

---

# Causes and consequences of financial corruption: a conceptual inquiry

Nguyen Tan Phat

Faculty of Economics, University of Economics & Law, Vietnam National University HCMC

## Email address:

ngtaphat@yahoo.com (N. T. Phat)

## To cite this article:

Nguyen Tan Phat. Causes and Consequences of Financial Corruption: a Conceptual Inquiry, *International Journal of Economics, Finance and Management Sciences*. Vol. 1, No. 2, 2013, pp.115-118. doi: 10.11648/j.ijefm.20130102.17

---

**Abstract:** When mentioned, corruption is often thought to take place just in areas of civil authority where the mandarins squeeze people and public property. This definitely breaks the laws and doesn't obey social ethics. There is, however, another form of corruption existing in front of people's eyes and obeying legally basic principles of the market economy, internationally financial rules such as WB, IMF, ADB, WTO, etc. and even the laws in all countries. That is financial corruption of economic, financial and banking corporations. Financial corruption is the root of the economic crisis worldwide in 2008 although it is known by the world's largest market economies and recognized by global financial organizations but they do not dare admit it. Financial corruption is one of the challenges of the global economic security in the 21<sup>st</sup> century and unless it is stoppable, its companion will be financial fraud. It is possible to stop and curb financial corruption by the 3 tools: the State's intervention, market tool and public media.

**Keywords:** Financial Corruption, Global Financial Crisis, Internationally Financial Rules, Financial Fraud

---

## 1. Financial Corruption - the Root of Global Financial Crisis

Economic crisis is a challenge the world is facing. It is becoming more and more drastic, spreading globally, threatening the lives of billions of people worldwide, affecting the prosperity of humankind, pulling backwards human values, civilization and later, pushing people to new difficulties and challenges.

Economic crisis is not a new issue, even it is considered as an economic circle with regard to the 2 recent centuries. The early economic crises were overproduction (from 1825 to 1929-1933). Each of the crises was marked by the collapse of a particular field which later became the crisis's name itself such as energy crisis in the 1970s, monetary crisis in 1997 and then economic crisis in 2008. It has kept on sweeping other fields, resulting in unemployment, standstills, bankruptcy and poverty increase, etc.

Financial crisis in 2008 was the consequence of the rapid growth of banks and financial-credit organizations with new diverse and uncontrollable credits during the 10 recent years. The financial-credit system has developed too far

compared with its conventional functions<sup>1</sup>, creating the outbreak of investment, speculation in delicate markets such as gold, oil, real estate, stocks and insurance, etc, causing the artificial supply-demand.

Financial crisis is indeed the melt of the cream layer of economic crisis. Virtual values created by speculation and risky investment revealed on the cover of stocks or collateral credits broke in order to come back to its true value of the economy. While some banks and leading financial organizations in the US and Europe went bankrupt or needed urgent reliefs, motor manufacturers also sent signals of emergency help. Thus, it can be confirmed that financial crisis was the first starting point of the economic system then has spread to other industries such as car production, construction materials, trade, investment and service, etc.

The question is that what was the true reason of the crisis in 2008? It was believed that it was due to the too hot development, causing under-standard loans in real property, or due to the capitalizing the economy, or owing to the crisis of beliefs, etc. All were not the core of the problem but a defense or an outside form of an inside profound reason.

The problem is that why there was a too fast collapse of banks and insurance companies. In the US, for instance,

---

<sup>1</sup>Bank's conventional function is inter-mediate of credit and payment.

there are approximately 10 banks and insurance companies exclusive of those getting reliefs from the government in such a bad situation every month. The too abrupt failure makes people think of the fact that these financial organizations seemingly had lost their ability of payment for a long time. Not until the global economic obstacles occurred, was it a drop of water overflowing from the glass and waited to go mass bankrupt.

It was obvious that banks and insurance companies had no reasons to lose their profits so much that they had to file for bankruptcy abruptly. First, loan interest rates are always higher than borrow interest rates under any circumstances<sup>2</sup>. Second, diverse financial services create a great added value at any time. Thus, it can be sufficient for operation fees and for making profits. Third, evaluation business of pledge of property of banks and insurance organizations is always at the highest level of security thanks to the strict regulations and the perfect specialist skills. Fourth, the experience of operation for centuries does not allow them to make such mistakes and suffer such systematic damages.

Behind the surface, what was the true reason? Just take a look at Bernard Madoff<sup>3</sup>, Richard Fuld<sup>4</sup>, Dubai World<sup>4</sup> and recent Goldman Sachs<sup>5</sup>, etc which involved big sums of money awarded to fat cats of financial corporations and banks no matter how they worked. Such a luxury has made public opinion, media, people and leaders worldwide and even the world's largest free market economies hit the ceiling. Some governments must intervene directly in applying sanctions against these unreasonable rewards, which had never happened before in history of the market economy as it violated the principle of self-control and free operation of entrepreneurs.

The fact that the things have been taking place in relation to the enormous pay rewarded to financial and banking leaders and the collapse of a series of banks and financial organizations is an evidence to make a conclusion of the truth that financial corruption is existing in front of people's eyes, matching all economic rules of free market which are legalized under the regulations of international organisations such as WB, IMF, ADB, WTO, etc.

## 2. Reasons and Mechanism of Financial Corruption

### 2.1. Reasons of the Corruption

<sup>2</sup>A fraud worth 50 billion USD disturbed global stock markets in 2008.

<sup>3</sup>The President and General Manager of Lehman Brothers (the over 100- year-old bank). His salary and rewards during the 5 working years was worth 350 million USD.

<sup>4</sup>Dubai World Corporation of Dubai, the United Arab Emirates declared to delay paying the debt worth 59 billion USD until the end of November 2009, staggering the Asian stock market.

<sup>5</sup>The famous investment bank on Wall Street was sued by America's Stock Economic Committee (SEC) about defrauding customers on April 16, 2010.

<sup>6</sup>The US Government directly interfered in applying sanctions against financial and banking organisations which had received its money relief and did not allow them to give more than 10% of the projected total source of rewards.

The evident existence of financial corruption originated from the basic principle of the capitalist free market economy based on Adam Smith's idea of the free economy. The capitalist market economy is acknowledged as an economic system making all people get rich. He was the first to see the benefits from creating more competitions, so he had arguments to support policies that promoted it. This also required few interferences of State in the economy and it soon became the truth for the model of conventional market economy with American and southwestern European style. The acclaim of individual benefits when doing business has brought wealth for capitalists and at the same time accidentally brought community benefits – that was beyond his first intention- in the guide of an invisible hand.

Such an influential awareness has spread over times and become a dominant idea encouraging activities of business production and boosting the amazingly evolutionary process of capitalism in the period of free competition. This was a boom period of a new mode of production and idea which coincided the real life<sup>7</sup> by chance, creating a resonance for the fast development of a new socio-economic structure. It is the capitalist market economy with the market mechanism self-adjustable thanks to objective principles of economics. Thus, all the economic activities must be on the grounds of competitive freedom without State's interventions. Adam Smith kept on being backed by school of new-classics, especially the theory of general balance of Le Waras; and then the new liberalism. All became legal principles of financial rules worldwide such as WB, IMF, ADB, WTO, etc.

Yet Adam Smith would have had different thoughts if he had witnessed the exclusive period of capitalism, the economic crises since the early 19th century and particularly the self-interest of managers of financial corporations that lead to the unimaginably abrupt collapse of the crisis in 2008. The self-interest of economic human factor of Adam Smith was distorted the fact that personal interests should have brought common interests as it did in his original, trusted, thought but now a selfish personal interest of a mere individual regardless of the community destruction instead. Global financial corruption and uncontrollable financial transactions are a gigantic challenge menacing the economic security of the 21st century.

Adam Smith hardly imagines that the market economy has developed beyond the control so far that all in the past considered as its conditions or principles have turned into an odd disguise. Personal interests are performed on the grounds of eroding common interests and believed to represent the economic system of millions of people throughout the world. Once common benefits are damaged, they are kept on being used to support selfish personal interests.

The proof was that billions of USD was used by the governments to buy bad debts or stocks for banks and financial organisations in the risk of bankruptcy. For instance, American government spent 800 billion USD; Europe, 1,000 billion and likewise Korea, China and Singapore, etc.

However, we wonder whether such enormous sums of money are able to deal with the crisis? The answer is yes. Nevertheless, they can just help halt temporarily the crisis which will persist if money is in short supply. The situation is like a car low on gas is pumped gas to keep on running but it'll stop again when out of gas. It is also the explanation why the biggest market economies are exceedingly worried and unclear about economic growth. Thus, Dominique Strauss-Kahn<sup>8</sup> stated that we should reconsider our model of growth itself. According to IMF, the financial crisis controled partly is concealing and will come back in the early 2010. It should be kept in mind that money is a kind of wine stimulating the economy but this glass of wine is scarcely given to the lips at times.

## 2.2. Mechanism of Performing Financial Corruption<sup>3</sup>

Financial corruption is taking place publicly and legally counted on the mechanism of the principles of free-competitive market under various forms.

## 2.3. Diverse Products of Finance, Credit and Insurance are Developed in the Form of Contracts Agreed Mutually-between a Company and a Customer-and the Original Value of Assets will be Split from the Beginning

No sooner the contract is signed and money is given by a customer, is it at once divided in the ratio of percentage from an officer directly performing the deal to his superior. The amount of money left eventually is worth less than 50% of the original. For example, a life insurance officer has his customer for a deal. If the negotiation is reached successfully and the contract is signed, he will be given between 30%-40% of the total value, then 5%-10% to his superior; after that X% to the regional manager and finally Y% to the general manager. It is wondered how much the original value of the assets is left so that it can be used later for investment which can make super -profits adequate to the refund and an added value for the customer on the maturity date. This is truly a type of multi-level sale<sup>9</sup> and will collapse when the system is exceedingly widespread. Victims are the latter customers. Visibly, the size and personnel of these organisations are really large. So the benefits distributed from the beginning are higher and higher, approximately 40% of the value of the contract. Later when the maturity date is coming nearer and nearer, the size becomes larger to mobilize capital to have the latter's money to pay the earlier. Hence, when there was an economic crisis - capital was in short supply and customers withdrew money and stopped the contract suddenly - they hardly paid and collapsed promptly as a result.

## 2.4. Salaries and Rewards to Managerial Layer are Immensely High due to the Principles through Syste-

## matically Operational Regulations of Financial and Banking Organisations and Economic Corporations

The too high division of these benefits to managers eats away the assets of customers and shareholders. Big salaries and massive rewards become a behavioral culture of these organisations even in recession. To legalise, senior officers invest without thinking or finance super-big schemes to get commission from their partners in the aim of creating purposefully a pretext to mobilize more capital of shareholders and consolidating customers' beliefs<sup>10</sup>.



**Figure 1.** This is a series of super big projects of Dubai World corporation in the aim of turning deserts into paradises.

All the above-mentioned mechanisms are legalized and based on rudimentary laws of the free market. The mass development of joint-stock companies and the fluctuation of stocks and bonds prices produces conditions to expand a kind of the so-called stocks goods<sup>11</sup> or belief goods. As the fact that the see- saw of the prices depend chiefly on beliefs and expectations rather than the happenings in production.

## 3. Financial Corruption has Broken the Basic Principles of the Conventional Market

When basic laws of the conventional market economy like free competition, warranty of personal benefits, free trade, investment, commerce, incorporated companies and stock market, etc. become general principles in international regulations in commerce, investment, finance and the estalishment of global rules like WB, IMF, ADB, WTO, etc. to regulate the global economy, there comes into existence financial corruption, in which the economic human factor and personal interests play the key role, giving rise to severe damages for society. Limiting corruption is a hard math problem because its parameters-general principles-must be changed to have a correct answer, which could upset the whole system and global rules of the capitalist market economy. To repair such shortcomings, many countries have come back to protectionism, restricted investment and controled finance, etc. even on largest market economies themselves.

At the same time, the widespread connection between regions and countries help market economies operate on the basis of group benefits but when difficulties emerge, they have no idea for their solutions due to the obstructions of the general principles. That is the reason why interna-

<sup>9</sup>According to Bloomberg, before being arrested by FBI in New York, Madoff had admitted that his investment fund basically was a great pyramid-shaped plan of mobilizing capital and made investors lose 50 billion USD.

tionally financial rules and countries with developed market economies barely admit that the ongoing crisis is the financial corruption. Despite their criticisms of big salaries and rewards, they do not acknowledge that it is truly a financial corruption.

Financial corruption happens not only in finance, banking but also in industry, service and investment, etc. It will be the biggest danger threatening the security of global economy in the 21st century unless the principles of market economy can be adjusted or unless they are adjustable. Forms of incorporated companies and stock market are hardly deficient in market economy.

Currently, market economies should be approached with caution not to be gone with the conventional market economy so that they can repair or prevent damages more easily.

Thus, there will be technical adjustments to prevent the corruption in the coming years made by government and organisations of internationally financial rules. For instance, salaries and awards will be controlled thanks to their stipulations; the quality of financial products such as financial services and forms of life insurance will be evaluated; the structure of possession and ways of mobilized capital of joint-stock companies will be corrected especially when the transferable stocks and bonds is issued.

#### **4. Manifestations of Financial Corruption Impacting the Current Vietnamese Economy**

First, there is an existence that super-big projects with little or without performance registered by internationally financial corporations have become suspense projects. Typically, for example, steel schemes in Ninh Thuan and Thanh Hoa provinces registered tens billion of USD but the investors have gone with the wind. These schemes made a home and foreign echo and were granted hundreds hectares of land by the local government without any hesitation in moving away thousands of local people. It was no doubt that they were calculated and a perfect script was written by financial corporations to mobilize easily more share capital and calm down investors and banks. It has been very popular and is generally understood in a particular way but not a manifestation of financial corruption. For instance, it could be a registration to own large lands then transfer them to earn interest.

Second, the development of State-owned economic corporations in multi-industry and multi-field, particularly in non-professional areas such as real estate, stocks, banking and telecommunication leading to losing profits and capital is one of a demonstration of financial corruption. Taking advantages of policies and trusts of Party and State in the

ongoing international integration, some economic corporations investing in non-professional areas is regarded as a big concern since it is inefficient, resulting in losing State's capital-usually capital loaned from ODA and paid on maturity date- and at the same time, it creates artificial supply-demand of goods on the market and unnecessarily virtual competition.

The 2 above cases are now threatening the social-economic security in Vietnam and they must be considered with caution in the long run. According to the author, there are some suggestions to reduce financial corruption in Vietnam as follows:

In the attraction of foreign investment, it is not advisable for local areas to follow super-big projects worth billions of USD but collect enough information to estimate the real abilities of each partner before granting investment license. Smaller but feasible projects should be given priority.

New and non-conventional products such as life insurance of financial companies must be controlled, specially re-investment activities from capital mobilized in order to have preventive measures. Restricting sub-standard loans, namely, consumption loans based on beliefs. There should be interference measures and warning solutions to develop market healthily, minimizing this type of financial corruption.

State-owned economic corporations must be checked and audited to limit the investment in left-handed industries and rewarding big salaries. Investment-business laws for these corporations should be issued and an independent controlling committee should be established by Parliament for the supervision.

---

#### **References**

- [1] Phan Manh Ha (2008), From a game theory to resolving crises of the 7 Nobel-winning, Light Ray Journal, website: <http://www.tiasang.com.vn/Default.aspx?tabid=66&CategoryId=7&News=2506>.
- [2] Tran Hai Hac (2007), a WTO game: The ways to set up problems of J. E. Stiglitz, New era, No. 12 - / July-2007
- [3] John Maynard Keynes (1994), General theory of employment, interest and currency, Education Press, Ha Noi.
- [4] Steven Pressman (1999), 50 predominant economists, Labor Press, Ha Noi.
- [5] Maurice baslé – Francoise Benhamon – Bernerd Havance Alain Gélédan – Jean Léobal – Alain Lipietz (1996), History of economic thinking –Vol.1: Founders, Social Science Press, Ha Noi.
- [6] Robert B. Ekelund, JR Robert F Hébert (2004), History of economic theories, Statistics Press, Ha Noi.