



Money Laundering: Muddying the Macroeconomy

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Money laundering can have devastating economic consequences. Fighting it should be a priority for all countries and is not incompatible with financial market liberalization.

A FEW YEARS ago, a group of IMF staff went to a small island country to assess economic developments. As they walked around the capital, they noticed a surprisingly large number of small banks (more than 100 in a country of less than 100,000 people). A year later, it was revealed that many of these banks had no legitimate banking business and that the country's government had begun to shut them down with help from bank regulators in a major international financial market.

This example illustrates two points: first, that offshore banks have been an important and visible vehicle for money laundering—the transfer of illegally obtained money through third parties to conceal its source—and, second, that there are both a need and an established framework for international cooperation in the fight against money laundering.

The framework

In 1996, the IMF was asked by the Paris-based Financial Action Task Force (FATF) on money laundering (Box 1) to prepare a study on the macroeconomic implications

of money laundering. The impetus for the study was clear-cut. The IMF promotes openness of international financial markets, or “currency convertibility,” through the abolition of exchange controls. But this liberalization is sometimes perceived as dangerous, because it opens up more channels for laundering dirty money. In fact, the media have carried stories with headlines like “1992 Means a Single Market for Crime, Too—As EC customs and exchange controls fall, money laundering will flourish unless new laws are enacted” (Larry Gurwin, *Global Finance*, January 1990). And some governments had told the FATF that they could not implement its “40 Recommendations” for fighting money laundering because to do so would require adopting regulations contrary to the IMF's advice for liberalizing financial markets.

The first part of the rebuttal to this argument is straightforward. The FATF's Recommendation 23 states that, “The feasibility of measures to detect or measure cash at the border should be studied subject to strict safeguards to ensure proper

use of information and *without impeding in any way the freedom of capital movements.*” (Emphasis added.) Monitoring for money laundering requires information on, rather than control of, the foreign exchange transaction, and the type of information required for monitoring is different from that required for exchange controls. Countries that retain exchange controls require, for enforcement purposes, information on the economic function of transactions, while monitoring for money laundering is focused on establishing the identities of transactors and the patterns of their transactions (“know your customer”). In addition, studies show that large-scale capital flight has been triggered by economic incentives created by exchange controls and nonmarket exchange and interest rates rather than by criminal activity.

The second—and more forceful—part of the rebuttal has been harder to establish: money laundering has a significant negative impact on the macroeconomy, and there are therefore good economic reasons for urgently adopting anti-laundering

Box 1

The Financial Action Task Force

At the July 1989 economic summit in Paris, the Group of Seven countries set up the Financial Action Task Force (FATF), whose brief is to prevent banks and financial institutions from laundering the proceeds of criminal activities—in particular, sales of controlled substances, organized criminal activities, and manipulation of markets by insiders. The FATF, which has 28 member countries and governments, primarily from the industrial world, encourages countries to make money laundering a criminal activity in itself (many have already done so); it also seeks to strengthen international cooperation between criminal investigation agencies and the judiciaries in different countries.

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measures. Very little of the large body of economic literature on crime deals with money laundering, although much has been written about the “hidden” or “underground” economy and tax evasion.

How big is the problem?

To prove that money laundering is significant for the macroeconomy, it is necessary to show that it involves large sums relative to overall economic activity. Attempts by macroeconomists—mainly in the 1980s—to measure the underground economy had actually been measuring money laundering (although this was not specifically stated) because they looked at the displacements in time series for currency demand associated with, for example, higher taxes, and thus tax evasion. Another approach to estimation, used by the law-enforcement community rather than by economists, was to build up estimates by crime category (a “micro-economic” approach), based on street knowledge; sampling; and detailed medical, social, and financial/tax records. The result of these efforts is a very wide range of estimates of the size of underground economies, as a percentage of GDP—for example, for Australia, 4–12 percent; Germany 2–11 percent; Italy, 10–33 percent; Japan, 4–15 percent; the United Kingdom, 1–15 percent; and the United States, 4–33 percent.

The large variations in estimates have led to reliance on “consensus” numbers. For example, on October 18, 1994, the *Financial Times* reported that, according to recent estimates by UK and US officials, the amount of money laundered annually in the financial system worldwide was roughly \$500 billion—some 2 percent of global GDP. The basis for this estimate was not given; it may have been derived from an informal updating and generalization of earlier FATF micro-based estimates.

A study published last year (Quirk, 1996) differs from the earlier macro work in two respects: (1) it is cross-sectional for 19 industrial countries, and (2) it uses Interpol crime data and data on labor participation as proxies for noncriminal informal markets, in addition to the earlier tax evasion variables, to explain currency and money demand across industrial countries. Its main conclusions are as follows:

- Crime is highly significant in explaining differences among the industrial countries; a 10 percent increase in crime is associated with a 10 percent *reduction* in currency demand and a 6 percent *reduction* in overall money demand.

- The relationship between crime and currency demand changed direction between the early 1980s and early 1990s. An upswing in crime once led to increased demand for currency; now, increases in crime lead to decreases in currency demand. In other words, money laundering methods have changed (Box 2), moving away from the banking system and cash and toward parallel financial markets, sophisticated nonmonetary instruments (such as derivatives), and possibly barter (such as an exchange of boats and guns for drugs). If money laundering has moved to the parallel market—that is, debits and credits booked by organized criminal quasi-banks, say, over the Internet—there could be important implications for anti-laundering efforts, which have typically focused on criminal activity at the point at which the proceeds enter the aboveground economy.

Given the seriousness of the problem, there is clearly a need for better data. On the one hand, while estimates based on macroeconomic data can provide indications of both direct and indirect influences of money laundering, the inclusion of indirect influences creates uncertainty as to exactly what is being measured. On the other hand, a micro-based approach requires the creation of a very large amount of data specifically for measurement purposes. Sampling and survey approaches offer a means of extrapolating to otherwise unobservable aspects of money laundering, although care needs to be taken to ensure that a comprehensive methodology is applied in the sampling and in-depth follow-up of transactions. A consistent international methodology would offer economies of scale as well as the sharing of insights across countries.

Macroeconomic effects

Because crime, underground activity, and money laundering take place on a large scale, macroeconomic policymakers must take them into account. But, because these activities are hard to measure, they distort economic data and complicate governments’ efforts to manage economic policy. In addition, the ability to identify statistically the country and currency of issuance and the residency of deposit holders is key in understanding monetary behavior. To the extent that money demand appears to shift from one country to another because of money laundering—resulting in misleading monetary data—it will have adverse consequences for interest and exchange rate volatility, particularly in dollarized economies, as the tracking of monetary aggregates becomes more uncertain.

The income distribution effects of money laundering must also be considered. To the extent that the underlying criminal activity redirects income from high savers to low savers, or from sound investments to risky, low-quality investments, economic growth will suffer. For example, there is evidence that funds from tax evasion in the United States tend to be channeled into riskier but higher-yielding investments in the small business sector, and also that tax evasion is particularly prevalent in this sector. Fraud, embezzlement, and insider trading seem likely also to be more prevalent in rapidly growing and profitable businesses and markets, because “that’s where the money is.”

Money laundering also has indirect macroeconomic effects. Illegal transactions can deter legal ones by contamination. For example, some transactions involving foreign participants, although perfectly legal, are reported to have become less desirable

Box 2

How money is laundered

- *Smurfing* involves the use of multiple cash deposits, each smaller than the minimum cash reporting requirement.
- *Misinvoicing* of exports and falsification of import letters of credit and customs declarations can conceal cross-border transfers of, say, the proceeds of drug trafficking.
- *Barter*: stolen property (e.g., antiques or automobiles) can be exchanged, across national borders or domestically, for illegal substances.
- *Parallel credit transactions* can be used to avoid the formal economy, except for the final use made of the net proceeds of illegal activity to purchase legally marketed goods or services.
- *Interbank wire transfers* may not be subject to reporting on money laundering; bribery of bank officials can thus make it easier to conceal large illegal transfers between accounts.
- *Derivatives* that replicate insider trading opportunities (e.g., a synthetic version of a company stock subject to merger or takeover) can be used to avoid detection of an unusual change in a listed stock price.

because of an association with money laundering. More generally, confidence in markets and in the efficiency-signaling role of profits is eroded by widespread insider trading, fraud, and embezzlement. And, money that is laundered for reasons other than tax evasion also tends to evade taxes, compounding economic distortions. Moreover, contempt for the law is contaminating—breaking one law makes it easier to break others.

Accumulated balances of laundered assets are likely to be larger than annual flows, increasing the potential for destabilizing, economically inefficient movements, either across borders or domestically. These balances could be used to corner markets—or even small economies.

The above effects are to some extent speculative; however, the Quirk study (1996) also conducted *empirical* tests on the relationship between GDP growth and money laundering in 18 industrial countries for the first time. It found evidence that significant *reductions* in annual GDP growth rates were associated with increases in the laundering of criminal proceeds in the period 1983–90.

Policy implications

Because money laundering has such extensive adverse macroeconomic effects, macro policies must play a role in anti-laundering efforts.

Exchange controls. Anti-money laundering measures are sometimes perceived as being in conflict with exchange control deregulation, whose effect is likely to be a vast increase in the volume of international transactions—and in opportunities to disguise the sources of funds. However, economic growth and the growth of financial markets could be said to have the same effect. Moreover, exchange controls have led to the establishment of parallel markets with close connections to the underground economy. Instead of turning the clock back on economic and financial reforms, policymakers need to devise countermeasures that allow them to stay ahead of financial market developments. One such measure is to extend the reporting and monitoring framework for money laundering to less formal bodies, such as *bureaux de change*. Another is to ensure that information and training on anti-laundering surveillance are provided to foreign exchange dealers through such channels as the foreign exchange codes of conduct that are generally drawn up by national associations of foreign exchange dealers or banking institutions, some with technical assistance from the IMF.

Prudential supervision. In the absence of a money laundering law and accompanying measures, it is not necessarily in the direct financial interest of financial institutions to adopt anti-laundering behavior. For this reason, both the FATF and the Basle Committee on Banking Supervision have issued statements on the prevention of criminal use of their members' banking systems for the purpose of money laundering. The statements deal with cooperation with law enforcement agencies in identifying customers and their behavior, keeping relevant records, and reporting possible illicit behavior.

Money laundering activities can corrupt parts of the financial system and undermine governance of banks. If bank managers are corrupted by the sizable sums involved in money laundering, nonmarket behavior can spread into operating areas other than those directly related to money laundering, which creates risks for the safety and soundness of banks. Bank supervisors can also be corrupted or intimidated. However, law enforcement efforts should not crowd out the traditional responsibilities of bank supervisors.

Over the past several years, the IMF has helped a number of developing and transition countries to establish effective financial market supervision. In many of the transition economies, supervisory capabilities are as yet at a basic level, affording relatively little assistance to law enforcement authorities in their anti-laundering efforts. In many developing countries, however, central banks are among the most organized and effective institutions; governments are therefore urging them to take on both support and core functions in countering money laundering. In some cases, the new emphasis has raised questions of the adequacy of training for supervisors and the extent of monitoring.

Tax collection. Of the underlying forms of illegal activity, tax evasion is, perhaps, the one with the most obvious macroeconomic impact. A government deficit is at the center of economic difficulties in many countries, and correcting it is the primary focus of most economic stabilization programs. The IMF has therefore been involved in efforts to improve the tax collection capabilities of its member countries. Although the small business sector is an important nexus of tax evasion, it also drives economic growth. It is therefore possible that many countries at a relatively early stage of economic development will be especially prone to tax evasion and the associated money laundering.

Statistical reporting. Several years ago, after an attempt to estimate flows of laundered money directly, using international banking statistics and capital accounts of the balance of payments, the BIS and the IMF concluded that although deposits covered by international banking and balance of payments statistics may include a substantial amount of drug money, this component probably accounts for only a small (but, unfortunately, significant) percentage of the totals and can therefore not be singled out.

Some early attempts to gauge the importance of money laundering relied on scrutiny of cash-to-GDP ratios, such as those reported in the IMF's *International Financial Statistics*. Techniques related to balance of payments calculations allow estimates to be made of aggregate capital flight from individual countries, which in some instances is thought to be associated with money laundering. Macroeconomic estimates of misinvoicing can be made by comparing domestic trade data with partner-country data from the IMF's Direction of Trade database, after factoring in errors and omissions in the balance of payments.

Legislation. In recent years, many countries have reformulated, with technical assistance from the IMF, laws governing central banking, commercial banking, and foreign exchange. It may be more appropriate to set up separate banking laws and regulations covering reporting requirements for nonprudential purposes than to include such requirements in core banking laws and regulations. Provisions covering bank confidentiality and treatment of offshore banking are particularly relevant to money laundering.

Conclusion

Fears that anti-money laundering laws and regulations will undermine efforts to liberalize financial markets, or that opening up financial markets will promote money laundering, are unfounded. Money laundering threatens economic and financial systems in many countries, and the international financial community should strongly support anti-laundering efforts.

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