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# Money Laundering and the International Financial System 1/

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## Abstract

This paper looks at money laundering from a macroeconomic and international perspective. It shows that the potentially large amount of money that is being laundered internationally is likely to have implications for both the international allocation of resources and the stability of the international financial system. It makes a proposal that, if adopted and fully implemented, might eventually reduce international money laundering.


JEL Classification:

E2, E6, F30, F33, F42

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1/ The views expressed in this paper are strictly personal and not official Fund position. The author benefitted a lot from conversations with the Managing Director of the IMF, Mr. Michel Camdessus. I owe to him the idea behind the proposal outlined in Section V. I also benefitted from the assistance of Mr. David Nellor on an earlier draft. An earlier version of this paper was presented at the "International Conference on Preventing and Controlling Money Laundering and the Use of the Proceeds of Crime: A Global Approach," organized by the International and Professional Advisory Council of the United Nations Crime Prevention and Criminal Justice Program (ISPAC) in cooperation with the Italian government and under the auspices of the Crime Prevention and Criminal Justice Branch of the United Nations Office in Vienna. The conference took place at Courmayer Mont Blanc, Italy from June 17-21, 1994 and was attended by representatives of 56 countries. This earlier version, together with several other papers presented at the conference, will be published in *Responding to Money Laundering: An International Perspective*, edited by Ernesto Savona (UK: Hardwood Publishers, 1996).

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## Summary

The globalization of economic activities and of financial markets has had many positive impacts on the world economy. It is becoming obvious, however, that there are also some costs. The facility with which "dirty money" can now be laundered internationally is one of these costs. The paper discusses the relationship between globalization and money laundering, as well as some of the economic implications of large-scale money laundering.

The paper starts with a discussion of some quantitative aspects of money laundering. Although there are no hard estimates, experts have assumed that US$300 billion to US$500 billion of "dirty money" enter the international capital market every year. This money is generated by criminal activities, which directly absorb resources that could be allocated to legitimate uses. Money laundering allocates dirty money around the world not so much on the basis of expected rates of return but on the basis of ease of avoiding national controls. Dirty money tends to flow to countries with less stringent controls. As a consequence, the world allocation of resources is distorted--first, by the criminal activities themselves, and then by the way the dirty money is allocated.

The paper discusses some of the effects of dirty money on economic policy. It points to the fact that asset prices, interest rates, and exchange rates can be distorted by large movements of dirty money and that wrong signals may be sent to the policymakers. It also discusses the potential instability that large movements of dirty money can bring to specific countries and to the international financial system.

The paper concludes with the discussion of a proposal that would compel countries to adopt similar rules (or a similar role of conduct) aimed at controlling money laundering. The countries that would not abide by these rules would be penalized. This would be an application of a Pigouvian tax aimed at a negative externality. Pigouvian taxes have played an important role within countries. In the future they are likely to play an increasing role internationally.

## I. Globalization and Money Laundering

One of the most important economic developments of recent years has been the growing globalization of the world economy and, especially, of the world capital market. The globalization of the economy has led to an expansion of world trade twice as fast as that of the world economy. Most economies have become much more open than they were in the past. The globalization of the world capital market, that allows individuals and firms to shift money from one country to another with little or no impediments, has made possible for huge amounts of money to move freely and rapidly across frontiers in search of the most desirable economic habitat and the highest rate of return.

The globalization of capital markets has many desirable consequences: (a) by allowing capital to move out of countries where its productivity is low and into countries where its productivity is high, it leads to a better allocation of world savings and, consequently, to a higher rate of growth of the world economy; (b) it has facilitated progress in overcoming the debt crisis by giving easier access to the international capital market to countries willing to pursue necessary adjustment policies; (c) it helps in the enormous task of integrating into the international economic system the economies in transition; and, finally, (d) it facilitates the recycling of capital from countries with current accounts surpluses, such as Japan, to those in deficit, such as the United States.

While the potential benefits of greater economic integration and of freedom of capital movements are obvious and significant, there are inevitably some costs. For example, with the freer and larger movement of goods and the increased volume of trade, it has become easier for drug dealers and weapon smugglers to move their wares across countries. 1/ As far as the globalization of the capital market is concerned, one such cost is the occasionally large, sudden, capital movements promoted by speculators in search of quick gains, or by legitimate investors who may be influenced by herd instincts to take their money out of the country where they had invested it. The growth of hedge funds and the increasing importance of derivatives may have contributed to these sudden capital movements that may create difficulties for the countries involved.

Another potential cost of globalization is that it allows countries with structural fiscal deficits, that is with deficits not caused by the economic cycle, to postpone making the needed corrections to their fiscal accounts because of their easier access to foreign borrowing. These countries may, thus tend to accumulate more debt than may be wise. Still another cost, and one of particular relevance for this paper, is the greater

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1/ During the deliberations leading to the North American Free Trade Association (NAFTA) among Canada, Mexico and the United States, some opponents to the agreement called attention to this factor especially in relation to the drug trade. Some newspaper articles have attributed to NAFTA the growing importance of Mexico in the drug trade.

facility that the integration of capital markets has provided to criminal elements to launder internationally the money that they acquire from their illegal or criminal activities in particular countries.

The international laundering of money has the potential to impose significant costs on the world economy by (a) harming the effective operations of the national economies and by promoting poorer economic policies, especially in some countries; (b) slowly corrupting the financial market and reducing the public's confidence in the international financial system, thus increasing risks and the instability of that system; and, (c) as a consequence of (a) and (b), reducing the rate of growth of the world economy.

## II. Quantitative Aspects of Money Laundering

Several studies, including the annual reports of the Financial Action Task Force (FATF), have documented the growing importance of the criminal activities that generate large monetary gains to those who engage in them. 1/ These are not the activities of the petty criminals who engage in minor or random crimes. Rather they are the activities of well-organized groups. They include, first of all, the production and distribution of illegal drugs. Over the years, this activity has acquired immense international dimensions. It concerns most countries as consumers and few countries as producers and major distributors. The criminal activities extend to the smuggling and the illegal sale of weapons and, in worrisome recent developments, to the smuggling and sale of nuclear material. They also cover usury, fraud, embezzlement, high level corruption, 2/ kidnapping, extortion, prostitution, theft of artworks and other valuable assets, and large-scale tax evasion.

Some of these illegal activities attract significant economic resources, as for example those that go into the *production* and the *distribution* of illicit drugs and, perhaps, weapons. These resources are subtracted from the regular economy thus reducing its output and its rate of growth. This reduction is an important economic aspect of these criminal activities but it is more related to the criminal activities *per se* than to the laundering of the proceeds from those activities. These activities at times generate far more "income" to those who engage in them than these individuals can reasonably or prudently spend in the short run. In order to be enjoyed over a longer time horizon, these "incomes" need to be stored (or invested) in ways that will, to the extent possible, preserve their value and possibly convert them into assets that can later be claimed legitimately

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1/ The FATF was set up following the 1989 Paris meeting of the G-7. The FATF has developed recommendations related to financial transactions (deposit in cash, banking secrecy, etc.) that member countries are advised to follow.

2/ Especially bribes related to large government projects.

or without attracting the attention of the authorities. 1/ This is, thus, what money laundering attempts to do: to maintain, to the extent possible, the value of the acquired assets and to transform them (i.e., to launder them) into more legitimate or more usable assets. 2/ This process of storage of value and conversion into more accessible and usable forms may have macroeconomic consequences when it involves, as it often does, large sums.

Because the activities that generate the money to be laundered are illegal activities that by necessity, must take place far from the eyes of the authorities, it is impossible to measure directly or precisely the size of the net financial gains that they bring to those who engage in them. In some cases, as with narcotics, major costs may have to be met at the stage of production of the raw material (say, coca leaves) and its transformation into a usable product (such as cocaine), or at the stage of distribution of the finished product. These costs sustain the standard of living of the producers or the distributors thus they do not enter the circuit of money laundering and especially of international money laundering. 3/ Those who manage and control the whole process, the "drug lords", are the ones who end up with the large profits. Anecdotal reports as well as the guesses or the estimates of well informed observers, including some of the official agencies with jurisdiction in these areas such as the U.S. Customs Office, suggest that the total earnings from these activities are likely to be very large. 4/

Some guesstimates, and they cannot be more than guesstimates, have pointed to total annual gains from these criminal activities that, for the whole world, may reach U.S. $500 billion. 5/ How much of these gains need to be laundered is difficult to say. It is even more difficult to assess the value of the stock of all assets, including cash, acquired with laundered money. This stock would, of course, include this year's as well as past years' laundered money (at its present value) less the money that

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1/ There is thus a kind of life-cycle character to these "incomes". Their earning is more concentrated in time than the consumption based on them.

2/ The golden rule of investing, that it is better not to put all of one's eggs into one basket, applies also to money laundering.

3/ The peasants who produce the coca leaves used to produce cocaine generally spend the money they receive. They have no need to launder their earnings. This may apply also to the "foot soldiers" who distribute the drugs in the streets.

4/ As a supporting bit of evidence, on May 9, 1996, an article by Robert Graham in the Financial Times (page 3) reports that "anti-mafia investigators in Sicily ... froze U.S. $640 million of assets in a crackdown on suspected laundered drug money." Some of the captured shipments to the United States have had street values of hundreds of millions of U.S. dollars.

5/ See for example, William C. Gilmore, *Dirty Money, The Evolution of Money Laundering Counter-Measures* (Council of Europe Press: 1994).

has been spent. Changes in exchange rates and in the rates of return to the previously "invested" profits would influence the total present value. The laundering of money is reported to be very expensive. According to some reports, sometimes, fees of 30 percent or even higher of the amount to be laundered have to be paid or loss-making activities have to be bought. With all these qualifications, a reasonable conclusion must still be that the value of the total stock of laundered money must be larger, and perhaps much larger, than the yearly figure. 1/ The value of this stock is likely to exceed the gross domestic product of many countries.

The proceeds from criminal and illegal activities to be laundered are not evenly distributed among countries. In some countries, the proceeds from crime tend to be small and atomized among many petty criminals who spend them as soon as they receive them. In others, and especially in those engaged in the management of the drug trade, or where crime is organized or corruption is on a large scale, the proceeds from illegal activities tend to be large and to be concentrated into a relatively few hands. In the latter case, the money needs to be laundered especially when it is received in countries other than the ones where the managers of these activities reside. This is the case, for example, when cocaine produced in Colombia is sold in the United States.

Because of the volume of money to be laundered, because of the concentration of this money in a few countries and in relatively few hands; and because the countries' authorities are more likely to uncover or to be interested in the domestic laundering of illegally obtained money, there have been progressively more sophisticated attempts to launder these assets internationally. Recent developments--such as (a) the large-scale privatization of public enterprises in many countries, (b) the growth of stock markets in developing countries, (c) the growing diversification of financial instruments in the international financial market, (d) the growing share of international capital controlled through entities which report tax haven countries as their legal place of residence, (e) the as yet not stringent regulatory controls in many countries and especially in economies in transition and in several developing countries, and (f) the great need for foreign capital on the part of economies in transition and many developing countries--have created both a strong demand for foreign financial capital and the conditions that facilitate the anonymous investment of this capital.

The globalization of the capital market and its increasing technical sophistication have oiled the process. The much larger volume of legitimate capital moving at any one time in the world and the relatively limited official controls on that movement have made possible for money of questionable origin to enter this huge money stream without attracting much attention. It is often impossible to distinguish between capital movements

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1/ The measurement problems extend beyond the lack of statistics. They cover also conceptual questions such as when money that has been laundered in the past stops being considered "laundered".

encouraged or induced by differences in economic policies and capital movements that reflects attempts at laundering money. Currently available statistics and controls do not allow this distinction to be made. 1/ Furthermore, the fact that many countries welcome the inflow of foreign capital implies that the authorities of the capital-importing countries are not likely to look too closely at the origin of the incoming capital. 2/ Some corruption of the private institutions that manage capital flows (such as the banks and the exchange houses) or of some of the officials who are charged with regulating these flows has also contributed. When the money involved is so large, the power to corrupt is also great.

## III. The Allocation of Laundered Money

Available information suggests that while the activities that generate the money to be laundered tend to be country-specific and somewhat fragmented, the laundering of the money tends to be more international. There is thus increasing distance between the places where the criminal activities that have generated the money have taken place and the places where that money is laundered.

The international laundering of money is often not done by the same individuals who engage in the criminal and illegal activities but by experts who are familiar with the workings of the international capital market and who are thus able to determine risks of detection and to exploit differences in controls and regulations among countries. 3/ They can thus channel the funds towards financial instruments and other assets such as real estate and small enterprises and towards countries in which the money can more easily be invested without too many questions asked about its origin. Often, the money is first channelled, perhaps in cash, towards offshore countries or centers from which it is subsequently invested in other countries. 4/ The economies of the offshore countries are not large enough to be able to absorb domestically the volume of money that searches for places where it can be invested. Therefore, these countries are used mainly as conduit for financial or real investments made elsewhere.

There have been reports that some of these highly trained and skilled professionals have carried out, or have commissioned others to carry out,

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1/ See Chapter XI (pp. 89-95) of the *Report on the Measurement of International Capital Flows* (IMF, September 1992).

2/ Recently some small countries have almost advertized their willingness to accept laundered money.

3/ International money laundering on a large scale requires a technical preparation and a sophistication that relatively few individuals have.

4/ With increasing frequency, cases have been discovered in which employees of legitimate institutions such as banks, foreign exchange offices, investment houses and real estate agents have lent their services to money launderers in exchange for large payments.

sensitivity analyses on behalf of those who wished to launder money. These analyses attempt to assess the probability that the origin of the laundered money will be uncovered or they aim at spreading the risk among many investments and/or countries. As long as major differences exist in controls and in regulations among countries, there will be scope for well informed professional money launderers to exploit them.

There are still enormous differences in controls and regulations among countries with respect to the activities that lend themselves to money laundering. In this area, the international playing field remains highly uneven. 1/ Some of the tax haven countries and many other capital-starved countries, and some economies in transition, have almost no controls. They may welcome any capital inflow regardless of its origin. 2/ Therefore, money can be exported to these countries and, if necessary, it can be reinvested in third countries. By the time it is re-exported, the original provenience of the capital invested is no longer an issue.

## IV. Effects On Economic Policy

The globalization of the capital market has allowed professional money launderers to exploit differences in controls and regulations far more efficiently and easily than it was possible when capital movements were controlled and restricted. In a way, the freedom of movement of capital, without the necessary steps of levelling controls and regulation, has increased the importance of the differences in controls. Capital movements induced by attempts at laundering money are not promoted by differences in economic fundamentals, such as differences in after-tax rates of return to real investment or, in real interest rates. Rather, they are largely induced by differences in controls and regulations which make money laundering a safer activity in some countries than in others. 3/

Those who wish to launder money are generally not looking for the highest rate of return on the money they launder but for the place or the investment that most easily allows the recycling of the criminally or illegally obtained money *even when this requires accepting a lower rate of return*. Therefore, these movements may well be in directions opposite to those that would be expected on the basis of economic fundamentals. Money may move from countries with good economic policies and higher rates of

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1/ As of now, most countries are still not members of the Financial Action Task Force. Furthermore, not all the countries that are members have equally effective controls. For example, many countries still do not require the reporting of large cash transactions.

2/ It has been reported that some banks in these countries are in the hands of criminal groups; thus, they facilitate the process of money laundering.

3/ The professionals, when engage in money laundering activities, are likely to be well informed about these controls.

return to countries with poorer economic policies and lower rates of return, thus seeming to defy the laws of economics. This implies that, because of money laundering, the world capital tends to be invested less optimally than would be the case in the absence of money laundering activities. The world rate of growth is thus reduced not only because of the effects of the criminal activities on the allocation of resources but also because of the allocation of the proceeds from those activities. As a consequence of these counter intuitive capital movements, the policymakers may get confused as to the policies to be pursued. For example, the policymakers of a country that, in the face of high inflation, overvalued exchange rate, and a large fiscal deficit experienced capital inflow might be less inclined to change their current policies.

If the reported estimates of the proceeds of crime are broadly of the right order of magnitude, the value of all the assets controlled by criminal organizations must be very large. A sizeable share of this value may be invested in countries other than the ones in which reside those who own and control these organizations. 1/ Some of these assets may be held in the form of deposits in foreign banks and especially in those that respect bank secrecy; some in shares in foreign enterprises; 2/ some in real estates; others in public bonds; others still may be held in cash either domestic or foreign. On the basis of the advice they receive from their financial advisers, those who own and control these assets make the decisions on whether to leave them where they are or to move them to other habitats. These decisions may be influenced more by the attempt to escape controls and to avoid detection than by the search for the highest rate of return. In a way they are still maximizing rates of return adjusted for risk of detection. However, this private maximization is not consistent with an optimal allocation of resources. Therefore, as already mentioned, there may be a large misallocation of world resources associated with the allocation of laundered money in different countries.

Apart from the issue of the optimal or at least the efficient allocation of resources, a large stock of laundered capital may bring some inherent instability to the world economy. The total assets controlled by criminal organizations or criminal elements or by their agents may be so large that the transfer of even a small fraction of them from one country to another could have important economic consequences. If the annual total flow of laundered money is in the hundreds of billions of dollars, and if the stock of all laundered money is even larger, it is not too farfetched to imagine that billions of these dollars could be moved around at particular times. These movements could create macroeconomic difficulties for the

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1/ For example, a large proportion of the assets controlled by the Colombian drug lords is likely to be invested outside of Colombia and a large proportion of the assets controlled by Russian criminal elements is invested outside Russia.

2/ Some reports have indicated that the privatization of public enterprises has attracted some of the money to be laundered.

countries that receive or lose this money and, at least in theory, could have a potentially significant impact on the world economy.

At the national level, large inflows or outflows of capital could significantly influence variables, such as the exchange rates and the interest rates, or even the prices of particular assets toward which the money is invested, such as land and houses. In some countries identified with money laundering activities there have been increases in asset prices (land and houses) that often could not be explained by the changes in the countries' policies. 1/ When the exchange rate is free to fluctuate, the inflow of large amounts of laundered money into a country would lead to its appreciation and/or to an expansion of the country's monetary base. The appreciation of the exchange rate would reduce the competitiveness of traditional exports and would encourage more imports. The expansion of the monetary base, in the absence of sterilization, would also put some upward pressure on domestic prices. Faced with this version of the "Dutch disease", the policymakers of the country would be forced to tighten its fiscal policy in order to try to create a budgetary surplus to use to sterilize the monetary effects of the capital inflows. A country experiencing a capital outflow would have opposite effects.

These capital movements originating from money laundering activities, especially when they are considered to be of temporary nature, could have internationally destabilizing effects because of the integrated nature of global financial markets. This integration implies that financial difficulties originating in one center can easily spread to other financial centers thus transforming a national problem into a systemic one. The destabilizing effects could arise because these capital movements would not be seen to reflect differences in economic fundamentals across countries. Thus, they send confusing signals to the world economic community. International coordination of economic policy cannot be completely successful without addressing the causes of these perverse capital flows. These causes are, of course, the criminal or illegal activities and, perhaps, as importantly for the international policy coordination, the differences in controls and regulations among countries.

An interesting aspect of international money laundering worth mentioning is the role that American dollar bills play into it. Being by far the largest market for narcotics, the United States generates a large share of the "income" produced by this activity. The sale of illegal drugs alone has been estimated to generate as much as US$100 billion a year in the United States. These drugs are imported from Colombia and some other places. When drugs are sold in the streets of the American cities, they are bought with American currency, i.e., with actual dollar bills. 2/ These dollars, normally collected in small amounts reflecting the purchases by

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1/ The same conclusion has often been reached for some regions such as Sicily.

2/ These transactions are normally conducted with the use of cash. Thus they lead to an increase in the demand for dollar bills.

individual drug users, are used by the local distributors to buy their merchandize from the wholesalers. These in turn use them to pay the distributors who represent the drug lords. These dollar bills are generally smuggled out of the country. 1/ As far back as 1984, the U.S. President's Commission on Organized Crime had estimated that US$5 billion a year in the form of currency was being taken out of the United States through the illegal drug trade. Recent estimates indicate much larger amounts.

Other indirect evidence points to a large stock of U.S. dollars held abroad. For example, there is a great disparity between the total amount of dollar bills known to have been issued by the American authorities, and thus known to be in circulation (about US$350 billion), and the amounts reported to be in the hands of Americans by periodic surveys made by the Federal Reserve System. On the basis of the known quantity of dollar bills issued by the American authorities, each American should be carrying about $1,500 in cash in his/her pocket. Obviously, this is not the case. Richard Porter of the U.S. Federal Reserve System has estimated that the amount held abroad is at least US$200 billion out of a total of about US$350 billion. 2/ How much of this has left the United States because of money laundering activities is unknown.

Important macroeconomic implications follow from this. First, the holding of these dollars by foreigners implies that an interest-free loan is given to the U.S. government because no interest is paid by it to those who hold them. Second, by reducing the demand for *domestic* money in the countries where the U.S. dollars are held (that is, through the phenomenon of currency substitution), the holding of dollars abroad raises the rate of inflation in those countries or at least it reduces the seigniorage that the governments of those countries receive from issuing their own money. Finally, it creates some potential instability for the world financial system because of the possibility that at some point (if, say, the value of the dollar were predicted to fall significantly) these dollars could suddenly be unloaded in exchange for other foreign currencies.

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1/ As a report by the United States General Accounting Office has put it: "Smuggling currency out of the country is relatively easy." *See Money Laundering, U.S. Efforts to Fight It Are Threatened by Currency Smuggling* (March 1994), p. 3. This report outlines the efforts by the U.S. government to control currency smuggling. However, these efforts are unlikely to be very successful. The use of dollar bills in these transactions has led to greater demand for large denomination bills because they are easier to carry.

2/ See Richard Porter, "Foreign Holdings of U.S. Currency," in *International Economic Insights*, November/December 1993. See also Vito Tanzi, "A Second (and More Skeptical) Look at the Underground Economy in the United States" in *The Underground Economy in the United States and Abroad*, Vito Tanzi, editor (Lexington, Massachusetts: Lexington Books, 1982), pp. 103-118.

The development of an efficient world capital market requires that those who participate in this market have full confidence in it. If this market came to be significantly contaminated by money controlled by criminal elements, this confidence would inevitably be affected. The trust that normal individuals have in the capital market would be reduced. The market would then react more dramatically to rumors and to false statistics thus generating more instability.

The transparency and the soundness of financial markets are key elements in the effective functioning of economies and both may be threatened by money laundering. Criminally obtained money can corrupt some of the officials who make decisions concerning the financial market of countries. If some damage should occur to the financial markets, it could be long lasting because the credibility of markets can be reduced instantaneously but it takes a long time to rebuild. 1/ Thus countries that do not make a substantive effort to control money laundering are *de facto* imposing negative externalities on other countries.

It is not farfetched to imagine that, through the use of proxies, criminal elements could intentionally seek to subvert financial markets by corrupting some of the designers and administrators of the laws governing banking, currency, and financial markets in particular countries and the administrators of the financial market. In a worst case and admittedly unlikely, but not impossible, scenario, a cartel of criminal organizations, with control over large financial resources, could attempt to de-stabilize a national economy by intentionally coordinating a transfer of funds (controlled through proxies) out of that economy. They might do this, say, for punishing the authorities of that country for becoming extra vigilant or for introducing stricter controls. These shifts could create difficulties for some of the countries involved. Of course, these criminal elements may also corrupt the political process of particular countries by financing candidates who may be more likely to let these elements have their way. 2/ When the money involved is so large and the pay off to the criminal elements is so significant, it seems realistic to expect that attempts will be made by criminal elements to install more friendly administrations in some countries.

## V. On Policy Coordination and Money Laundering 3/

While domestic money laundering can often be fought at the national level, by each country acting with determination and good policies, an

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1/ The experience with the Bank of Credit and Commerce International (BCCI) raised some questions about the effectiveness of the supervisory role of central banks.

2/ This may have already happened in some countries.

3/ I owe to Mr. Camdessus the basic idea outlined in this section. However, some details have been added with which he may not necessarily be in agreement.

effective solutions to the *international* money laundering problem can be found only at the international level. The reason is that the scope for international money laundering activity is provided by differences in controls and regulations across countries and jurisdictions. Thus, the more effective are the controls introduced in some countries, the more attempts will be made to exploit the less stringent environment of other countries. The international coordination of economic policy cannot be fully effective as long as the controls and the regulations imposed by individual countries differ and as long as there is a large pool of unstable money in search of the habitat that is most attractive from a regulatory point of view.

The solution to the international money laundering problem must be sought via international mechanisms: it is an international problem which requires an international solution. International money laundering is based on the exploitation, by sophisticated financial operators, of differences in financial and banking regulations of countries across the globe. Therefore, the solution to eliminating the scope for this form of money laundering must be found in a mechanism that reduces, if not eliminates, these differences among countries.

When they met in Paris in 1989, the representatives of the G-7 established the Financial Action Task Force (FATF). The Task Force was mandated to examine measures that could be adopted *by each country* to combat money laundering. In April 1990, FATF issued a well-balanced set of 40 recommendations which it urged its members to implement in order to control money laundering. The FATF comprises 28 jurisdictions and regional organizations; 24 members of the OECD, Hong Kong, Singapore, and representatives of the European Commission and the Gulf Cooperation Council.

Many members of the FATF have made significant progress in recent years in implementing the 40 FATF recommendations. The FATF has also monitored developments in money laundering methods and examined refinements to the counter-measures that it suggested in its recommendations. In addition, it has pursued external relations activities to promote widespread international action against money laundering. The main focus of the FATF had initially been to counter the laundering of money related to illegal drug activities. More recently it has paid more attention to the laundering of the proceeds of other serious criminal activities or other offenses which also generate large funds. Proceeds from nondrug related illegal activities are now estimated to be a significant proportion of the total money laundered.

Initiatives have also been undertaken in the United Nations System particularly in the area of illegal drug trafficking. Most notable is the UN Convention on this matter agreed on in Vienna in 1988. The Council of Europe and the European Communities have issued a number of statements on this question including recommendations on banking practices. The Basel Statement of Principles in 1988 also recognized that public confidence in the banking system could be undermined through association with criminals and made recommendations intended to reduce this possibility. The

Commonwealth has pursued the matter by seeking to facilitate programs of mutual assistance. 1/

Despite the substantial progress achieved by the FATF, and in other international fora, there remain significant drawbacks to the current arrangements. In particular, as long as the membership of the organization is not comprehensive, there will be free-riders who will seek to benefit from the fact that other countries have adopted rules that discourage the inflow of illegal capital. The development of the various offshore tax havens and, more recently, the growth of illegal activities and organized crime in the previously centrally planned economies, together with weak controls on their banking system, suggest that the present measures to counter money laundering need to be strengthened. Moreover, the guidelines of the FATF and other groups are in any case only recommendations. The question is whether the framework established by the FATF can be applied internationally. The time may have come to take the next step--to build on the experience of the FATF and on the work already done.

The international financial system is an international public good which can provide its full benefits to the world community *only if all its participants ensure that it remains transparent and credible*: activities by any one participant to seek short-term gains can impose high costs on all. 2/ Unfortunately, as recent experiences show, the incentives for some countries or territories to gain economic advantages by attracting, through lax controls and regulations, criminal money are very high. So far there are no mechanisms to penalize them for the costs they impose on others. As long as these possibilities continue to exist, international laundering will remain a problem. It is now easy for criminals to invest their money through convenient conduits provided by offshore countries or by countries with inadequate controls.

The G-7, or possibly a group representing more countries, could, for example, take the initiative by issuing a strong statement that financial practices, by any country, that facilitate international money laundering will no longer be tolerated. This group could announce the intention that it would reflect this view in its countries' dealings with the countries that follow practices that facilitate money laundering. The objective would be to raise the cost to these countries of continuing to follow these practices.

However, the international community may need to go beyond that. It could consider the establishment of *a set of rules which will form the basis for full participation by any country in the international financial market*. This market should become an exclusive club with benefits and obligations for those who wish to belong to it. An international meeting, in which *all*

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1/ For details on money laundering counter-measures, see William Gilmore, *Dirty Money*.

2/ In a Pigouvian world, this negative externality would justify a punitive tax on the country that generates it.

countries or economic entities would be invited to attend, should (building on the work of the FATF) establish *minimum* worldwide standards of statistical, banking, prudential and financial rules that would be binding *on all countries*. These rules would eliminate, or at least drastically reduce, the differences in domestic regulations that encourage and to some extent make possible international money laundering. The support of the international organizations should be enlisted to effectively establish these minimum standards and, subsequently, to monitor and enforce these rules.

This leaves unanswered a fundamental question--how can countries be encouraged to participate in the meeting and to enforce the agreed set of minimum standards of financial behavior which would limit the scope of money laundering? All countries can share in the economic gains that flow from the free movement of capital. These gains, however, are not enough if some countries feel that they can gain even more by attracting to them capital of doubtful origin. Therefore, some punitive measures must be introduced to induce all countries to play by the same rules.

Consideration could be given to denying international legal recognition for any financial operations transacted and rights acquired within countries that did not agree or did not adhere to the terms of the international agreement. Moreover, part of the agreement could involve the imposition of substantial or punitive withholding taxes on capital flows to or from countries not participating in, or not adhering to, the rules of the international agreement. For example, an offshore country that attracted criminal money and served as a conduit to channel it to the main international financial centers would have its capital flows in and out of the financial centers, taxed at significant punitive rates. 1/ This kind of quarantine for those not willing to play by the internationally agreed rules of the game could come into effect after a given period during which the countries would make the required changes. This code of conduct for participation in the international financial system would have the objective of moving the world's allocation of resources closer to an optimum.

The IMF views international money laundering as an obstacle to its task of maintaining an effectively operating international monetary system. There is some, though small, risk that international money laundering operations may either de-stabilize the international financial system or that countries, frustrated by the behavior of those countries offering shelter to the proceeds of criminal behavior, may eventually introduce controls on the free flow of capital. Both of these outcomes would impose serious costs on the global economy that should and could be avoided by international agreement. In Article VIII of its Articles of Agreement, the IMF requires that its members furnish information necessary for the discharge of its mandate. If its members requested it, the IMF could, in its surveillance activities, monitor in more detail the rules governing

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1/ For similar ideas related to the tax area, see Vito Tanzi, *Taxation In An Integrating World* (Washington, D.C.: The Brookings Institution, 1995).

capital flows and the capital operations in the balance of payments to facilitate the monitoring of an internationally agreed upon set of rules for capital transactions. However, many offshore centers are not Fund members so that other channels must be used to control them.

## VI. Concluding Remarks

This paper has discussed briefly some of the macroeconomic implications of international money laundering activities. It has pointed out that the allocation of the world resources is distorted not only when labor and capital are used in criminal activities and in the production of illicit products and services but also when the proceeds of these crimes are invested in ways that are not consistent with economic fundamentals. The paper has also speculated on other macroeconomic consequences of these activities showing the potential dangers to individual economies and to the international financial system.

The paper has suggested a way to reduce international money laundering by imposing a common code of conduct to all countries that are part of the international financial system. However, it has not discussed the political, legal, administrative, and financial implications of that proposal. It is clear, however, that detailed analyses, reflecting different angles--legal, political, etc.--would need to be made before that proposal were seriously considered. It would be easy to anticipate many objections to it. However, we live in a world of second best so that it would be impossible to find a solution that passed all the objections. The alternative of ignoring the problem may become progressively more costly to the international community.

The paper has relied on published estimates or, better, guesstimates of the size of the money laundering phenomenon. The issues discussed in this paper become more important, the larger is the volume of money that is being laundered internationally each year. It is, therefore, essential to generate firmer estimates than we have so far. There is no question that the size of this phenomenon is very large but there are still major questions about just how large it is.

It may be worthwhile to add that if international money laundering became much more difficult because of better controls on it, the incentive to engage in some criminal activities might be reduced because those who engage in them would have to spend (or to launder) their illicit earnings domestically. Thus the benefits to those who engage in these activities would fall while the probability of getting caught would increase. Both changes would tend to make them less attractive to those who engage in them as the analysis of criminal activity by Gary Becker predicts. 1/

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1/ See Gary Becker, "Crime and Punishment: An Economic Approach," *Journal of Political Economy*, Vol. 76, No. 2, 1968, pp. 169-217.