

THE CONSEQUENCES OF MONEY LAUNDERING AND FINANCIAL CRIME

*By John McDowell, Senior Policy Adviser, and Gary Novis, Program Analyst,
Bureau of International Narcotics and Law Enforcement Affairs,
U.S. Department of State*

Money laundering has a corrosive effect on a country's economy, government, and social well-being, two State Department officials say.

The officials -- senior policy adviser John McDowell and program analyst Gary Novis of the Bureau of International Narcotics and Law Enforcement Affairs -- say the practice distorts business decisions, increases the risk of bank failures, takes control of economic policy away from the government, harms a country's reputation, and exposes its people to drug trafficking, smuggling, and other criminal activity.

Given the technological advantages money launderers now employ, they say, a high level of international cooperation is necessary to keep them in check.

Money laundering is the criminal's way of trying to ensure that, in the end, crime pays. It is necessitated by the requirement that criminals -- be they drug traffickers, organized criminals, terrorists, arms traffickers, blackmailers, or credit card swindlers -- disguise the origin of their criminal money so they can avoid detection and the risk of prosecution when they use it.

Money laundering is critical to the effective operation of virtually every form of transnational and organized crime. Anti-money-laundering efforts, which are designed to prevent or limit the ability of criminals to use their ill-gotten gains, are both a critical and effective component of anti-crime programs.

Money laundering generally involves a series of multiple transactions used to disguise the source of financial assets so that those assets may be used without compromising the criminals who are seeking to use them. These transactions typically fall into three stages: (1) placement -- the process of placing unlawful proceeds into financial institutions through deposits, wire transfers, or other means; (2) layering -- the process of separating the proceeds of criminal activity from their origin through the use of layers of complex financial transactions; and (3) integration -- the process of using an apparently legitimate transaction to disguise illicit proceeds. Through these processes, a criminal tries to transform the monetary proceeds derived from illicit activities into funds with an apparently legal source.

Money laundering has potentially devastating economic, security, and social consequences. It provides the fuel for drug dealers, terrorists, illegal arms dealers, corrupt public officials, and others to operate and expand their criminal enterprises. Crime has become increasingly international in scope, and the financial aspects of

crime have become more complex due to rapid advances in technology and the globalization of the financial services industry.

Modern financial systems, in addition to facilitating legitimate commerce, also allow criminals to order the transfer of millions of dollars instantly using personal computers and satellite dishes. Because money laundering relies to some extent on existing financial systems and operations, the criminal's choice of money laundering vehicles is limited only by his or her creativity. Money is laundered through currency exchange houses, stock brokerage houses, gold dealers, casinos, automobile dealerships, insurance companies, and trading companies. Private banking facilities, offshore banking, shell corporations, free trade zones, wire systems, and trade financing all can mask illegal activities. In doing so, criminals manipulate financial systems in the United States and abroad.

Unchecked, money laundering can erode the integrity of a nation's financial institutions. Due to the high integration of capital markets, money laundering can also adversely affect currencies and interest rates. Ultimately, laundered money flows into global financial systems, where it can undermine national economies and currencies. Money laundering is thus not only a law enforcement problem; it poses a serious national and international security threat as well.

Exposed Emerging Markets

Money laundering is a problem not only in the world's major financial markets and offshore centers, but also for emerging markets. Indeed, any country integrated into the international financial system is at risk. As emerging markets open their economies and financial sectors, they become increasingly viable targets for money laundering activity.

Increased efforts by authorities in the major financial markets and in many offshore financial centers to combat this activity provide further incentive for launderers to shift activities to emerging markets. There is evidence, for example, of increasing cross-border cash shipments to markets with loose arrangements for detecting and recording the placement of cash in the financial system and of growing investment by organized crime groups in real estate and businesses in emerging markets. Unfortunately, the negative impacts of money laundering tend to be magnified in emerging markets.

A closer examination of some of these negative impacts in both the micro- and macroeconomic realms helps explain why money laundering is such a complex threat, especially in emerging markets.

The Economic Effects of Money Laundering

Undermining the Legitimate Private Sector: One of the most serious microeconomic effects of money laundering is felt in the private sector. Money launderers often use front companies, which co-mingle the proceeds of illicit activity with legitimate funds, to hide the ill-gotten gains. In the United States, for example, organized crime has used pizza parlors to mask proceeds from heroin trafficking. These front companies have access to substantial illicit funds, allowing them to subsidize front company products and services at levels well below market rates.

In some cases, front companies are able to offer products at prices below what it costs the manufacturer to produce. Thus, front companies have a competitive

advantage over legitimate firms that draw capital funds from financial markets. This makes it difficult, if not impossible, for legitimate business to compete against front companies with subsidized funding, a situation that can result in the crowding out of private sector business by criminal organizations.

Clearly, the management principles of these criminal enterprises are not consistent with traditional free market principles of legitimate business, which results in further negative macroeconomic effects.

Undermining the Integrity of Financial Markets: Financial institutions that rely on the proceeds of crime have additional challenges in adequately managing their assets, liabilities and operations. For example, large sums of laundered money may arrive at a financial institution but then disappear suddenly, without notice, through wire transfers in response to non-market factors, such as law enforcement operations. This can result in liquidity problems and runs on banks.

Indeed, criminal activity has been associated with a number of bank failures around the globe, including the failure of the first Internet bank, the European Union Bank. Furthermore, some financial crises of the 1990s -- such as the fraud, money laundering and bribery scandal at BCCI and the 1995 collapse of Barings Bank as a risky derivatives scheme carried out by a trader at a subsidiary unit unraveled -- had significant criminal or fraud components.

Loss of Control of Economic Policy: Michel Camdessus, the former managing director of the International Money Fund, has estimated that the magnitude of money laundering is between 2 and 5 percent of world gross domestic product, or at least \$600,000 million. In some emerging market countries, these illicit proceeds may dwarf government budgets, resulting in a loss of control of economic policy by governments. Indeed, in some cases, the sheer magnitude of the accumulated asset base of laundered proceeds can be used to corner markets -- or even small economies.

Money laundering can also adversely affect currencies and interest rates as launderers reinvest funds where their schemes are less likely to be detected, rather than where rates of return are higher. And money laundering can increase the threat of monetary instability due to the misallocation of resources from artificial distortions in asset and commodity prices.

In short, money laundering and financial crime may result in inexplicable changes in money demand and increased volatility of international capital flows, interest, and exchange rates. The unpredictable nature of money laundering, coupled with the attendant loss of policy control, may make sound economic policy difficult to achieve.

Economic Distortion and Instability: Money launderers are not interested in profit generation from their investments but rather in protecting their proceeds. Thus they "invest" their funds in activities that are not necessarily economically beneficial to the country where the funds are located. Furthermore, to the extent that money laundering and financial crime redirect funds from sound investments to low-quality investments that hide their proceeds, economic growth can suffer. In some countries, for example, entire industries, such as construction and hotels, have been financed not because of actual demand, but because of the short-term interests of money launderers. When these industries no longer suit the money launderers, they abandon them, causing a collapse of these sectors and immense damage to economies that

could ill afford these losses.

Loss of Revenue: Money laundering diminishes government tax revenue and therefore indirectly harms honest taxpayers. It also makes government tax collection more difficult. This loss of revenue generally means higher tax rates than would normally be the case if the untaxed proceeds of crime were legitimate.

Risks to Privatization Efforts: Money laundering threatens the efforts of many states to introduce reforms into their economies through privatization. Criminal organizations have the financial wherewithal to outbid legitimate purchasers for formerly state-owned enterprises. Furthermore, while privatization initiatives are often economically beneficial, they can also serve as a vehicle to launder funds. In the past, criminals have been able to purchase marinas, resorts, casinos, and banks to hide their illicit proceeds and further their criminal activities.

Reputation Risk: Nations cannot afford to have their reputations and financial institutions tarnished by an association with money laundering, especially in today's global economy. Confidence in markets and in the signaling role of profits is eroded by money laundering and financial crimes such as the laundering of criminal proceeds, widespread financial fraud, insider trading of securities, and embezzlement. The negative reputation that results from these activities diminishes legitimate global opportunities and sustainable growth while attracting international criminal organizations with undesirable reputations and short-term goals. This can result in diminished development and economic growth. Furthermore, once a country's financial reputation is damaged, reviving it is very difficult and requires significant government resources to rectify a problem that could be prevented with proper anti-money-laundering controls.

Social Costs

There are significant social costs and risks associated with money laundering. Money laundering is a process vital to making crime worthwhile. It allows drug traffickers, smugglers, and other criminals to expand their operations. This drives up the cost of government due to the need for increased law enforcement and health care expenditures (for example, for treatment of drug addicts) to combat the serious consequences that result.

Among its other negative socioeconomic effects, money laundering transfers economic power from the market, government, and citizens to criminals. In short, it turns the old adage that crime doesn't pay on its head.

Furthermore, the sheer magnitude of the economic power that accrues to criminals from money laundering has a corrupting effect on all elements of society. In extreme cases, it can lead to the virtual take-over of legitimate government.

Overall, money laundering presents the world community with a complex and dynamic challenge. Indeed, the global nature of money laundering requires global standards and international cooperation if we are to reduce the ability of criminals to launder their proceeds and carry out their criminal activities.