THE NEGATIVE EFFECTS OF

MONEY LAUNDERING ON

ECONOMIC DEVELOPMENT

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Economic Research Report: The Negative Effects of Money Laundering on Economic Development

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SUMMARY

The negative economic effects of money laundering on economic development are difficult to quantify, yet it is clear that such activity damages the financial-sector institutions that are critical to economic growth, reduces productivity in the economy's real sector by diverting resources and encouraging crime and corruption, which slow economic growth, and can distort the economy's external sector—international trade and capital flows—to the detriment of long-term economic development. Developing countries' strategies to establish offshore financial centers (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.

The financial sector. A broad range of recent economic analyses points to the conclusion that strong developing-country financial institutions—such as banks, non-bank financial institutions (NBFIs), and equity markets—are critical to economic growth. Such institutions allow for the concentration of capital resources from domestic savings—and perhaps even funds from abroad—and the efficient allocation of such resources to investment projects that generate sustained economic development.

Money laundering impairs the development of these important financial institutions for two reasons. First, money laundering erodes financial institutions themselves. Within these institutions, there is often a correlation between money laundering and fraudulent activities undertaken by employees. At higher volumes of money-laundering activity, entire financial institutions in developing countries are vulnerable to corruption by criminal elements seeking to gain further influence over their money-laundering channels. Second, particularly in developing countries, customer trust is fundamental to the growth of sound financial institutions, and the perceived risk to depositors and investors from institutional fraud and corruption is an obstacle to such trust.

By contrast, 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, NBFIs, and equity markets themselves, reinforce the other good-governance practices that are important to the development of these economically critical institutions. Indeed, several of the basic anti-money-laundering policies—such as know-your-customer rules and strong internal controls—are also fundamental, longstanding principles of prudential banking operation, supervision, and regulation.

The real sector. Aside from money laundering's negative effect on economic growth through its erosion of developing countries' financial sectors, money laundering 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.

As can be seen from the various money-laundering typologies reports, money laundered through channels other than financial institutions is often placed in what are known as "sterile" investments, or investments that generate little additional productivity for the broader economy, such as real estate, art, antiques, jewelry, and luxury automobiles. For developing countries, the diversion of such scarce resources to less-productive domestic assets or luxury imports is a serious detriment to economic growth. Moreover, 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.

Money laundering also facilitates crime and corruption within developing economies, which is antithetical to sustainable economic growth. Just as an efficient financial sector is a key "input" to other productive processes in a developing economy—such as manufacturing—an efficient money-laundering channel is a key "input" to crime because the financial proceeds from crime are less valuable to the criminal (in a sense, an "unfinished product") than are laundered funds. The less expensive the money-laundering "input" to crime is as a result of lax anti-money-laundering policies, the more "productive" (active) the criminal element will be, just as in any industry or business. As numerous studies have demonstrated from statistical and anecdotal evidence, substantial crime and corruption act as a brake on economic development, while other studies have shown that anti-money-laundering policies can deter such activity.

The external sector. Unabated money laundering can also impair a developing country's economy through the country's trade and international capital flows. The well-recognized problem of illicit capital flight from developing countries is typically facilitated by either domestic financial institutions or by foreign financial institutions ranging from offshore financial centers to major money-center institutions such as those in New York, London, or Tokyo. Given that illicit capital flight drains scarce resources from developing economies, transnational money-laundering activity helps impair developing-country growth. By contrast, there is little evidence that the imposition of anti-money-laundering policies in a given jurisdiction spurs a significant flight of capital to more lax jurisdictions. Moreover, just as the confidence that developing-country citizens have in their own domestic financial institutions is critical to economic growth, the confidence that foreign investors and foreign financial institutions have in a developing country's financial institutions is also important for developing economies because of the role such confidence plays in investment decisions and capital flows.

Money laundering can also be associated with significant distortions to a country's imports and exports. On the import side, criminal elements often use illicit proceeds to purchase imported luxury goods, either with laundered funds or as part of the process of laundering such funds. Such imports do not generate domestic economic activity or employment, and in some cases can artificially depress domestic prices, thus reducing the profitability of domestic enterprises.

Offshore financial centers (OFCs) as a development strategy. Over the past decade dozens of OFCs have been created as part of developing countries' (or territories') efforts to develop their domestic economies through the provision of international financial services. These OFCs can be classified along a spectrum from "notional" OFCs (those that provide minimal financial services other than simply being a jurisdiction in which "name plate" operations may be established) to "functional" OFCs (those that provide a wide-range of value-added financial services).

Studies of the effectiveness of establishing an OFC as an economic-development strategy have shown that notional OFCs contribute little to the surrounding economy and do not form the basis for sustained economic growth. First, notional OFCs are virtually costless to establish, and therefore competition among them for customers is severe. Second, because notional OFCs provide little value-added services, such OFCs generate almost no economic demand for the surrounding "real" economy in terms of employment, goods, or services.

On the other hand, truly functional OFCs require significant investments in infrastructure—such as communication facilities, and even a skilled labor force—thereby limiting the pool of competing OFCs and increasing the commercial returns to those OFCs that emerge as strong competitors. Moreover, functional OFCs benefit their surrounding "real" economies through their demand for goods, services, and an educated workforce to support the OFCs' value-added activities.

This distinction between notional and functional OFCs becomes critical to assessing the economic effect of money laundering on OFCs as an economic development tool. Money laundering *per se* does not require the more costly value-added services of a functional OFC, and therefore may gravitate to merely notional OFCs—the very type of OFC least able to contribute to the country's real economy. By contrast, legitimate international capital is more likely to require the services of a functional OFC *and* will be deterred from making extensive use of an OFC tainted by widespread allegations of money laundering and the associated activities of fraud and corruption. Thus, for a country to implement a successful economic-development strategy based on the establishment of an OFC, the strategy must adopt measures to control money-laundering activity through the OFC.

Moreover, International Monetary Fund studies suggest that smaller countries can become favored by large-scale money launderers for short periods of time, causing a sharp surge in financial activity, followed by an equally sharp decline, resulting in severe macroeconomic instability as local authorities are unable to take offsetting monetary or exchange-rate measures.

I. BACKGROUND

There has been little research into the economic effect that money laundering has on economic development. Most of the formal economic analysis brought to bear on money laundering has been for the purpose of quantifying the extent of the activity rather than its effects[2] and even those few studies that have considered money laundering's economic consequences have focused on the global financial system rather individual economies.[3]

Arguments put forward for policy inaction. 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 optimal course of action for developing countries with respect to money laundering is what might be called the *inaction policy.* The defense of the inaction policy is based on 3 interrelated arguments, each of which is flawed:

- *"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*

[2] In particular, see Peter Quirk, *Macroeconomic Implications of Money Laundering*, (IMF Working Paper 96/66, "Quirk 1996"); John Walker, AUSTRAC, *Estimates of the Extent of Money Laundering In and Throughout Australia* (September 1995) ("AUSTRAC 1995"); Ted F. Brown, "Do Cash Surpluses at Federal Reserve Bank Indicate Money Laundering Activity?" U.S. Department of Treasury, Internal Revenue Service study, 1998.

[3] Some notable exceptions include Donato Masciandaro, *Money Laundering: The Economics of Regulation*, 7 European Journal of Law and Economics 238, May 1999. See also, Donato Masciandaro, *The Illegal Sector, Money Laundering and the Legal Economy: a Macroeconomic Analysis*, Journal of Financial Crime, vol. 8, no. 2, pp. 103-112, 2000. Other papers speculate on implications of broader financial-stability papers on particular economies (Nigeria: Chibuike U. Uche, "Money Laundering: A View from a Developing Country" *The Ninth International Anti-Corruption Conference*, 1999; Sierra Leone: Raymond Gilpin, "Macroeconomic Implications of Money Laundering in a Small, Open Economy," *Bank Of Sierra Leone Bulletin*, 1996). For the effects on a developed economy, see AUSTRAC 1995, chapter 11 ("Effects on the Australian Economy") and chapter 12 ("The Effects of Overseas Money Laundering"). The AUSTRAC 1995 study contains some analyses that are applicable, with some modification, to the real sectors of developing economies, as will be cited later.

crime in developed economies."[4] 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 3 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 defense) that money laundering has on economic development. This paper will consider these other effects in detail.

Approach of this study. As noted previously, there has been little economic research into the effect of money laundering on economic development. Viewed from a different perspective, however, there is actually an enormous body of economic-development literature that speaks, albeit indirectly, to the economic effects of such activity on economic development. Such research is focused on all the factors that may affect economic development—political, cultural, social, legal, technological, etc.

To make use of this reservoir of research, one must only connect money laundering to these economic-development factors, and then review the well-established roles these elements play in economic development. Therefore, this paper will (a) assess the role of money laundering in these broader issues and (b) briefly review, as appropriate, the impact of these matters on economic development.

Stages and directional flows of money laundering: some terminology. When discussing the stages of money laundering, this paper will use the 3-part terminology that has been widely adopted: *placement* (insertion of illicitly obtained funds into the money-laundering process), *layering* (undertaking transactions to obscure the source of the funds), and *integration* (the return of the funds to the economy for use by the criminal claimant).

When considering the effect of money laundering on developing economies, it is particularly useful to distinguish among 5 directions that the money-laundering flows may take with respect to such economies, as illustrated in **Figure 1**.

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4 For example, see *Times of India* editorial, "This Won't Wash," September 21, 2001, which relates this widespread sentiment but nonetheless concludes that the argument is invalid: "The argument that developing economies cannot afford to be too selective about the source of the capital they attract is a dangerous fallacy."

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.

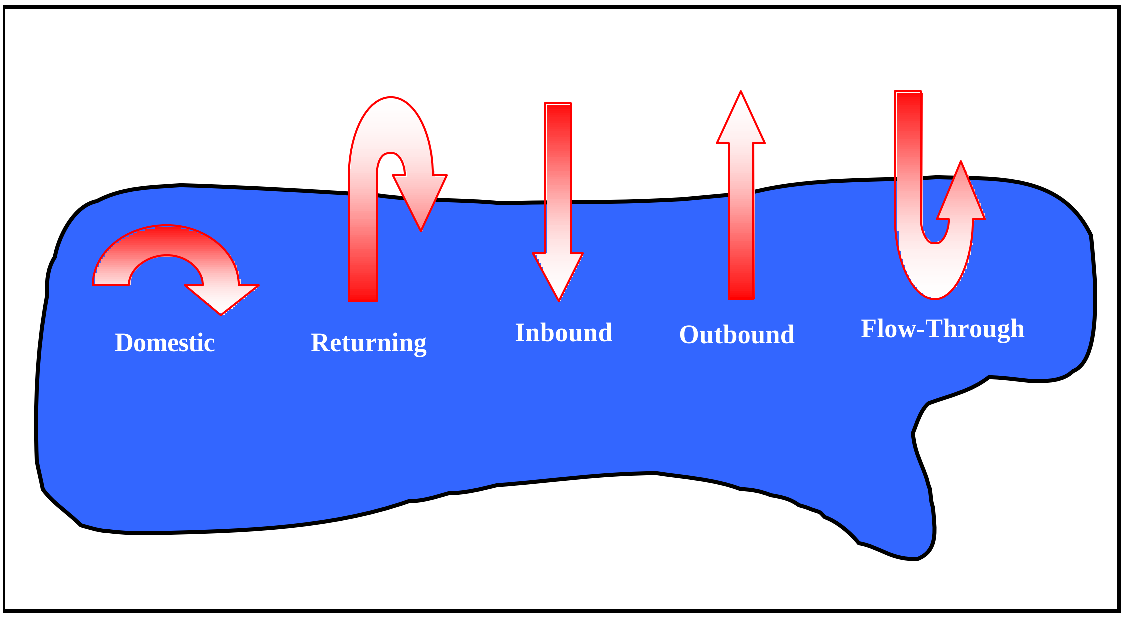
2. *Returning* laundered funds originate in the developing country, are laundered (in part or in full) abroad, and returned for integration.

3. *Inbound* funds, for which the predicate crime occurred abroad, are either initially laundered ("placed") abroad or within the developing country, and ultimately are integrated into the developing economy.

4. *Outbound* funds, which typically constitute illicit capital flight from the developing economy, do not return for integration in the original economy.

5. *Flow-through* funds enter the developing country as part of the laundering process and largely depart for integration elsewhere, thus playing little or no role in the economy itself (although the "fees" for money laundering activity may remain).

Types of Money Laundering Flows Through a Developing Economy **Figure 1**



As will become clear, the implications of money-laundering for developing-country economic growth differ depending on which of these flows is being examined. For 3 of these types of flows—domestic, returning, and outbound—the "predicate crime" (defined as the criminal activity which gives rise to the financial proceeds being laundered) occurs within the developing economy itself, while inbound funds are typically controlled by criminal elements during or even after placement.

Sector-by-sector economic analysis. This paper will assess the economic effects of money laundering by examining each of the 3major 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 in Section II. Second, the more direct effects of money laundering on the *real sector* (*i.e.*, manufacturing and non-financial services) will be addressed in Section III. Third, the paper will examine the effects on money laundering through the *external sector* (international capital and trade flows) on economic development in Section IV.[5]

Because of the unique nature of smaller economies acting as offshore financial centers (OFCs), Section V will separately examine the harmful effect that money-laundering activity through OFCs has on these smaller countries' efforts to use the OFC industry as a vehicle for economic development. Finally, other issues germane to money-laundering and economic development will be reviewed in Section VI, with conclusions outlined in Section VII.

It is important to distinguish between *longer-term, sustainable economic development* and the narrower question of *short-term economic stimulus*. 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.

II. THE FINANCIAL SECTOR: MONEY LAUNDERING UNDERMINES DOMESTIC CAPITAL FORMATION

Although money laundering does not require the use of formal financial institutions,[6] reviews of money-laundering typologies consistently indicate that 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.[7] 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 component in the financing of the legitimate economy, they can be a low-cost vehicle for the illicit economy to launder funds.[8] The money-laundering phases of greatest concern

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5 The *government sector* is typically considered a fourth sector in an economy's national accounts, but in this paper will be considered along with the real sector because of the similarity of issues.

6 For example, under-invoicing of exports can effectively launder, in an outbound direction, fraudulently acquired wealth from domestic developing-country sources. CITE FATF typology. See discussion of the effects of misinvoicing on economic development in Section IV.C.

7 This conclusion emerges from a review of the Financial Action Task Force's typologies reviews.

8 Tom Naylor of McGill University in Montreal notes that informal remittance houses, such as *hawala*, are insufficient to handle the volumes of money to be laundered as larger banks in the formal financial system. "Cheap and Trusted," *Economist*, Nov. 24, 2001, p. 71. The *Economist* quotes Martin Comley of the UK's National Criminal Intelligence

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 ostensibly legitimate businesses (as discussed in Section III on the real sector of the economy).

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 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 NBFIs, can reinforce the other good-governance practices that are important to the development of these economically critical institutions.

A. Money laundering erodes financial institutions.

Pervasive money laundering through developing-country financial institutions erodes these institutions in 3 broad ways: by increasing the probability individual customers will be defrauded by corrupt individuals within the institution; by increasing the probability that the institution itself will become corrupt or even controlled by criminal interests, again leading to customers being defrauded; and 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.[9]

These 3 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 (or other) 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. This vulnerability exists regardless of which of the 5 directional flow of funds (as shown in Figure 1) is occurring.

Service as reporting that some informal remittance houses with larger volumes of transfers must increasingly rely on formal banking institutions.

9 The other 4 forms are *credit* risk (for example, default by borrowers), *market* risk (for example, adverse changes in interest rates), *liquidity* risk (a shortfall in resources to meet obligations), and *legal* risk (exposure to adverse claims against the institution). See, for example, Federal Reserve Board, *Commercial Bank Examination Manual*. Credit risk unrelated to money laundering activity can be reduced by anti-money-laundering policies, as discussed in Section II.C.

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. [10]

One factor driving the rise in financial crime is likely the rapid increase in recent decades of financial activity in proportion to overall economic activity. For example, between 1990 and 2000 the nominal gross domestic products of Thailand, Malaysia, and the Philippines rose 124%, 185%,. and 206%, respectively, whereas the nominal level of bank deposits[11] in these economies increased by 237%, 379%, and 504% respectively—typically around twice the GDP increase. Just as financial activity and financial crime grow together, financial crime and money laundering grow together, as each facilitates the other. [12] 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"[13] in the bank's New York operations, recently was a victim itself. Two branch managers and an assistant manager at the Kaiping branch, allegedly colluded 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. [14] Following disclosure of the incident, there was a run on the bank's Kaiping branch.[15] Although the branch's financial losses will be absorbed by this state-owned bank, Bank of China's reputation has suffered,

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10 FATF typologies report (1997 p.2 cited). See also, International Monetary Fund, *Financial System Abuse, Financial Crime, and Money Laundering* (Background Paper) February 12, 2001, p.22 Annex IV ("IMF Background Paper 2001").

11 International Monetary Fund, *International Financial Statistics*, lines 24 (demand deposits) and 25 (time, savings, and foreign currency deposits).

12 In this regard, the same analysis outlined in Section III.B with respect to the role of money-laundering in facilitating non-financial crime is equally applicable to the financial crime (especially fraud) discussed here.

13 Kai Fang, *Corruption in PRC's Banking Sector; Bank of China NY Branch Scandal*, Feb. 1, 2002, ("*Corruption in PRC's Banking Sector*").

14 *Bank of China Officials Flee With $75 Million to Canada*, Tung Fang Jih Pao, Oct. 1, 2002.

15 *Corruption in PRC's Banking Sector.*

and plans to list its Hong Kong subsidiary on public stock exchanges are now in question.[16]

- **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.[17] The amounts involved exceeded $70 million.

- **Germany.** Since its bankruptcy in 1995, Dusseldorf 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 Laden's Al-Qaida network.[18]

In the PRC and Germany, the victimized institution was severely damaged or even destroyed by the combination of allegations of fraud and money laundering. As will be discussed below, the largest blow to the Swiss banking system occurred in the 1970s as a result of a similar combination of fraud and money laundering.

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 Barings case. Such consequences are even more likely in smaller countries with less sophisticated 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.[19]

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

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[16] *China's Bankers— Rotten to the Top,* Far Eastern Economic Review, Jan. 31, 2002. See also: *SCMP: Murky Scandals Cloud Bank of China's Hopes for Listing*, South China Morning Post, Apr. 1, 2002.

[17] France—*Plus Ca Change,*" *The Banker*, Ap, 1, 2000; Barclays France Execs probed in Israel-linked money laundering, *The Jerusalem Post*, Nov. 21, 2001.

[18] "Private German Bank Charged With Laundering Terrorists' Money", *Welt am Sonntag*, Oct. 7, 2001.

[19] "Convicted Banker Released After Big Bail Payment," *The Baltic Times*, Feb. 7, 2002.

themselves have problems with criminal penetration of institutions or lower-level fraud.

As summarized in a paper prepared by the Management Development and Governance Division of the United Nations Development Programme,

> *businesses that are effective venues for money laundering, such as banks and casinos, risk criminal takeovers. 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.*

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.

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.

> *A reputation for integrity… is one of the most valued assets by investors … Various forms of financial system abuse may compromise financial institutions' and jurisdictions' reputation, undermine investors' trust in them, and, therefore, weaken the financial system.*[20]

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. As the non-profit International Financial Risk Institute (IFRI[21]) based in Switzerland summarized the issue:

> *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.*

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20 IMF Background Paper 2001.

21 "The IFRI was established as a not-for-profit foundation under the supervision of the Swiss Federal Authorities in 1984. The founders of the Institute include the world's leading derivative exchanges, a number of large OTC providers, auditing companies, information service providers, market regulators, certain end-users." IFRI 2002, http://risk.ifci.ch.

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) even without the coordinated sanction process such as that associated with FATF activity, as discussed later. Research shows that the negative effect of a damaged reputation on the viability of a bank is more than theoretical: examples abound.[22] For example, as noted with the recent Bank of China scandal discussed previously, large-scale runs on banks can occur in addition to more difficult to observe reluctance among potential customers to make use of the bank.

Such consequences are particularly acute for developing countries with financial systems in their infancy: recently in Croatia, a "rogue trader" who lost approximately $100 million while working at Croatia's third largest bank, is at the center of Eastern Europe's largest speculation scandal. Eduard Nodilo brought his employer, German-owned Rijecka Banka, "almost to its knees by the losses" and had to be bailed out by Croatia's central bankers. As a result of the losses, the German owner, Bayerische Landesbank, has returned its 60% stake—once worth $76 million—to the Croatian government for the token sum of $1. As press accounts noted, Croatia's banking system "remains fragile … While the government has assured investors that their money is safe, the affair has shaken public confidence."[23] The "reputational" factor is even more important for offshore financial centers suspected of engaging in flow-through money laundering activity on a significant scale, as discussed in Section V.)

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

[22] As an International Chambers of Commerce manual on corporate practices noted, "any business, whether a financial institution, professional service, industrial enterprise, charitable NGO or otherwise, caught in the web of money laundering could have its reputation irreparably damaged. Its directors, management, and staff could be the subjects of private and public investigations out of which indictments and prosecutions could arise. At best, it would be a public relations nightmare. It only takes one unethical person who has the discretion to make decisions to jeopardize an entire organization. A reputation for integrity takes many years to build, and only a few moments to damage, debase, decimate or destroy." ICC, *Corporate Practices Manual on Extortion and Bribery* (1999).

[23] "Croat Trader Puts Bank in 70m pounds Crisis," *Sunday Telegraph*, March. 24, 2002.

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.

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 paper, the detrimental effects that money laundering has on developing-country financial institutions makes it necessary to review the importance of this linkage. Over the past decade, several in-depth studies have been undertaken to assess the role of financial institutions in economic growth, and the results have been consistent and unambiguous: economic growth depends on sound domestic financial institutions. As summarized in a recent (2001) report that reviewed the available evidence:

> *A large body of research finds that financial development exerts a large positive impact on economic growth. The conclusion emerges from cross-country studies, industry-level studies, firm-level studies, and time-series evaluations. Furthermore, the positive link between financial development and economic growth hold after controlling for other growth determinants...*[24]

The study further notes that this strong linkage has been found to be causal: it is not simply that faster-growing economies have stronger financial institutions, but that stronger financial institutions drive faster economic growth. The force of this finding cannot be overemphasized: since the first studies into the linkage between financial institutions and economic growth began in the 1960s, researchers have believed that 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; yet the preponderance of the research shows that 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"[25] as one of the 3 fundamental tasks necessary for economic development (the others being governmental reform and the enhancement of physical infrastructure).

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 2 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-

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24 Thorsten Beck, Asli Demirguc-Kunt, Ross Levine, and Vojislav Maksimovic, *Financial Structure and Economic Development: Firm, Industry, and Country Evidence*, Financial Structure and Economic Growth, Asli Demirguc-Kunt, Ross Levine , eds., p. 188 (2001).

25 World Bank, *About the World Bank Group* (2002).

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."[26]

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. Research supports this view: one study[27] statistically examined nearly 70 cases and concluded that "the evidence is clear that 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. Such sanctions need not involve governments directly, as demonstrated by the damaging international-bank ban on U.S. dollar transactions with Vanuatu undertaken in response to the inadequacy of anti-money-laundering measures in that jurisdiction.[28] Even outside the realm 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—as shown by suggestions that the IMF should reconsider its continuing financial assistance to the Russian Federation in light of evidence that such assistance was being misappropriated on a large scale and laundered "outbound" by criminals in the form of capital flight.[29] Similarly, several economic organizations reportedly sparked "a run" on a Bosnian bank when they moved their funds out of the institution after indications that the bank was allegedly involved in money laundering. Economic aid from developed countries can be contingent upon progress on anti-money-laundering efforts.

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26 World Bank, *About the World Bank Group* (2002). Emphasis added.

27 James L. Strachan, David B. Smith, and William L. Beedles, *The Price Reaction of (Alleged) Corporate Crime,* The Financial Review, p. 121 (1983). See also the example of the Bank of China discussed Section II.A, wherein the planned floatation of a subsidiary's shares was dropped after a money laundering scandal became public.

28 International Monetary Fund, "IMF Concludes Article IV Consultation with Vanuatu", September 5, 2000. "Activity in the offshore financial center remained weak in 1999. Much of this weakness may have followed allegations of money laundering levied against some offshore institutions, which led several major international banks to ban U.S. dollar transactions with Vanuatu." Id.

29 Michel Camdessus, "Russia: Long Climb Out of a Black Hole," *The Washington Post,* Sept. 13, 1999.

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.[30] 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 (outlined in Section III), or through the damage to the external sector (Section IV). 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 enhanced financial prudence

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.

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,"[31] 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. In 1988, BIS's Committee on Banking Supervision (the Basel Committee) stated that while "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*

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[30] "Activities underlying financial system abuse and financial crime are, by definition, concealed and therefore direct observation by the macroeconomist or statistician is not possible... Thus, an adequate measure of financial system abuse remains illusive." IMF Background Paper 2001, p. 10.

[31] Bank for International Settlements *at* http://www.BIS.org.

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.[32]

Notably, the Basel Committee's endorsement of anti-money-laundering banking practices arose originally from the need to address the potential damage to banks from significant money-laundering activity, namely reputational damage ("public confidence … undermined") and/or fraud by criminal customers, or employees corrupted by such customers.[33] In 1997, the Basel Committee published its *Core Principles for Banking Supervision*[34] which further elaborated 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.[35]

More recently,[36] 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.*
>
> *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.*[37]

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32 Basel Committee, *Prevention of Criminal Use of the Banking System For the Purpose of Money-Laundering*, Preamble (December 1988).

33 See Section II.A.

34 BIS, *Core Principles for Banking Supervision* (1997).

35 BIS (1997) Core Principles 14 and 15.

36 BIS, *Customer Due Diligence for Banks*, Basel Committee Publication No. 85 (October 2001).

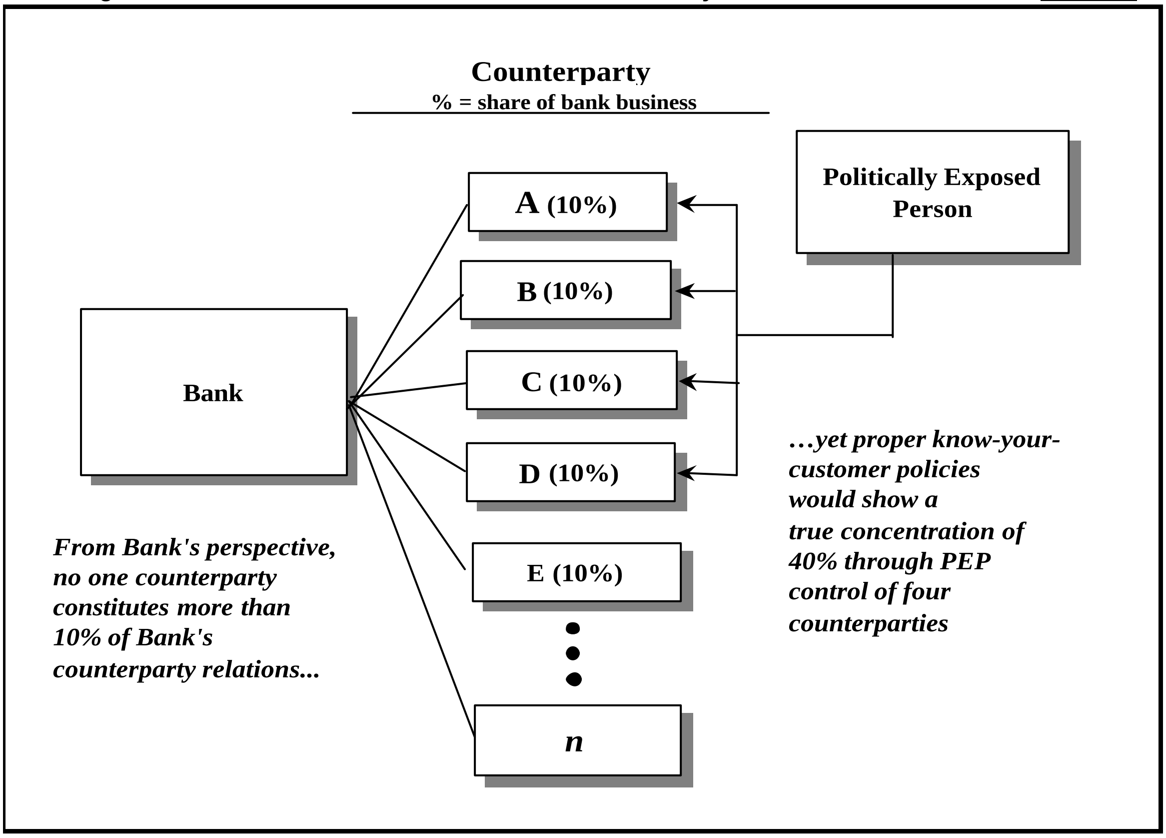
37 BIS, *Customer Due Diligence for Banks*, 2001, introduction.

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."[38]

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,[39] 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.

38 BIS, *Customer Due Diligence for Banks*, 2001, paragraph 55.
39 BIS, *Customer Due Diligence for Banks*, 2001, paragraph 14.

Reducing Concentration Risk with a Know-Your-Customer Policy **Figure 2**



As illustrated in **Figure 2**, without knowing the true nature of its counterparties, a bank may be under the mistaken impression that it has a low concentration risk because no one counterparty constitutes more than 10% of the bank's business (assets, deposits, etc.), yet several of these apparently independent counterparties may be effectively the same entity because of their control by a PEP. Given that PEPs with large financial resources often fit the profile of individuals engaged in money laundering, a strong KYC policy in the presence of PEP clients serves both anti-money-laundering and concentration-risk-avoidance purposes.

Similar prudential reasons for sound anti-money-laundering practices exist in equity markets. For example, the International Organization of Securities Commissions, which is charged with "the protection of investors; ensuring that markets are fair, efficient and transparent; [and] the reduction of systemic risk" states in Section 8.5 *Objectives and Principles of Securities Regulation* that regulators "should also require that market intermediaries have in place policies and procedures designed to minimize the risk of the use of an intermediary's business as a vehicle for money laundering."

Private institutions and associations often adopt parallel rules. The parallelsbetween 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].*[40]

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.[41]

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.[42] Of particular relevance to offshore financial centers (discussed in detail in Section V), the accounting firm KPMG found that in the Cayman Islands "most fraud was discovered by the company through internal mechanisms such as existing internal controls, internal audits, or informants" and only rarely does an external auditor identify fraudulent activity.[43] Such internal controls are closely related to anti-money-laundering practices.

The cost burden of anti-money-laundering policies on financial institutions must be assessed in context Procedures involved in anti-money-laundering policies can impose additional costs on financial institutions. For example, one researcher (Masciandara, 1999) attempted to quantify such costs within the Italian banking system and concluded that such policies are sometimes at odds with banking efficiency.

Nevertheless, other considerations must be borne in mind when considering these efficiency costs. First, such "gross" institutional costs must be weighed against the broader benefits of such policies on the institution, the wider financial system, and the surrounding economy, as outlined in this paper. Indeed, as discussed above, private financial institutions and their associations often make independent decisions to adopt

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[40] Letter from the Swiss Bankers Association to the Basel Committee (Mar. 28, 2001).

[41] "Keeping the Code", *Swiss Business*, May 1990; "Credit Suisse Scandal Casts Shadow over Swiss Banks," *Washington Post*, May 22, 1977; Associated Press, July 3, 1979.

[42] Objectives and Principles of Securities Regulation *at* http://newrisk.ifci.ch/144440.htm

[43] KPMG, *1999 Caribbean Fraud Survey Report: Cayman Islands*, p. 10.

internal policies that reduce the likelihood of money laundering through their channels, which suggests that the costs of policies can be outweighed by the benefits.

Second, as the previously cited Masciandara paper noted, an improvement in the form and efficacy of anti-money-laundering regulations can address some of the concerns regarding costs that institutions must bear. Indeed, Masciandara showed that in the early 1980s Italian anti-money-laundering regulations were more burdensome and less effective than they were after changes were made.

Third, the need for international coordination to fight money laundering is often discussed from a law-enforcement perspective, yet such coordination also serves to reduce the economic costs to financial institutions of anti-money-laundering efforts. For example, if banks of only a single jurisdiction within a region implement anti-money-laundering policies, whatever administrative costs are associated with these policies will be borne by those banks, and not their competitors in other jurisdictions, implying that the costs cannot be passed along to customers who have alternative, nearby banks without such costs, thus creating a competitive imbalance with respect to such costs (although offsetting these costs will be certain commercial benefits, as discussed previously). Equal action by all jurisdictions will reduce this inequity by allowing all banks subject to such costs to better pass them along to their customers.

III. 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 that 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.[44] 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[45] 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."[46]

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. This perspective, first used in a study for Australia's AUSTRAC (see textbox[47]) is not readily applicable to the 4 directional flows of money laundering activity involving the external sector; as shown in Figure 1, but could perhaps be developed into part of a broader technique for estimating the economic damage caused by money laundering though non-financial channels.

44 AUSTRAC 1995, chapter 11.

45 Pablo A. Molina, *Illegal Drug Trafficking and Economic Development in Colombia* (1995), (Masters Thesis, University of Illinois at Urbana-Champaign).

46 Molina (1995), p. 17. Further distortions were caused by the much higher inflow of illegal imports financed by drug money; such imports were consumed by the criminal class and caused a sharp reduction in the aggregate demand for domestic Colombian-produced goods, which further eroded economic development. Id.

47 IMF, *International Financial Statistics*, "Australia" p. 110 (line 99b.r for 1995) (March 2002).

Applying an Input-Output Model to Estimate the Lost Economic Activity from Domestic Money-Laundering: The Case of Australia

In a study prepared for the Australian Transactions Reports and Analysis Centre (AUSTRAC), John Walker Consulting Services used a standard input-output model of the Australian economy to estimate the economic effects of diverting A$1 million from expenditure on conventional consumption—as might occur with legitimate wealth—to A$1 million in real estate purchases as a layer in the money-laundering process. The resulting loss to the Australian economy in terms of output, income, and employment is, therefore, the difference in the level of these activities generated by the legitimate expenditure minus the level of these same activities generated by the money-laundering investments.

Under one "mid-point" scenario, which assumed that the legitimate expenditure would have been spread evenly throughout the economy but that laundered funds were placed in "dwelling properties," the net effect on the Australian economy of A$1 million in laundering activity was estimated to be A$1.13 million in lost output, A$609,000 in lost income, and 25 lost jobs. When these results were applied to the A$5 billion to A$10 billion in actual money laundering activity that was estimated to have occurred annually in Australia at the time the study was carried out in 1995, the total net losses to the Australian economy range between A$5.6 billion and A$11.3 billion in lost output, between A$3 and A$6 in lost income, and between 125,000 and 250,000 lost jobs. In comparison, in 1995 these output losses constituted 1.1% to 2.2% of Australian GDP.

Note that this drag on economic productivity in the real sector is separate from the effects of erosion of the financial sector as discussed in Section II or, as discussed later, the damage caused by facilitating corruption and crime (III.B), and/ornegative economic effects transmitted through the country's external sector (IV).

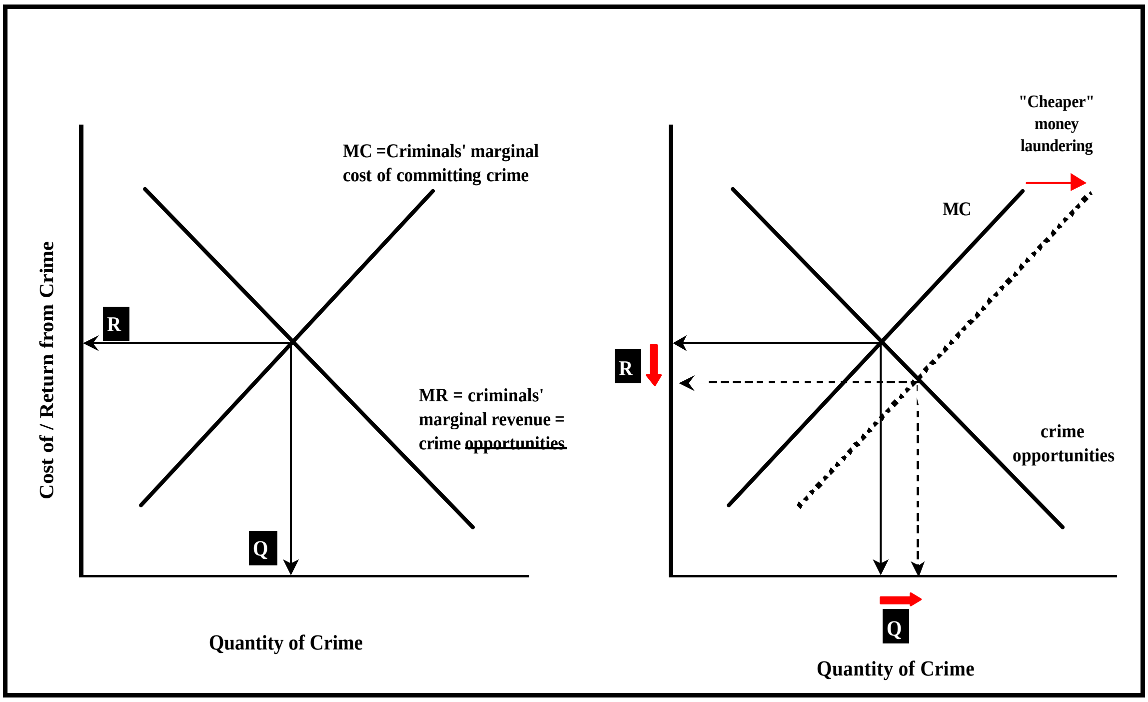
B. Money laundering facilitates corruption and crime at the expense of economic development.[48]

Money laundering reduces criminals' cost of crime, thereby increasing the level of crime. Interestingly, just as an efficient financial sector is a key "input" to other productive processes in a developing economy—such as manufacturing—an efficient money-laundering channel is a key "input" to crime because the financial proceeds from crime are less valuable to the criminal (in a sense, an "unfinished product") than are laundered funds. The less expensive the money-laundering "input" to crime is as a result of lax anti-money-laundering policies, the more "productive" (active) the criminal element will be, just as in any industry or business.

[48] "Corruption" may sometimes be distinguished from "crime" in that the latter depends on the particular legal regime in question, whereas the former has a broader economic meaning.

Theoretically, the role of money laundering can be viewed using simple modifications to a conventional supply-and-demand framework. As shown in **Figure 3** in the left diagram, the level of crime (**Q**) is determined by the intersection of criminals' marginal cost[49] of committing crime (**MC**) and the criminals' marginal revenue from undertaking one more criminal act (**MR**), which can be seen as simply the list of crime opportunities ranked from the most profitable (on the left) to the least profitable (on the right). The criminal element will continue to commit crimes (take advantage of crime opportunities) until the costs of doing so consume all the proceeds of crime.

Money Laundering: A Cost Component in the "Business" of Crime and Corruption **Figure 3**



The diagram on the right illustrates the effect of reducing the cost of money laundering (by lowering its risk, for example) to the criminal: the **MC** line shifts to the right because the criminal can undertake more crime for the same cost (or the same amount of crime for less cost). The intersection of the new **MC** line and the same **MR** line (same crime opportunities) imply more crime (**Q** is larger) and, at the margin, these additional crimes will become smaller (more "petty"; of course, all of the higher-value crimes will continue to be committed). This greater crime revenue can then become domestic laundered money, whereby it is "reinvested" in further criminal activity.

Professor Donato Masciandaro tested this phenomenon when he examined the relationship in Italy among the imposition of anti-money-laundering regulations,

49 To simplify the diagram, the risk of being caught and punished is incorporated in this line as a "cost" to the criminal.

identifiable money-laundering activity, and identifiable crime in 95 Italian districts during the 1980s:

> *…we showed how money laundering can be seen as a multiplier of criminal financial activities. Transforming potential into effective purchasing power, money laundering allows the reinvestment of laundered illegal funds, thus playing a crucial role in strengthening ties between the real and financial side of a criminal economy*.[50]

The paper finds an inverse relationship between money-laundering activity and the level of anti-money-laundering regulation.[51]

As in the case of Italy, the ease of money laundering in the financial sector attracts increased criminal activity in the real economy. This can be seen clearly even in larger, more-developed countries where money laundering is a major problem. In Switzerland, for example:

> *A leading Swiss lawyer has warned that Russian mafia groups are increasingly infiltrating the country's economy in spite of the adoption of stricter laws against money laundering. The Attorney-General, Carla del Ponte, said Russian criminals had established footholds in some 300 Swiss companies, attracted by the Swiss tradition of conducting banking business in secret. …She said the country faced a growing risk of becoming embroiled in gang violence.*[52]

Similar examples can be found in other countries where money laundering is a problem. Israel, a significant money-laundering center, has seen criminal elements penetrate the economy with the proceeds (See textbox). A study of the money laundering problem in Brazil suggests that the infiltration of Russian, Nigerian, Korean, and other organized crime elements into the Brazilian economy in the early 1990s was due in part to the attractiveness of Brazil's "large and modern financial services sector" which attracted money-laundering activity from abroad.[53]

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50 Donato Masciandaro, *Money Laundering: The Economics of Regulation*, 7 European Journal of Law and Economics 238, May 1999. See also, Donato Masciandaro, *The Illegal Sector, Money Laundering and the Legal Economy: a Macroeconomic Analysis*, Journal of Financial Crime, vol. 8, no. 2, pp. 103-112, 2000.

51 Donato Masciandaro (1999) See also, Gideon Yaniv, *Tax Evasion, Risky Laundering, and Optimal Deterrence Policy*, International Tax and Public Finance, 6, 27-38 (1999). Yaniv puts forth an economic model to support the contention that money laundering is a riskier (more costly) enterprise than mere tax evasion and, as a corollary, there may be a higher social return in pursuing money laundering investigations than tax-evasion investigations.

52 *Russian Mafia threatens Switzerland*, BBC, August 8, 1999.

53 Andrea Frota Machado de Morais, *Money Laundering in Brazil* (2000), p. 33.

Money Laundering and Criminal Infiltration in the Economy: The Case of Israel

A U.S. National Security Council report in April 2001 found that: "Russian organizations, an estimated 10 to 15 so far, have also been taking advantage of Israel's large Russian immigrant community to commit crimes in that country, such as illegal production and importation of CDs, and money laundering of the proceeds. According to Robert Friedman, author of the book *Red Mafiya: How the Russian Mob Has Invaded America*, Hezi Leder, Israeli Police Attache in Washington and former chief of Israeli Police Intelligence, reported that "Russian organized groups [had] become a strategic threat" to Israel and that Israel "remained attractive to gangsters because 'Israel is good for money laundering'." Israeli police estimate that Russian mobsters have "poured more than $4 billion of dirty money into Israel's economy, though some estimates range as high as $20 billion." The criminal gangs have "bought large parcels of impoverished development towns, taking over everything from local charities to the town hall." They have even "handpicked several candidates to run for local and national offices," according to minutes leaked to the press from an Israeli Cabinet meeting.

Higher crime and corruption reduces economic growth. Given the linkage between money laundering and domestic crime, the final linkage to be examined is that between the higher rate of corruption and crime facilitated by money laundering and developing countries' economic growth. Here again, much economic research demonstrates that corruption and crime deters such growth. A 1997 review of the research completed in this area concluded that "corruption has its adverse effects not just on static [economic] efficiency but also on investment and growth."[54] This confirms an earlier literature review that reported that "most studies conclude that corruption slows down development."[55] As summarized in a paper by the Management Development and Governance Division of the United Nations Development Programme which reviewed the conclusion reached in other studies:

> *…cross-country research suggests that high corruption levels are harmful to economic growth. When corruption is associated with organized crime,*

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54 Pranab Bardhan, *Corruption and Development: a Review of Issues*, University of California, Berkeley, *Journal of Economic Literature* (September 1997). See also, *The Economics of Corruption: a Survey,* Norwegian Institute of International Affairs (December 1990).

55 Andrei Shleifer and Robert W. Vishny, "Corruption," *Quarterly Journal of Economics*, p. 600 (August 1993).

legitimate business is discouraged, the allocation of resources is distorted, and political legitimacy is compromised.[56]

Overall, the economic damage caused by corruption is an unambiguous finding in the economic literature,[57] and the money-laundering process is a key facilitator of such corruption. The damaging economic effects of corruption facilitated by money laundering are particularly acute in the public sector in many developing countries because of the larger role the government often plays in providing goods and services.

C. 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 lucrative 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[58] 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.[59]

A third problem can arise, as seen during the international financial crises in 1997 and 1998, whereby financial problems in one jurisdiction can be transmitted to other

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56 UNDP, *Corruption and Good Governance,* Discussion Paper 3, p. 35 (1997).

57 See also, Paulo Mauro, Institute for International Economics, *The Effects of Corruption on Growth, Investment, and Government Expenditure: a Cross-Country Analysis*, *Corruption and the Global Economy*, p. 83 (June 1997). This is an update of Mauro's earlier 1995 paper, Paulo Mauro, *Corruption and Growth*, Quarterly Journal of Economics (February 1995). The economic effect of corruption can be considered a subset of the economics of "rent-seeking" on economic growth; see Kevin Murphy, Andrei Shleifer, and Robert W. Vishny, *Why Is Rent-Seeking So Costly to Growth?* American Economic Review, p. 409 (May 1993). For a review of the enormous problem in Russia, see Louise I. Shelly, "Paying the Price: Organized Crime Has Exacted a Heavy Toll on Russia's Economy," *The Russian* (April 1997) and, by the same author, "The Price Tag of Russia's Organized Crime" in the World Bank's *Transition* (1997). For the Caribbean, there are "growing reports of drug-related corruption" and narcotics-related corruption has meant "governments must divert attention and resources away from development needs to respond to the challenges posed by such criminals." Richard L. Bernal, Winsome J. Leslie, and Stephen E. Lamar, "Drugs, Debt, and Structural Adjustment in the Caribbean," *The Political Economy of the Caribbean* (2000).

58 Quirk (1996). See also IMF Background Paper 2001.

59 Quirk (1996).

jurisdictions through the "contagion effect," and such financial problems can quickly become larger, macroeconomic problems. A factor underlying the contagion effect is the perception that whatever serious problem sparked a liquidity crisis in one financial institution or system may also exist, heretofore unappreciated, in another financial institution or system. Another factor is that there are perceived to be a significant number of interrelationships between the problem institution and other jurisdictions that will raise the possibility of liquidity problems in the former being spread to the latter. Significant money-laundering activity can exacerbate both these factors, as the discussion of "reputational effects"—which drive investor perceptions—in Section II.A demonstrates.

IV. 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.

A. 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.*[60]

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[61] capital flight from developing (and transition) countries has been facilitated with identifiable centers of money laundering activity.[62] 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 repatriated after being laundered (were "outbound"), money

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60 Prakash Loungani and Paolo Mauro, *Capital Flight from Russia* (2000).

61 Capital flight can also consist of non-illicit funds, but these are not germane to this paper.

62 See Brooking Event Transcript 1999, "Criminal Money Laundering and Illegal Capital Flight," September 29, 1999. See also: Mark P. Hampton, "Exploring the Offshore Interface: The Relationship Between Tax Havens, Corruption, and Economic Development," in *The Globalization of Financial Services* (1996), Mervyn K. Lewis, ed.

laundering at home and abroad helped drain resources from the economy through the external sector. (To the extent that the funds were repatriated—"returning"—they were under criminal control, and gave rise to the economic problems discussed in Section III.)

The massive illicit capital flight from Nigeria since the mid 1990s also made full use of money-laundering centers 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."[63] 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.[64]

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.[65]

As an extensive UN study of the effect of money laundering on Russia noted, "In the Russian Federation, money laundering is always linked to the problem of capital flight and a subsequent lack of investments."[66] It is estimated that the amount of illicit capital flight laundered from Russia exceeds $100 billion,[67] implying an enormous drain on investment resources.[68]

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

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63 *UK banks warned over Nigerian money*, BBC News, Mar. 8, 2001 *at* http://news.bbc.co.uk/hi/english/business/newsid_1209000/1209798.stm.

64 *Zambia bank accused of laundering*, BBC News, June 6, 2000, BBC News, *at* http://news.bbc.co.uk/hi/english/world/africa/newsid_1372000/1372368.stm.

65 *Pakistan moves on money laundering*, BBC News, Nov. 6, 2001, *at* http://news.bbc.co.uk/hi/english/business/newsid_1641000/1641138.stm

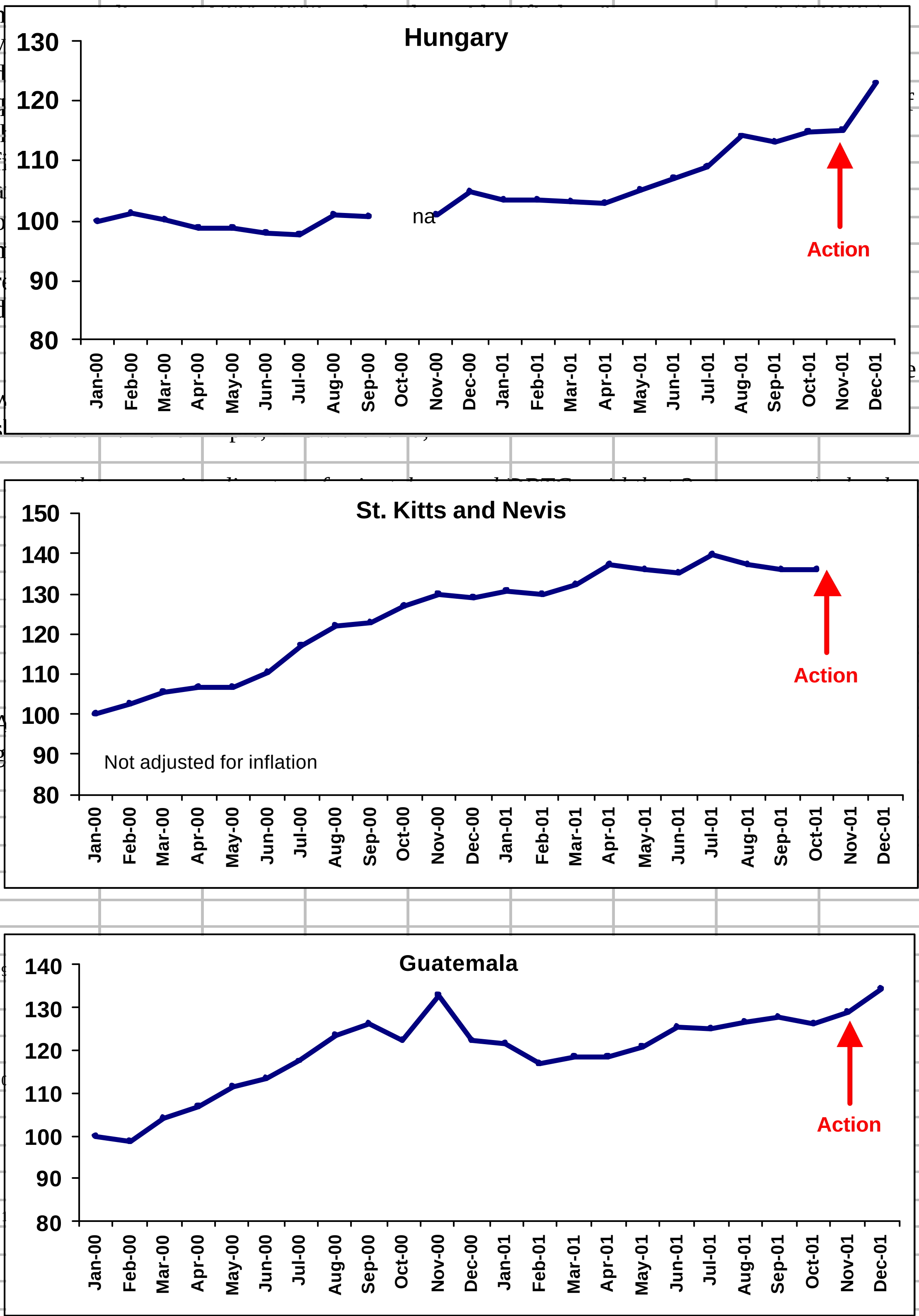
66 UN Report 2001, p. 15.

67 Id. Chapter 2.

68 Although a substantial portion of these laundered funds were returning to Russia after being laundered abroad (as opposed to being strictly outbound), these were under the control of criminal elements, leading to the economic problems discussed in Section III.B.

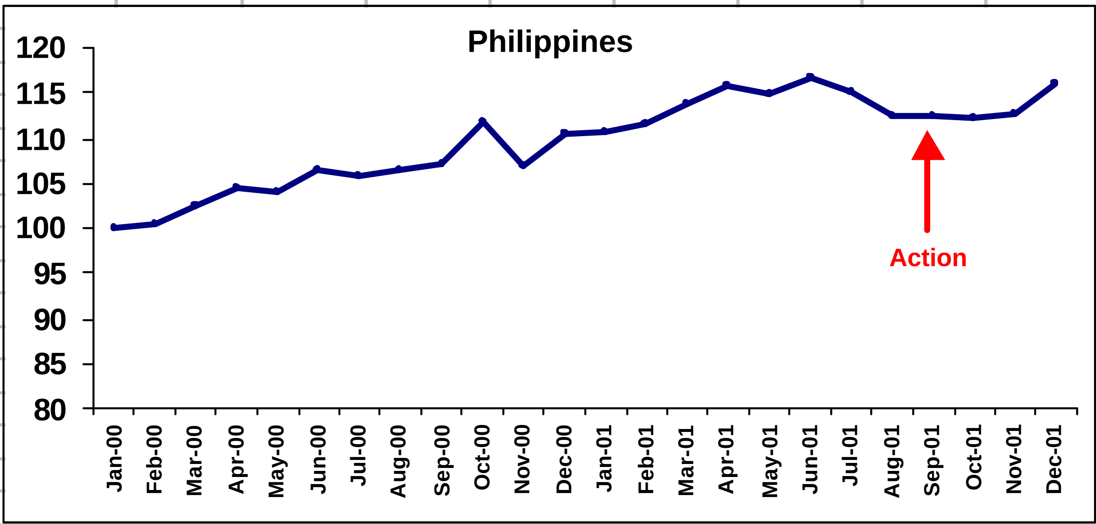
governments. Yet a review of the key financial indicators that would suggest such a response by investors does not confirm this theory

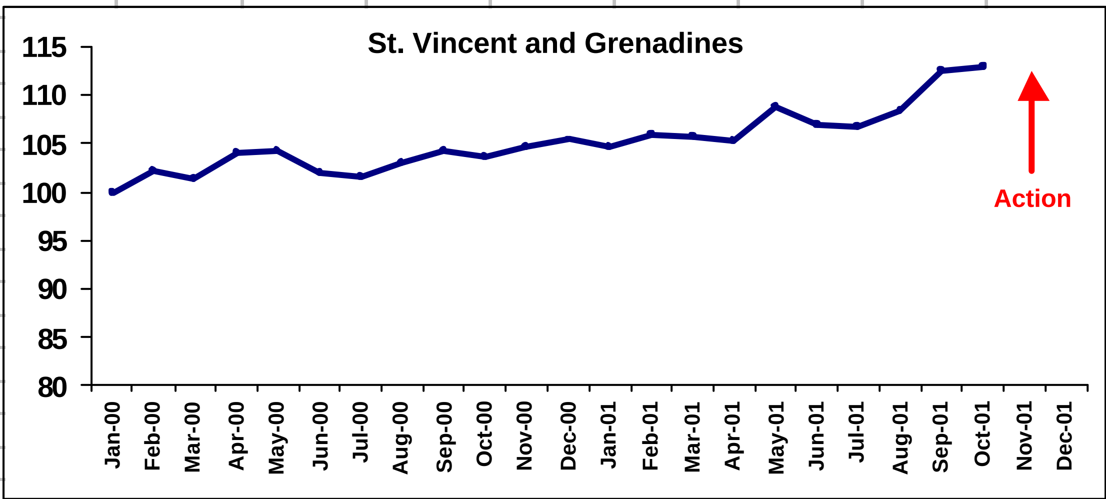
Figure 4 presents the level of bank deposits (indexed at January 2000 = 100 and adjusted for inflation of the country in question[69]) in those countries and territories that

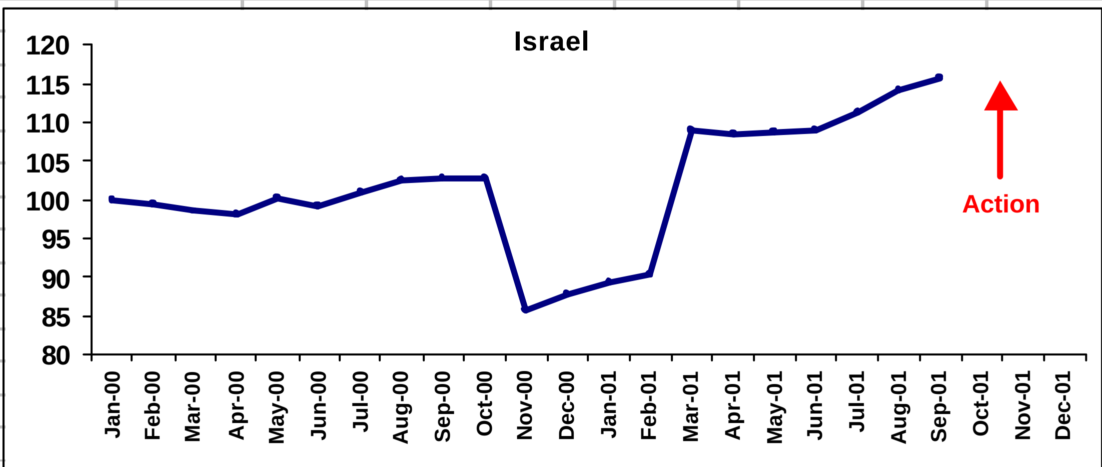


Recent Implementation of Anti-Money-Laundering Policies and the Use of Banks in NCCTs (continued)

Figure 4 (continued)







recent regulatory efforts to respond to the country's status as a FATF "non-cooperative" country, the financial sector would, "notwithstanding some short-term adjustment costs, ... retain its vitality over the medium and long term."[72]

B. Inward capital flows: depressing foreign investment

As discussed in Section III.B, money laundering facilitates an increase in domestic crime and corruption in domestic economies. A large body of economic research shows that a high incidence of such activity deters inward portfolio investment and foreign direct investment to developing economies. For example, as the IMF recently noted,

> *… Such allegations or actions can through reputational effects affect the willingness of economic agents, particularly those outside the country, to conduct business in a given country (e.g. inward investment, banking correspondent relationships) with adverse consequences.*[73]

Overall, the effect of extensive money laundering in a developing country on foreign investment in many ways parallels the effects outlined with respect to the damage to the financial sector, as discussed in Section II. These parallel effects on foreign investment, however, are in many ways more serious because of the special benefits, such as technology, labor skills and know-how, and immediate access to international distribution channels, that such foreign resources bring to developing economies.

C. Trade: distorting prices and content

A money laundering technique that does not directly involve the financial system or expenditures in the real domestic economy is the use of inaccurate pricing ("misinvoicing") of imports or exports to hide the transfer of funds during the layering process within what appears to be a value-for-value transaction. When such transactions are extensive, the impact on a country's entire external sector can be substantial. In Nigeria, for example, government officials have claimed that the country's official exchange rate was difficult to manage from a policy perspective because

> *the exchange rate differential reflected to a large extent a premium that purchasers of foreign exchange were willing to pay to falsify import documents so that they could evade customs duties, or to make transfers that were otherwise restricted (e.g., capital flight) or illicit (e.g., money laundering).*[74]

In other words, the demand for foreign exchange was being inflated by money-laundering activities using trade channels, thus driving up the "price" of foreign exchange, which is the exchange rate. By driving up the Nigerian exchange rate, the mere technique of using

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72 Inter-American Development Bank, *Situation and Prospects: The Bahamas,* p. 4 (March 2002).

73 IMF Background Paper 2001

74 IMF Staff Report on Nigeria, 2001 available at http://www.waado.org/NigerDelta/Essays/NigerianEconomy/IMFonNigerianEconomy.html

trade as a money laundering technique had reduced the competitiveness of Nigerian (non-dollarized) exports on world markets, thus slowing the country's economic growth.

The content of trade—particularly imports—can also be warped by money laundering activity. For example, a corrupt official may wish to launder his illicit funds outside the country and return the proceeds to the country for his own consumption and enjoyment. Yet, bringing large amount of funds into back into the developing country might nullify the laundering effort, and therefore a more effective laundering technique would be to "integrate" the funds abroad by buying foreign goods rather than repatriating the funds for domestic purchases. Thus, growth-enhancing domestic demand is shifted to imports solely by the need to obscure the existence of the illicit funds. A salient example of this problem was highlighted in the study of the economic effects of Colombian drug money, cited previously.

V. OFFSHORE FINANCIAL SECTORS: MONEY LAUNDERING HINDERS THEIR DEVELOPMENT ROLE

Recently, there have been 2 parallel developments with respect to offshore financial centers (OFCs). First, dozens of OFCs have been created as part of developing countries' (or territories') efforts to deve lop their domestic economies through the provision of international financial services. Second, OFCs have become an increasing concern in efforts to curtail transnational money laundering activity. Thus, the effect of money laundering on the establishment of OFCs as an economic development strategy warrants special focus here.[75]

A. OFCs as an economic-development strategy

Over the past 2 decades, dozens of small countries and territories have established OFCs 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 panacea for their economic disadvantages".[76]

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75 There has been some skepticism that the negative effects of money laundering on economic development apply to OFCs because most of the funds being laundered are foreign in origin and are re-invested outside of the OFC (are "flow-through" funds) and thus provide the OFC with the benefit of its "cut" without otherwise damaging the economy surrounding the OFC. For example, see Gianluca Fiorentini and Sam Peltzman, *The Economics of Organized Crime*, Introduction, p. 23 (1995) asserts that most economists are skeptical about the efficacy of giving incentives to small developing economies to comply with anti-money-laundering initiatives because there are very few "short-run" negative externalities for the small economies.

76 Jason Abbott, *Treasure Island or Desert Island? Offshore Finance and Economic Development in Small Island Economies: the Case of Labuan,* Development Policy Review, p. 157 (2000).

Yet jurisdictions seeking to use OFCs as vehicles for economic development face 2 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 OFCs are called ***notional*** OFCs because they often allow for institutions that are little more than “brass plates” with little substantive value added by the OFC itself.

The OFCs that have been the most successful both in terms of the OFCs' 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*** OFCs provide a significant degree of economic functionality, or value-added, to the transactions undertaken in the jurisdiction. In reality, most OFCs lie on a spectrum between the extreme definitions of notional and functional.[77] Moreover, many OFCs 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 OFCs tend to contribute to economic growth whereas notional OFCs do not*. Functional OFCs 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).

As a study by Professor Mark Hampton demonstrated, functional OFCs have been far more effective at generating domestic economic growth and employment than have notional OFCs.[78] “Notional” OFCs have a “nominal” contribution to employment (less than 3% of the workforce) and GDP (less than 10%),[79] whereas "functional" OFCs often make contributions that are several multiples of these levels.

77 Hampton uses the term “compound” to describe intermediate OFCs, but this paper will use only the 2 terms for clarity.

78 Mark P. Hampton, "Where Currents Meet: The Offshore Interface Between Corruption, Offshore Finance Centres, and Economic Development," *IDS Bulletin*, vol. 27, no. 2 (1996) and Mark P. Hampton, "Exploring the Offshore Interface: The Relationship Between Tax Havens, Corruption, and Economic Development," in *The Globalization of Financial Services* (1996), Mervyn K. Lewis, ed.

79 Hampton 1996, p. 422. For a case study in how an OFC's contribution to GDP depends on its functional characteristics, see Therese Huggins and Christine Greene, "The Economic Contribution of the Financial Sector of the Bahamas: A Ten Year Overview 1977-1987," *International Financial Centres*, Volume 4, 1997.

Establishing OFC Services as an Economic Development Strategy: The Case of the British Virgin Islands

In 1997, economists at the Eastern Caribbean Central Bank (ECCB) examined factors behind the success of the British Virgin Islands (BVI) in establishing itself, beginning in 1984, as an OFC capable of producing benefits for the broader BVI economy. In addition to its favorable regulatory environment for IBCs—which is the simplest aspect for an aspiring OFC to replicate—BVI's success was attributed to significant investments in communications infrastructure and human capital, and the BVI's strong social and political stability. These factors allowed BVI to supply more than "brass plates" and within 10 years more than 200 BVI citizens occupied "white collar" positions in the newly established IBCs, including dozens as accountants, trust officers, and corporate secretaries.

The ECCB study concluded that the future growth of the OFC sector, and the resulting benefits for the surrounding BVI economy, will depend in large part on whether the BVI can successfully diversify into a broader array of OFC services, rather than focusing on BCIs as it currently does. This is further evidence that there is a strong linkage between being a truly "functional" OFC and positive economic growth for the domestic economy as a whole.

Source: ECCB (1997).

Case studies of specific OFC contributions to their host economies consistently cite the role that the provision of truly functional OFC services play in supporting economic development.[80] (See text box on BVIs.). As another development economist reviewing the issue concluded:

> *... outside of centres such as the Channel Islands, the Isle of Man, and a few of the Carribbean havens, offshore services appear to make a relatively small contribution to both GDP and employment.*[81]

Yet another study by the Organization of Eastern Caribbean States (OESC) concluded that while Caribbean OFCs had made significant contributions to their host economies in some circumstances, "it is premature for OESC policymakers to view the offshore sector as replacing the [traditionally important] agriculture sector at least in the short- and medium term."[82] In sum, for a country or territory to use an OFC as a development strategy, it must make significant investments and have the patience to build a reputation, clientele, and linkages to the surrounding economy.

B. The effect of money-laundering activity on OFC development

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80 Abbott (2000).

81 *Id*. p. 157-175.

82 Nand C. Bardouille, "The Offshore Services Industry in the Caribbean: A Conceptual and Sub-Regional Analysis," *Economic Analysis and Policy* (September 2001).

The establishment and encouragement of an OFC by a country or territory seeking to obtain broader economic benefits from the OFC must recognize that such benefits will be extremely limited unless investments are made in building a "functional" OFC and the OFC's reputation is maintained. A strategy whereby the OFC is merely "notional", and therefore less expensive to maintain, will lead to few benefits to the broader economy and, perhaps, put at risk the country's political and economic integrity. This conclusion is supported by several significant episodes in which otherwise successful OFCs were dealt serious commercial blows as a result of scandals affecting their reputation among international investors.

For example, the Isle of Man, which is now considered a high-end functional OFC that contributes substantially to the island's economy, initially had somewhat lax supervision and suffered a major financial scandal beginning in the late 1970s. As a result, the OFC's reputation was damaged, investors pulled back, and the OFC's contribution to the island's economic development lagged behind. In response, government and industry worked together to bolster the monitoring of financial operations. A subsequent study[83] confirmed that this stronger policy was key to the Isle of Man's recovery as an OFC: survey respondents from OFC institutions stated that the post-scandal “more rigorous” regime was “crucial” to reestablish positive investor relationships.

> *A large number of respondents cited the creation of the [Manx] FSC in 1983 as the critical turning point for the island’s attractiveness to legitimate offshore investors.”*
>
> *Findings suggest that the major reason for growth was the establishment of a proactive regulatory regime which enabled the island to develop a superior reputation in the world of offshore finance.*[84]

Similarly, in the 1970s, the Bahamas was the third-largest offshore banking center. Largley as a result of widespread publicity concerning drug trafficking and corruption of its institutions, by the end of the 1980s it had fallen to 11th place.[85] In an extreme case, Panama's growth as an OFC was reversed as the volume of money laundering expanded to such levels that the entire financial system was viewed as corrupt, and funds withdrew from the Panamanian financial system even before the U.S. government began applying sanctions against it. As one researcher noted, even narcotics traffickers came to see Panama as a disreputable and unreliable financial center.

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83 Hampton (1996), p. xi.

84 Hampton (1996) p. xi. This is similar to the experience in Switzerland, where the failure of a Swiss bank in the 1970s led the Swiss Bankers Association to tighten itsown rules, as discussed in Section II.C..

85 R. Palan and Jason Abbott, *State Strategies in the Global Political Economy* (1996). An extensive account of the rise and fall of the Bahamas as a money center is given in *Evil Money: Encounters Along the Money Trail* by Rachel Ehrenfeld (Harper Business 1992).

By contrast, the government and OFC industry officials of the British Virgin Islands (BVI, see previous textbox) have sought to maintain a "clean" reputation with respect to financial crime by undertaking a series of regulatory and supervisory measures. These actions are aimed at sustaining the economic strength of the OFC sector in the BVI.[86] Indeed, in the 1997 ECCB study of the BVI's economic benefits from the islands' OFC makes clear that the loss of the OFC's reputation would have devastating effects on the BVI economy: "any significant shock to revenues, e.g. as a result of a scandal in the offshore financial sector ... will result in an economic contraction."[87] Further evidence of an OFC's motivation to maintain rules to prevent scandal can be seen in Switzerland's "Chiasso" affair in 1977, and the Swiss Banking Association's adoption of KYC rules, as discussed in Section II.C.

It is also important to note that the economic damage that an OFC scandal can do to its host country can extend beyond the direct withdrawal of OFC business. In particular, developing countries seeking to build truly functional OFCs capable of contributing to the underlying economy must make significant investments in telecommunications and travel infrastructure, as well as preparing the labor force to support the industry. A decline in OFC activity puts those investments at risk, leaving the government with the liabilities.

Moreover, many smaller island OFCs are heavily dependent on tourism, and a scandal arising from the financial sector could have spillover effects on the volume of tourism, either through a direct loss of financial clients or through the knock-on loss of a "safe" reputation.

VI. CONCLUSION

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

[86] See, for example, Michael Riegels, "Financial Services in the British Virgin Islands," *Bulletin*, p. 143 (1992), in which an industry leader draws a sharp distinction between the BVI's status as a "tax haven," which BVI officials defend vigorously, and the BVI's clean reputation regarding the OFC's use for money laundering and its strong prudential regulations.

[87] Reginald Darius and Oral Williams, *Growth of International Business Corporations in the British Virgin Islands: Lessons for the ECCB Area*, Social and Economic Studies (Special Issue), p. 181 (1997). Emphasis added.

help sustain economic development, particularly through the strengthening of the financial sector.