CHAPTER- 5

THE NEGATIVE EFFECTS OF MONEY LAUNDERING ON ECONOMIC DEVELOPMENT

5.1 INTRODUCTION:

The negative effects of money laundering on economy are hard to put into numbers. However, it is clear that such activities damage not only the financial institutions directly, but also country’s productivity in its various economic sectors, such as real sector, international trade sector and capital flows, among others; indirectly.

Many of the existing formal economic analyses of money laundering have sought to quantify the extent of money laundering, rather than qualify its effects on individual economies or groups of economies.

The negative economic effects of money laundering on economic development can be qualified in terms of three sectors of the economy: financial, real and external. Money laundering damages the financial-sector institutions that are critical to economic growth (internal corruption & reputational damage); reduces productivity in the economy's real sector by diverting resources and encouraging crime and corruption, which slow economic growth; distorts the economy's external sector international trade and capital flows (reputational damage & market distortion) to the detriment of long-term economic development. Developing countries' strategies to establish offshore financial centres (OFCs) as vehicles for economic development are also impaired by significant money laundering activity through OFC channels. Effective anti-money-laundering policies reinforce a variety of other good governance policies that help sustain economic development, particularly through the strengthening of the financial sector.
In the absence of research on money laundering’s effect on developing economies, some observers have advanced the view that developing-country governments should not devote scarce resources to policies designed to reduce money laundering activity, thus implying that the best possible course of action for developing countries with respect to money laundering is what might be called the *inaction policy*. The defence of the inaction policy is based on 3 interrelated arguments, each of which is imperfect:

- "*Money-laundering funds flow from developed economies to developing economies, and therefore money laundering results in a flow of capital to developing countries.*" As will be shown later, this argument is not supported by the data and, indeed, money laundering facilitates illicit capital flight from developing economies.

- "*To the extent that money laundering encourages economy-depressing crime, that crime occurs in developed economies, and developing-country governments should not be spending their limited resources on preventing crime in developed economies.*" The data suggest that much of the economic damage done by money laundering through developing-country channels is at the expense of developing economies.

- "*The imposition of anti-money-laundering financial regulations discourages the use of developing-country banks and encourages citizens to move their savings offshore.*"

On the contrary, there is evidence that a stronger financial regulatory regime encourages the use of the financial system subject to such regulation and, indeed, a review of net financial flows from banking systems during periods in which anti-money-laundering policies have been imposed shows no evidence of savings-flight in response to such policies.
Perhaps more important than the weaknesses of these arguments individually is the fact that they do not account for what might be considered the other side of the balance sheet: the other negative effects (unrelated to the inaction defence) that money laundering has on economic development. Here we will see other effects in detail.

5.1.2 STAGES AND DIRECTIONAL FLOWS OF MONEY LAUNDERING:

When considering the effect of money laundering on developing economies, it is particularly useful to distinguish among five directions that the money-laundering flows may take with respect to such economies, as illustrated below.

Types of Money Laundering Flows through a Developing Economy

![Diagram](http://www.u4.no/recommended-reading/the-negative-effects-of-money-laundering-on-economic-development/downloadasset/682)
1. Domestic money laundering flows in which illegal domestic funds are laundered within the developing country's economy and reinvested or otherwise spent within the economy\(^2\).

2. Returning laundered funds derive in the developing country, are laundered either in part or in full to overseas, and returned for integration.

3. Inbound funds, for which the predicate crime occurred overseas, are either at the starting point of laundered overseas or within the developing country, and eventually are integrated into the developing economy.

4. Outbound funds, which usually comprise illegal capital departure from the developing economy, do not return for integration in the original economy.

5. Flow-through money come in the developing country as part of the laundering process and mainly disappears for integration in another place, thus performing little or no role in the economy itself. It will become clear that, the implications of money-laundering for developing country economic growth differs depending on which of these flows is being examined. For three of these types of flows domestic, returning, and outbound the predicate crime\(^3\) occurs within the developing economy itself, while inbound funds are typically controlled by criminal elements during or even after placement.

### 5.2ECONOMIC IMPACT:

#### 5.2.1 THE INTERNATIONAL PROSPECT:

According to the International Monetary Fund (IMF), global money laundering is estimated between 2 and 5 percent of world GDP. Stated

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\(^3\) defined as the criminal activity which gives rise to the financial proceeds being laundered
differently, between $800 billion and $2 trillion dollars is laundered per year (IMF, 2001). See Table for a perspective of this problem.

A comparison between country GDP as a percentage of World GDP and International Money Laundering (IML) as a percentage of World GDP (2003)

<table>
<thead>
<tr>
<th>Country/GDP as % of World GDP.</th>
<th>(IML) as a % of World GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>2.0%</td>
</tr>
<tr>
<td>Russia</td>
<td>2.7%</td>
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<tr>
<td>Italy</td>
<td>3.0%</td>
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<tr>
<td>UK</td>
<td>3.1%</td>
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<tr>
<td>France</td>
<td>3.2%</td>
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<tr>
<td>Africa</td>
<td>3.2%</td>
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<tr>
<td>Germany</td>
<td>4.4%</td>
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<tr>
<td>India</td>
<td>4.8%</td>
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<tr>
<td>N/A</td>
<td>5.0%</td>
</tr>
</tbody>
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Further, advances in technology, expansion of trade and financial systems, increased global travel, and the development of international organized crime have all contributed to the criminal’s arsenal for laundering funds.

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4 International Monetary Fund, Website 2003
The health of financial institutions and the political stability of nations may depend on authorities controlling the infiltration of their markets by criminals. The United Nations, in their Declaration and Action Plan against Money Laundering, made this threat very clear by stating\(^5\)

The laundering of money derived from illicit drug trafficking, as well as from other serious crime, has become a global threat to the integrity and stability of financial and trading systems\(^6\). The international community must work together to stop these practices to protect itself and to deny drug traffickers their ill gotten gains.

### 5.2.2 CLOSER TO HOME:

According to the U.S Department of State, there are seven, main consequences an economy faces when confronted with money with money laundering.\(^7\)

The undermining of the legitimate private sector is the first. As was discussed earlier, some criminals will use front companies to launder illicit funds and mix legally obtained money with illegal cash. This is done to disguise their source. Due to criminal’s ability to draw on these excess funds, they are able to “subsidize” their products, offering them at below market levels. Some criminals have been known to offer their products at prices below the manufacturer’s cost.

Consequently, the front companies have a competitive advantage over the legal enterprises that borrowed capital from financial markets, making it difficult for these legal firms to compete. Ultimately, private sector business is crowded out by this criminal element.

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\(^5\) United Nations website, 1998


\(^7\) By John McDowell, Senior Policy Adviser, and Gary Novis, Program Analyst, Bureau of International Narcotics and Law Enforcement Affairs, U.S. Department of State
Second, money laundering may challenge the integrity of financial markets. For instance, criminals have been known to move large sums of cash, via wire transfers, suddenly and without notification, causing liquidity problems and possible bank runs. Generally, this is done due to non-market forces such as investigations or inquiries by the authorities.

Further, cases have been documented where criminal activity was the main cause for bank failure.

The collapse of European Union Bank, the first bank on internet, serves as one such example.

Third, economic policy is compromised. Due to the large amount of money laundered each year, these funds have the potential to corner markets. Currencies and interest rates are also negatively affected as money launderers move their assets to escape detection rather than to a market where their money will yield a higher return. In brief, money laundering distorts money demand and creates volatility in global capital flows as well as interest and exchange rates, thereby disturbing any attempt to establish beneficial economic policy.

Fourth money launderers are interested in hiding their wealth to avoid detection rather than investing their assets in projects that would benefit the local economy. As a result, the funds are concealed in poor quality investments, which are short term in nature. Eventually, the projects are abandoned by the criminal enterprise, causing a negative surge in the surrounding areas.

Fifth, there is a loss of government revenue. Once again, because criminal proceeds are hidden to escape detection, governments are not able to tax the funds, causing governments to lose millions of dollars in revenue. In addition, law-abiding citizens realize a higher tax rate than would be expected without the presence of money laundering.
Sixth, there are risks associated with government privatization. Much like the launderers ability to purchase front companies, she is also able to outbid other for previously, state owned enterprises. Once obtained, the criminal is able to launder the funds through the purchased enterprise, which may include such businesses as casinos, banks, and marinas.

Finally, there is reputation risks associated with money laundering. Once a nation is branded with condoning money laundering, market confidence is reduced, global opportunities are lost, growth cannot be sustained, and criminal organizations will enter the country. All of these contribute to stifling a country’s development and economic growth.

5.2.3 HIDDEN BENEFITS:

In the aggregate, there is sufficient evidence to demonstrate money laundering negatively affects financial markets and helps to sustain the criminal element. However, there may be economic benefits for countries that condone this illegal act\(^8\). Currently, there are a number of countries, designated as non-cooperative, that do not abide by international recommendations to limit or eliminate money laundering within their borders.

5.3 THE ADVERSE IMPLICATIONS:

Money laundering has a corrosive effect on a country's economy, government, and social well-being\(^9\). Some of the negative impacts are:

5.3.1 INCREASED CRIME AND CORRUPTION:

Successful money laundering helps make criminal activities profitable; it rewards criminals\(^{10}\). Thus, to the extent that a country is viewed as a

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\(^8\) https://www.soils.org/publications/aj/articles/91/6/975

\(^9\) By John McDowell, Senior Policy Adviser, and Gary Novis, Program Analyst, Bureau of International Narcotics and Law Enforcement Affairs, U.S. Department of State

\(^{10}\) Money Laundering Impacts Development www.apgml.org/issues/docs/30/WB_Impacts on development pdf
haven for money laundering, it is likely to attract criminals and promote corruption. Havens for money laundering and terrorist financing have:

- A weak AML/CFT regime;
- Some or many types of financial institutions that are not covered by an AML/CFT framework;
- Little, weak or selective enforcement of AML/CFT provisions;
- Ineffective penalties, including difficult confiscation provisions; and
- A limited number of predicate crimes for money laundering.

If money laundering is prevalent in a country, it generates more crime and corruption. It also enhances the use of bribery in critical gateways to make money laundering efforts successful, such as:

- Employees and management of financial institutions,
- Lawyers and accountants,
- Legislatures,
- Enforcement agencies,
- Supervisory authorities,
- Police authorities,
- Prosecutors, and
- Courts.

A comprehensive and effective AML/CFT framework, together with timely implementation and effective enforcement, on the other hand, significantly reduce the profitable aspects of this criminal activity and, in fact, discourage criminals and terrorists from utilizing a country. This is especially true when the proceeds from criminal activities are
aggressively confiscated and forfeited as part of a country’s overall AML/CFT legal framework.

5.3.2 INTERNATIONAL CONSEQUENCES AND FOREIGN INVESTMENT:

A reputation as money laundering alone could cause significant adverse consequences for development in a country. Foreign financial institutions may decide to limit their transactions with institutions from money laundering havens; subject these transactions to extra scrutiny, making them more expensive; or terminate correspondent or lending relationships altogether\(^\text{11}\). Even legitimate businesses and enterprises from money laundering havens may suffer from reduced access to world markets or access at a higher cost due to extra scrutiny of their ownership, organization and control systems\(^\text{12}\).

Any country known for lax enforcement of AML/CFT is less likely to receive foreign private investment. For developing nations, eligibility for foreign governmental assistance is also likely to be severely limited.

Finally, the Financial Action Task Force on Money Laundering (FATF) maintains a list of countries that do not comply with AML requirements or that do not cooperate sufficiently in the fight against money laundering. Being placed on this list, known as the “non-cooperating countries and territories” (NCCT) list\(^\text{13}\), gives public notice that the listed country does not have in place even minimum standards. Beyond the negative impacts referred to here, individual FATF member countries could also impose specific counter-measures against a country that does not take action to remedy its AML/CFT deficiencies\(^\text{14}\).

\(^{11}\) Money Laundering Impacts Development www.apgml.org/issues/docs/30/WB_Impacts on development pdf

\(^{12}\) http://www1.worldbank.org/finance/assets/images/02-chap02-f.qxd.pdf

\(^{13}\) See Chapter III, FATF, The NCCT List

\(^{14}\) See Chapter III, FATF, The NCCT List.
5.3.3 UNDERMINING THE LEGITIMATE PRIVATE SECTOR:

One of the gravest microeconomic sound effects of money laundering is felt in the private sector. Money launderers frequently use front companies, which co-mingle the proceeds of illicit activity with legitimate funds, to hide the ill-gotten gains\(^\text{15}\). In the United States, for example, organized crime has used pizza parlours to mask proceeds from heroin trafficking. These front companies have access to considerable illegitimate money, allowing them to support financially front company products and services at levels well lower 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.

5.3.4 DETERIORATION THE FINANCIAL INSTITUTIONS:

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 unravelled had significant criminal or fraud components.

Money laundering can weakened the soundness of a country’s financial sector, as well as the stability of individual financial institutions in multiple ways. The following discussion focuses on banking institutions, but the same consequences, or similar ones, are also applicable to other types of financial institutions, such as securities firms, insurance companies, and investment management firms. The adverse consequences generally described as reputational, operational, and legal and concentration risks are interrelated. Each has specific costs:

- Loss of profitable business,
- Liquidity problems through withdrawal of funds,
- Termination of correspondent banking facilities,
- Investigation costs and fines,
- Asset seizures,
- Loan losses and
- Declines in the stock value of financial institutions\(^\text{16}\).

Reputational risk is the potential that adverse publicity regarding a bank’s business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution. Customers, both borrowers and depositors, as well as investors cease doing business with an institution whose reputation has been damaged by suspicions or allegations of money laundering or terrorist financing. The loss of high quality borrowers reduces profitable loans and increases the risk of the overall loan portfolio. Depositors may also withdraw their funds, thereby reducing an inexpensive source of funding for the bank.

Moreover, funds placed on deposit with a bank by money launderers cannot be relied upon as a stable source of funding. Large amounts of laundered funds are often subject to unanticipated withdrawals from a financial institution through wire transfers or other transfers, causing potential liquidity problems.

Operational risk is the potential for loss resulting from inadequate or failed internal processes, people and systems, or external events. As noted above, such losses occur when institutions incur reduced, terminated, or increased costs for inter-bank or correspondent banking services. Increased borrowing or funding costs can also be included in such losses.

Legal risk is the potential for law suits, adverse judgments, unenforceable contracts, fines and penalties generating losses, increased expenses for an institution or even closure of such an institution. Money laundering involve criminals in almost every aspect of the money laundering process. As a consequence, legitimate customers may also be victims of a financial crime, lose money and sue the institution for reimbursement. There may be investigations, by banking or other law enforcement authorities resulting in increased costs, as well as fines and other penalties involved. Also, certain contracts may be unenforceable due to fraud on the part of the criminal customer.
Concentration risk is the potential for loss resulting from too much credit or loan exposure to one borrower, statutory provisions or regulations usually restrict a bank’s exposure to a single borrower or group of related borrowers. Lack of knowledge about a particular customer, the customer’s business, or what the customer’s relationship is to other borrowers, can place a bank at risk in this regard. This is particularly a concern where there are related counter-parties, connected borrowers, and a common source of income or assets for repayment. Loan losses also result, of course, from unenforceable contracts and contracts made with fictitious persons.

Banks and their account holders are protected when effective due diligence regimes are in place. Identification of the beneficial owners of an account is critical to an effective AML/CFT regime. Such identification procedures protect against business relationships with fictitious persons or corporate entities without substantial assets, such as shell corporations, as well as known criminals or terrorists. Due diligence procedures also help the financial institution to understand the nature of the customer’s business interests and underlying financial issues.

5.3.5 LOSS OF CONTROL OF ECONOMIC POLICY:

The estimated magnitude of money laundering is between 2 and 5 percent of world gross domestic product, or at least $600,000 million\(^\text{17}\). In some emerging market countries, these illicit proceeds may disturb the 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

\(^{17}\) Michel Camdessus, the former managing director of the International Money Fund
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.

5.3.6 INTERNATIONAL CONSEQUENCES AND FOREIGN INVESTMENT:

A reputation as money laundering alone could cause significant adverse consequences for development in a country. Foreign financial institutions may decide to limit their transactions with institutions from money laundering havens; subject these transactions to extra scrutiny, making them more expensive; or terminate correspondent or lending relationships altogether. Even legitimate businesses and enterprises from money laundering havens may suffer from reduced access to world markets or access at a higher cost due to extra scrutiny of their ownership, organization and control systems.

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\(^{18}\) See Chapter III, FATF, The NCCT List.
specific counter-measures against a country that does not take action to remedy its AML/CFT deficiencies.

5.3.7 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.

5.3.8 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.

5.3.9 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.

5.3.10 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 signalling 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.

5.3.11 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.

5.3.12 COMPROMISED ECONOMY AND PRIVATE SECTOR:

Money launderers are known to use “front companies,” i.e., business enterprises that appear legitimate and engage in legitimate business but are, in fact, controlled by criminals.

These front companies co-mingle the illicit funds with legitimate funds in order to hide the ill-gotten proceeds. Front companies’ access to illicit funds, allows them to subsidize the front company’s products and services, even at below-market prices. As a consequence, legitimate enterprises find it difficult to compete with such front companies, the sole purpose of which is to preserve and protect the illicit funds, not to produce a profit.

By using front companies and other investments in legitimate companies money laundering proceeds can be utilized to control whole industries or sectors of the economy of certain countries. This increases the potential for monetary and economic instability due to the misallocation of resources from artificial distortions in asset and commodity prices\(^\text{19}\). It also provides a vehicle for evading taxation, thus depriving the country of revenue.

5.4 SECTOR BY SECTOR ECONOMIC ANALYSIS:

Here we will assess the economic effects of money laundering by examining each of the three major economic sectors in turn.

First, because money laundering is closely associated with the financial sector, the effects on the economy through the financial system will be considered in depth.

Second, the more direct effects of money laundering on the real sector i.e., manufacturing and non-financial services.

Third, we will examine the effects on money laundering through the external sector (international capital and trade flows) on economic development.

Lastly, because of the unique nature of smaller economies acting as offshore financial centers (OFC’s), we will separately examine the harmful effect that money-laundering activity through OFC’s has on these smaller countries’ efforts to use the OFC industry as a vehicle for economic development.

Before we see the impact of money laundering on economy it is important to distinguish between longer-term, sustainable economic development and the narrower question of short-term economic encouragement. Indeed, as noted later, money-laundering activities can, in some special cases, provide a temporary boost to economic activity in the short term but only at the expense of longer-term economic growth and development.

5.4.1 THE FINANCIAL SECTOR: MONEY LAUNDERING UNDERMINES DOMESTIC CAPITAL FORMATION:

Although money laundering does not require the use of formal financial institutions, reviews of money-laundering typologies consistently indicate that

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20 Report for the Asian development bank, Regional Technical Assistance Project No.5967, titled countering Money Laundering in the Asian and Pacific Region.
banks, equity markets, and non-bank financial institutions (NBFIs), such as insurance companies, are a favored means of laundering illicit funds both internationally and within developing countries.

The reason for this preference lies in the efficiency that financial institutions can provide for the money launderer: just as financial institutions are a critical part in the financing of the legitimate economy, they can be a low-cost vehicle for the illicit economy to launder funds.

The money-laundering phases of greatest concern when considering the impact on a developing country's financial institutions are the placement and layering phases, wherein the illicit funds are being laundered but have not yet been fully integrated into the economy for use by the funds' claimants as consumption goods, or as investments in apparently legitimate businesses.

From an economic development standpoint, the central importance of money laundering through financial institutions is threefold.

First, money laundering erodes financial institutions themselves.

Second, the development of sound, reliable banks and (non-bank financial institutions) NBFIs is a crucial element in overall economic development: indeed, such institutions have come to be recognized as essential for such development and—particularly in developing countries—customer trust is fundamental to the growth of sound financial institutions.

Third, beyond protecting such institutions from the negative effects of money laundering itself, the adoption of anti-money-laundering policies by government financial supervisors and regulators, as well as by banks and (non-bank financial institutions) NBFIs can reinforce the other good-governance practices that are important to the development of these economically critical institutions.
Impact of money laundering in detail.

A. Money laundering erodes financial institutions.

Constant money laundering through developing-country financial institutions erodes these institutions in three broad ways:

I. By increasing the probability individual customers will be defrauded by corrupt individuals within the institution;

II. By increasing the probability that the institution itself will become corrupt or even controlled by criminal interests, again leading to customers being defrauded; and

III. By increasing the risk of financial failure faced by the institution as a result of the institution itself being defrauded. Such dangers come under the formal heading of operational risk, and can contribute significantly to reputational risks faced by banks.

These three factors can emerge separately or together indeed, they can reinforce each other and they are particularly likely to increase operational risks, particularly via fraud, and reputational risks faced by banks. Of course, any operational damage caused by money laundering also worsens reputational damage and vice versa: a sudden loss of reputation can threaten the institution’s substantive financial position with, in the extreme case, a run on its deposits.

i. Money laundering activity increases the probability that individual customers, or the institution itself, will be defrauded by corrupt individuals within the institution.

Major money-laundering episodes undertaken by individuals within otherwise legitimate financial institutions often involve financial fraud by those same individuals. In particular, FATF reports that, after narcotics trafficking, financial crime is the most frequent predicate crime that gives rise to the proceeds to be laundered.
In human terms, employees willing to engage in money laundering are less likely to abstain from fraud or actively prevent it as part of their duties. Although difficult to quantify, this relationship emerges clearly from a review of substantial fraud committed within banks.

Some recent examples are:

- People’s Republic of China (PRC).

The Bank of China, on which the U.S. Office of the Comptroller of the Currency (OCC) recently levied a $20 million fine because employees committed "favoritism, committed irregularities, issued fraudulent letters of credit, and facilitated loan frauds" in the bank’s New York operations, recently was a victim itself. Two branch managers and an assistant manager at the Kaiping branch allegedly conspired with a government official and contacts in Hong Kong, to defraud the bank of $75 million. The Chinese personnel have absconded to Canada, but 2 people in Hong Kong, according to newspaper reports, have been charged with abetting money laundering.

- France

Beginning in late 2001, French authorities launched a series of investigations into officials of France’s leading banks in connection with fraud, tax evasion, and money laundering. According to press reports, “thousands of French cheques, some of them stolen, were ‘endorsed’ or signed over to new beneficiaries before being cashed at money-changers in Israel”, and then the proceeds were returned to France through correspondent banking relationships. The amounts involved exceeded $70 million.

- Germany

Since its bankruptcy in 1995, Düsseldorf prosecutors have been investigating 10 former employees of a private bank, BVH, on "suspicion of fraud, disloyalty and money laundering". It has now been alleged that the bank laundered funds in the form of bogus credits, and redirected them to a firm believed to have belonged to Osama Bin Lad en’s Al-Qaida network.
It is not unusual in any jurisdiction for spectacular bank failures to stem from the actions of a few individuals, or even a single employee, as exemplified by the infamous cases. Such consequences are even more likely in smaller countries with less difficult regulatory control over banking processes.

For example, in Estonia, a once-respected manager and majority shareholder of ERA Bank recently came under investigation in connection with the bank’s collapse in 1999. Media reports indicate the manager could face charges of "fraud, plunder, and money laundering" among other crimes.

ii. Money laundering increases the probability that the financial institution itself will become corrupt or even controlled by criminal interests.

The possibility is even greater in a developing country that criminal interests can eventually control an entire financial institution. First, such institutions tend to be smaller, which makes the task of control easier. Second, developing country financial regulation and supervision tends to be less rigorous than that in developed countries, which themselves have problems with criminal penetration of institutions or lower-level fraud.

“Businesses that are effective venues for money laundering, such as banks and casinos, have risk of takeovers by criminal. In countries such as the former Soviet Union, where banking regulations are lax or poorly enforced, financial institutions have been established and taken over by organized crime groups”21.

There are many indications that the volumes of illicit funds in developing-economy banking systems are substantial. At such high levels, the influence of criminal interests over financial institutions becomes a serious concern.

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21 paper prepared by the Management Development and Governance Division of the United Nations Development Programme,
iii. The reputational consequences: loss of critical investor trust.

The adverse effects of money laundering on developing-country financial institutions discussed above constitute clear operational risks to the financial soundness of the institution. But such risks also give rise to, and are compounded by, another adverse factor: reputational risk, or the loss of a reputation for integrity. Financial experts often emphasize the role of a financial institution’s reputation in promoting the soundness of that institution.

The connection between the 3 substantive effects mentioned previously and the reputational effect is simple: a potential user of a financial institution is less likely to risk his or her own funds in the institution if it becomes widely known that the institution: is more likely to contain individuals willing to commit fraud (the first substantive risk discussed); is a criminal institution itself (the second substantive risk) and therefore may defraud the individual; or may become insolvent and unable to return the committed funds.

“Reputational risk arises from operational failures, failure to comply with relevant laws and regulations, or other sources. Reputational risk is particularly damaging for banks since the nature of their business requires maintaining the confidence of depositors, creditors and the general marketplace”.

Compounding the reputation effect yet further is that the reputational problems can exist on a wholesale level: even if retail investors are unaware or unconcerned with a financial institution’s reputation, other financial entities—such as those with a potential correspondent banking relationship with the disreputable institution—will be reluctant to do business with that institution for fear that its own valuable reputation will be contaminated. Moreover, it is important to recognize that the loss of reputation can have severe effects on a financial institution (and an entire nation's financial system).

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22 As the non-profit International Financial Risk Institute (IFRI) based in Switzerland summarized the issue:
B. Money laundering weakens the financial sector's role in economic growth.

The previous section reviewed the various ways in which money laundering activity erodes financial institutions. To assess the implications of this problem for economic development, it is useful to review the linkage between the strength of developing-country financial institutions and economic growth in developing economies. In particular, in developing countries investor confidence—which is diminished by money laundering activity—plays a special role in the linkage between financial institutions and economic growth.

A. Strong developing-country financial institutions are critical to economic growth.

Although a comprehensive review of the linkage between strong financial institutions and developing-country growth is beyond the scope of this dissertation, the detrimental effects that money laundering has on developing-country financial institutions makes it necessary to review the importance of this linkage.

The form of a developing country’s dominant financial institutions banks vs. equity markets vs. NBFIs would prove to be the critical factor in economic growth; it is the strength of the financial institutions regardless of the form they take that is the most important factor. The critical role that banks, NBFIs, and equity markets play in economic development is through their function in capital formation and allocation a particularly crucial role in developing economies where such capital is scarce when compared to its greater availability in industrialized economies.

Indeed, the World Bank identifies "developing local capital markets and banking systems" as one of the three fundamental tasks necessary for economic development.
B. Confidence and reputation play a special role in developing economies' financial systems.

Money laundering's negative impact on financial institutions is of particular concern in a developing-country context for at least two reasons.

First, in many of these countries the largest, most sophisticated financial institutions have historically relied heavily on public funds rather than private deposits, and the success of wide-ranging financial reforms will depend in part on the sustained expansion of individual savers' trust in these institutions as private capital replaces public capital. As the World Bank notes in its mission statement, "sound financial systems [are] essential for private entrepreneurs to emerge, for business to flourish, and for local people and investors from abroad to find the confidence to invest, and create wealth, income, and jobs."

Second, financial institutions in developing countries are often undergoing a transition from being state-owned to private-investor ownership and control. Yet, studies have shown that private investors are more reluctant to commit funds to obtain ownership in enterprises cited for corruption. The announcement that a firm has allegedly been involved in corrupt activities is typically associated with materially negative equity return at the time of the announcement, indicating the investors are less likely to hold shares in the firm.

Finally, from a developing country's policymaking standpoint, there are other issues that must be taken into account, and foremost among these is the effect that international anti-money-laundering measures are likely to have on the developing country's economy. In the extreme, a country with lax anti-money-laundering enforcement measures can be subject to formal legal sanctions by important trade and investment partners.

Even outside the area of anti-money-laundering efforts, developing countries may be unable to gain full access to international economic resources as a result of money laundering problems—actual or perceived.
Given the problem of measuring the magnitude of money laundering, it is doubly difficult to quantify the damage of money-laundering flows on developing countries’ financial systems.

Thus, by undermining these institutions and the developing-country financial systems to which they belong, money-laundering activity undermines capital formation within developing economies. This negative economic effect associated with developing countries’ financial systems exists even before considering money laundering’s more direct effects on the real economy, or through the damage to the external sector. As discussed in the next section, however, anti-money-laundering policies can positively contribute to stronger financial institutions in developing countries.

C. Anti-money-laundering reforms support financial institutions

Through improved financial care several of the core anti-money-laundering policies are also policies that promote overall good governance of financial institutions, and therefore have positive secondary effects on economic development.

I. Strong correspondence between anti-money-laundering policies and financial good-governance rules.

As noted in the previous section, a strong rule of law governing financial institutions in developing countries is a fundamental prerequisite for economic growth. Anti-money-laundering policies are a constituent element in the good-governance policies that form a solid rule-of-law environment for developing-country financial institutions. A strong indicator of this is the large overlap that exists between the prudential financial-stability rules promoted by governmental and inter-governmental organizations on the one hand, and fundamental anti-money-laundering policies on the other.

Most significantly, the Bank for International Settlements (BIS), the purpose of which is to promote "cooperation among central banks and other agencies
in pursuit of monetary and financial stability," has endorsed key elements of the anti-money-laundering practices as explicitly supportive of sound banking practices that reduce financial risks for individual banks and, by extension, national and international financial systems as a whole.

"The primary function of [banking supervisory agencies] is to maintain the overall financial stability and soundness of banks rather than to ensure that individual transactions conducted by bank customers are legitimate", they should nevertheless address the use of banks by criminals:

...Public confidence in banks, and hence their stability, can be undermined by adverse publicity as a result of inadvertent association by banks with criminals. In addition, banks may lay themselves open to direct losses from fraud, either through negligence in screening undesirable customers or where the integrity of their own officers has been undermined through association with criminals.

The importance of "know your customer" (KYC) banking rules as a prudential risk-management issue, again citing the potential for reputational damage and fraud if such policies are absent, and identified KYC rules as an integral element of a bank's "internal control" mechanism for risk management.

More recently, however, the Basel Committee recognized the strong parallels between KYC and sound banking practices for reasons unrelated to the harmful financial effects of money laundering, and endorsed, implicitly or explicitly, many anti-money-laundering practices "from a wider prudential perspective":

KYC is most closely associated with the fight against money-laundering [but] the Committee's interest is from a wider prudential perspective. Sound KYC policies and procedures are critical in protecting the safety and soundness of banks and the integrity of banking systems.

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23 In 1988, BIS's Committee on Banking Supervision practices 1988 (the Basel Committee)
24 In 1997, the Basel Committee published its Core Principles for Banking Supervision
Sound KYC procedures must be seen as a critical element in the effective management of banking risks. KYC safeguards go beyond simple account opening and record-keeping, and require banks to formulate a customer acceptance policy and a tiered customer identification programme that involves more extensive due diligence for higher-risk accounts, and includes proactive account monitoring for suspicious activities.

The Basel Committee's interest in sound KYC standards originates from its concerns for market integrity and has been heightened by the direct and indirect losses incurred by banks due to their lack of diligence in applying appropriate procedures. These losses could probably have been avoided and damage to the banks' reputation significantly diminished had the banks maintained effective KYC programmes.

Indeed, the report concluded that "effective KYC procedures embrace routines for proper management oversight, systems and controls, segregation of duties, training and other related policies."

One clear example of how strong KYC policies promote sound banking practices, aside from their anti-money-laundering role, can be seen in the prudential problem of "concentration risk" (an element of credit risk), which is the problem of a bank putting too many of its eggs in a single customer's basket. If the customer encounters financial problems—or simply abandons the bank for other reasons—the bank is put at risk. Thus, prudent banking policy demands that no single customer becomes a dominant client. Yet, given the many close financial interrelationships that may exist among seemingly independent clients, managing concentration risk implies thorough knowledge of the institution's customers—are they related, or even fronts for the same client? As the Basel Committee has noted, the concentration risk is particularly acute for banks that have a substantial client base of "politically exposed persons" (PEPs) who seek to mask their financial relationships through the use of many intermediaries, each of which appears to be an
individual actor from the viewpoint of a bank lacking adequate KYC practices.

II. Private institutions and associations often adopt parallel rules.

The parallels between several anti-money-laundering practices and financial prudence policies can also be seen in the degree to which private financial institutions and their associations adopt similar practices for their own sound-business purposes.

For example, the Swiss Bankers Association (SBA) recently stated that its member banks are fully aware that "know-your-customer" (KYC) principles are not only a tool for combating financial crime but play an important role in the proper running of banking and securities business within the financial institution…. Swiss banks introduced in 1977—after negative experiences of a bank having neglected just this—the SBA's Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence [on customers].

This "negative experience" to which the SBA alludes was perhaps the worst financial scandal in Switzerland's history, the 1977 "Chiasso" affair, in which 2 Credit Suisse officials engaged in fraud and money laundering at one of the bank's Italian branches. The episode cost Credit Suisse $830 million, caused a run on the branch, and led Swiss bankers to create their own code of conduct on the acceptance of suspicious funds—a code that was studied carefully when the first international anti-money-laundering policies were developed in the 1980s.

Even outside the banking sector, other private financial institutions and their associations often voluntarily adopt KYC rules for reasons unrelated to money laundering.

For example, such rules are contained in the bylaws of the New York Stock Exchange (Rule 405) and the U.S. National Association of Securities Dealers (Article III section 2) to improve the reputation and credibility of these financial institutions.
5.4.2 THE REAL SECTOR: MONEY LAUNDERING DEPRESSES GROWTH:

Aside from its negative effect on economic growth through its erosion of developing countries' financial sectors, money laundering also has a more direct negative effect on economic growth in the real sector by diverting resources to less-productive activity, and by facilitating domestic corruption and crime, which, in turn, depress economic growth.

A. Money laundering distorts investment and depresses productivity

The flow of laundered illicit funds follows a path through the economy that is different than such funds would take if they were not being laundered. As can be seen from the various money-laundering mechanism typologies reports, money laundered through channels other than financial institutions is often placed in what are known as "sterile" investments, or investments that do not generate additional productivity for the broader economy. Real estate is the foremost example of such sterile investments; others include art, antiques, jewelry, and high-value consumption assets such as luxury automobiles.

Criminal organizations can transform productive enterprises into sterile investments by operating them for the purposes of laundering illicit proceeds rather than as profit-maximizing enterprises responsive to consumer demand and worthy of legitimate investment capital. Commitment of the economy's resources to sterile, as opposed to productive, investments (or to normal consumption expenditures that drive productive investments through higher demand) ultimately reduces the productivity of the overall economy. Finally, funds that are being laundered through the purchase of certain targeted assets—real estate is often favored—will drive the prices of such assets up, causing overpayment for them throughout the economy, thus "crowding-out" productive investment to less-productive uses.
This dynamic further erodes economic growth.

The magnitude of these effects is difficult to quantify, but is demonstrably substantial given sufficient levels of money laundering activity. One statistical study of the economic effect of illegal drug exports from Colombia on the Colombian economy reported that the macroeconomic benefits that would otherwise be expected from the narcotics’ export revenues were, in fact, significantly offset “by concentrating [illegal proceeds] spending in real estate [and therefore] drug traffickers’ money created distortions in the resource allocation process.”

Reduced economic activity from excess expenditure on more "sterile" sectors such as real estate can be seen in the input-output matrices of developing economies. Expenditure in sectors more often appearing in money laundering typology reports are associated with lower-than-average economic output.

B. Money laundering can increase the risk of macroeconomic instability

The International Monetary Fund has identified 2 mechanisms by which significant volumes of money-laundering flows can induce macroeconomic instability in a developing country.

- First, there is the "hot money" problem:

  large money-laundering flows through a particular region are often triggered by specific episodes of political flux, such as the fall of the Soviet Union or the brief but profitable reign of a corrupt dictator, and, therefore, the financial flows that accompany the money laundering activity are unstable, which can contribute to the instability of exchange rates, monetary aggregates (the amount of money available in an economy), and general price levels (inflation).

- Second, the IMF has noted that because some phases of money laundering transactions are "underground" or in the informal sector of
the economy, such transactions do not appear in official monetary and financial statistics, thus giving misleading information to policymakers attempting to manage macroeconomic variables, such as monetary levels, interest rates, inflation, and exchange rates.

5.4.3 THE EXTERNAL SECTOR: MONEY LAUNDERING DISTORTS CAPITAL AND TRADE FLOWS:

Laundering of outbound illicit funds constitutes the facilitation of illicit capital flight, which drains resources from developing economies, and extensive money laundering of all forms can deter legitimate inward foreign direct investment (FDI) beneficial to sustained economic growth.

- **Outbound flows: facilitating illicit capital flight**

The obvious effect of illicit capital flight is to worsen the scarcity of capital in developing countries. As IMF economists summarized the issue:

*The costs of capital flight are well known: they include a loss of productive capacity, tax base, and control over monetary aggregates—imposing a substantial burden on the public at large and rendering policymaking more difficult.* In many cases, such capital flight has been enormous.

Money laundering can be seen as a key element in illicit capital flight from throughout the developing world. Each of the major episodes of rapid, large-scale illicit capital flight from developing (and transition) countries has been facilitated with identifiable centers of money laundering activity.

**The well-known (if extreme) example of**

- Russia's illicit capital flight has been thoroughly reviewed elsewhere and need not be repeated in detail here. Yet it is important to note that much of those funds were laundered first through domestic Russian financial institutions, and ultimately through OFCs in the South Pacific, Mediterranean, and the islands in the UK orbit. To the extent
these funds were not sent back after being laundered (were "outbound"), money laundering at home and abroad helped drain resources from the economy through the external sector.

- The massive illicit capital flight from Nigeria since the mid 1990s also made full use of money-laundering centres in the developed world, and were largely not being repatriated—contrary to the notion that money laundering is a problem involving illicit developed country funds being laundered in the developing world. The UK's financial supervisory authorities estimate that illicit transactions in UK accounts that originated in Nigeria amounted to about $1.3 billion between 1996 and 2000."

Domestic institutions can also serve as the preferred initial "placement" institutions for illicit capital flight: the Central Bank of Zambia recently suspended the license of a major private bank, United Bank of Zambia, after allegations of outbound money laundering, according to press reports.

Although regions with large-scale illicit capital flight, such as Russia and Africa, attract the greatest attention in the press and among academics, the problem is pervasive and often operates on a more regional or local level.

For example, Pakistan's central bank governor recently put pressure on the United Arab Emirates to tighten controls on money-exchange operations. According to press reports, Dubai, the commercial capital of the UAE, is a hub for money changers and the biggest market for Pakistani rupees outside of Pakistan itself.

Despite claims to the contrary, anti-money-laundering regulations do not appear to cause significant capital flight. Ironically, the prospect of capital flight has been invoked to prevent or delay the imposition of anti-money-laundering measures on the grounds that deposits will be transferred to more lax regulatory environments (or funds will be put "under the mattress") as depositors seek greater secrecy from governments.
5.4.4 OFFSHORE FINANCIAL SECTORS: MONEY LAUNDERING HINDERS THEIR DEVELOPMENT ROLE:

Recently, there have been 2 parallel developments with respect to offshore financial centres (OFC’s). First, dozens of OFC’s have been created as part of developing countries’ (or territories’) efforts to develop their domestic economies through the provision of international financial services. Second, OFC’s have become an increasing concern in efforts to curtail transnational money laundering activity. Thus, the effect of money laundering on the establishment of OFC’s as an economic development strategy warrants special focus here.

- **OFC’s as an economic-development strategy**

Over the past 2 decades, dozens of small countries and territories have established OFC’s as an element—often the main element—of the government’s overall economic development strategy. As one development economist summarized the phenomenon, for many small countries the creation of an OFC “is seen as a solution for their economic disadvantages”.

Yet jurisdictions seeking to use OFC’s as vehicles for economic development face two enormous challenges, the solutions to which are somewhat contradictory.

  - First, the jurisdiction must be competitive with other jurisdictions in a variety of factors, including "price" or the sum total of fees, as well as a regulatory environment that is not burdensome for potential customers. In attempting to be competitive by these standards, an OFC could choose to feature itself as a “name plate” OFC that provides a jurisdiction in which a financial institution or corporation may be established, but few if any other services. Such OFC’s are called notional OFC’s because they often allow for institutions that are little more than “brass plates” with little substantive value added by the OFC itself.
Secondly, The OFC’s that have been the most successful both in terms of the OFC’s’ own growth and the OFC sector’s economic contribution to the rest of the economy have been those that have built a foundation of higher-level financial services. These functional OFC’s provide a significant degree of economic functionality, or value-added, to the transactions undertaken in the jurisdiction. In reality, most OFC’s lie on a spectrum between the extreme definitions of notional and functional.

Moreover, many OFC’s have chosen to target a market “niche” in terms of financial instrument (e.g., Bermuda and insurance) or region (e.g., Malaysia’s Labuan and Southeast Asia) or even currency (the Channel Islands and Eurodollars). In each case, however, the OFC has made an explicit or implicit decision regarding the level of services the OFC will provide.

To examine the effect of money laundering on the economy in which an OFC is located, the most important phenomenon to recognize is that functional OFC’s tend to contribute to economic growth whereas notional OFC’s do not. Functional OFC’s typically have "back offices" and larger "front offices" that undertake the functional financial activities, while providing direct employment (office workers) and indirect employment (goods and services to the OFC institutions).

The functional OFC’s have been far more effective at generating domestic economic growth and employment than have notional OFC’s.

“Notional” OFC’s have a “nominal” contribution to employment (less than 3% of the workforce) and GDP (less than 10%), whereas "functional" OFC’s often make contributions that are several multiples of these levels.

The negative economic effects of money laundering on economic development are difficult to quantify, just as the extent of money laundering itself is difficult to estimate. Nonetheless, it is clear from the evidence that allowing money laundering activity to proceed unchallenged is not an optimal
economic-development policy because it damages the financial institutions that are critical to economic growth, reduces productivity in the economy's real sector by diverting resources and encouraging crime and corruption, and can distort the economy's international trade and capital flows to the detriment of long-term economic development. Developing countries' strategies to establish OFCs as vehicles for economic development are also impaired by significant money-laundering activity through OFC channels. Effective anti-money-laundering policies, on the other hand, reinforce a variety of other good-governance policies that help sustain economic development, particularly through the strengthening of the financial sector.