author is indebted to an anonymous reviewer for suggesting this summary.

There have been animated scholarly debates on “*nomenklatura* capitalism,” that is, current or ex-communist cadres turning themselves into a new capitalist business elite. Some believe that this is only transitory and that market forces will soon uproot their advantages. Some contend that the phenomenon clearly indicates the staying power of state-socialist bureaucrats in the course of marketization.⁵⁷ More and more evidence from China (not to mention Russia, which is more obvious⁵⁸) suggests that the state-bank management will surely be an important source of the new capitalist class.

57. See the special issue of *American Journal of Sociology*, Vol. 101, No. 4 (1996).

58. See “Where did Russia’s money go?” *Newsweek*, 4 October 1999, pp. 16–21; “Russia probe focuses on brash banker,” *AWSJ*, 27–28 August 1999, pp. 1/10.