

# **Anti-Money Laundering Literature Search**

## **Economics**

### **World Bank Institute**

**<http://www.worldbank.org/wbi/governance>**

This document prepared by Christian Eigen-Zucchi, with the assistance of Massimo Mastruzzi and Erin Farnand, under the guidance of Daniel Kaufmann. It draws from a number of sources, including bibliographical information from the International Money Laundering Information Network (IMOLIN) (available at: <http://www.imolin.org/bibliogr.htm#GENERAL>), the Financial Crimes Enforcement Network (FINCEN) (<http://www.fincen.gov/>), the Organization for Economic Cooperation and Development (OECD) (<http://www1.oecd.org/daf/nocorruptionweb/moneylaundering/bib.htm>), and other sources.

**Bartlett, Brent. 2002. “The Negative Effects of Money Laundering on Economic Development,” For the Asian Development Bank, Regional Technical Assistance Project No.5967, Countering Money Laundering in The Asian and Pacific Region, May. (Available at: [http://www.apgml.org/Index\\_files/ann\\_meet\\_doc\\_2002\\_public/pdf/ADB's%20Economic%20Research%20Report%20Final.pdf](http://www.apgml.org/Index_files/ann_meet_doc_2002_public/pdf/ADB's%20Economic%20Research%20Report%20Final.pdf))**

**Abstract** (From the paper)

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.

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*The financial sector.* A broad range of recent economic analyses points to the conclusion that strong developing-country financial institutions—such as banks, nonbank 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 antimoney-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 wellrecognized 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 moneylaundering 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.

**Fiorentini, G. and S. Peltman. 1997. *The Economics of Organized Crime*. Cambridge: Cambridge University Press.**

**Hinterseer, R. K. 1997. "An Economic Analysis of Money Laundering." *Journal of Money Laundering Control*, Vol.1, No.2, October.**

**Keh, D. 1996. "Economic Reform and Criminal Finance." *Transnational Organized Crime*, Volume 2, n°1, spring: pp. 66-80.**

**Masciandaro, Donato. 1995. "Money Laundering, Banks and Regulators: An Economic Analysis," *Innocenzo Gasparini Institute for Economic Research, Working Paper No. 73*, May.**

**Abstract** (from the paper)

The purpose of this paper is to apply the tools of economic analysis to the topic of money laundering by connecting macroeconomic theory, the economic theory of crime and the theory of banking regulation. First, the macroeconomic analysis considers the hypothesis of a multiplication effect of money laundering, assessing the relationships between financial structure and real criminal businesses. Then we show the micro effects of money laundering caused by the presence of asymmetric and incomplete information in the banking industry and highlight the role of intermediaries and of the central bank.

**Masciandaro, Donato. 1998. "Money Laundering Regulation: The Micro Economics." *Journal of Money Laundering Control*. Institute of Advanced Legal Studies. Vol. 2, No. 2, Summer.**

**Masciandro, Donato and Filotto, Umberto. 2001. "Money Laundering Regulation and Bank Compliance Costs. What Do Your Customers Know? Economics and Italian Experience,"** *Journal of Money Laundering Control*, Vol. 5, No. 2: pp. 133-145.

**Abstract** (from the introduction)

The objective of this paper is to point up the link between the effectiveness of anti-laundering regulations and the characteristics of the relative compliance costs for banks, with particular attention to the bank-customer relationships. The work is organized as follows. The second section contains the economic framework, that starts with the assumption that intermediaries have an information advantage and then demonstrates, by means of a principal-agent model, how this advantage can produce collective advantages in the war against money-laundering only if the regulations take the problem of compliance costs into due consideration.

Based on the economic results, then, section three presents an empirical part, comprising a survey conducted in conjunction with an Italian bank present in 11 of Italy's 20 regions, on how banks perceive the relationship of customers with the obligations imposed by the anti-laundering regulations. The survey provides a better understanding of the nature and extent of compliance costs within banking operations. Section four contains the concluding remarks.

**Quirk, Peter J. 1996. "Macroeconomic Implications of Money Laundering". International Monetary Fund Working Paper 96/66. June. (Available at: <http://www.imf.org/external/pubs/cat/doctext.cfm?docno=WPIEA0661996>).**

**Abstract** (from the paper)

This paper reviews the main analytical, empirical and policy issues related to the macroeconomic implications of money laundering. It discusses, how money laundering can be measured, given that it is unobservable, and reports cross-section econometric estimates of the displacement of monetary behavior in industrial countries attributed to money laundering. It then examines the various potential channels by which money laundering influences macroeconomic performance, including an econometric estimate of its effects on GDP growth rates. Also, the paper discusses macropolicy implications, particularly in the areas of exchange controls, prudential banking supervision, tax evasion, statistical reporting and legislation.

**Summary** (from the paper)

Money laundering and measures to counter it have become the focus of an intense international effort. Evaluation of the resource costs and benefits of the countermeasures depends in part on an understanding of the macroeconomic effects of money laundering. The wide range of activities and financial instruments involved in money laundering is not directly observable, and comprehensive, microeconomic-based estimates are difficult to compile. Indirect, macroeconomic-based techniques that involve estimating the extent of money laundering are, therefore, the focus of most empirical work. This paper introduces an international cross-section econometric examination of the role of money laundering, tax evasion, and employment opportunities in determining monetary behavior, and concludes that money laundering has a significant role. A shift is detected from the use of currency in the 1980s to noncash money laundering in the 1990s.

The economic literature suggests that money laundering can distort economic data and thus distort macroeconomic analysis and policymaking. In addition, there may be direct effects on saving resulting from induced changes in income distribution and from the erosion of confidence in financial markets. The paper reports a first attempt at econometric estimation to link differences in economic growth rates among industrial countries to crime as a proxy for money laundering; some evidence is found of a depressant effect on growth.

Finally, the paper examines the implications for economic policymakers. Freedom to launder money could promote private economic welfare for some while undermining social welfare. Public policy considerations, therefore, suggest an antilaundrying role for financial institutions involved in prudential banking supervision, tax evasion monitoring, statistical reporting, and legislation. However, in order to minimize the negative consequences for macroeconomic efficiency, care must be taken in designing the form of the interventions.

**Quirk, Peter J. 1997 “Money Laundering: Muddying the Macroeconomy.” *Finance and Development*. International Monetary Fund. March. Vol. 34, No. 1. (Available at: <http://www.imf.org/external/pubs/ft/fandd/1997/03/pdf/quirk.pdf>).**

### **Abstract**

“Money laundering can have devastating economic consequences” (p. 7). Data on the size of money laundering is scant, UK and US officials estimate that “the amount of money laundered annually in the financial system worldwide was roughly \$500 billion - some 2% of global GDP” (p. 8). Moreover, crime is very important in explaining variations in “currency and money demand across industrial countries,” and “a 10% increase in crime, is associated with a 10% *reduction* in currency demand and a 6% *reduction* in overall money demand” (p. 8).

“Money laundering threatens economic and financial systems in many countries,” and has significant effects on income distribution and macroeconomic variables, because “accumulated balances of laundered assets are likely to be larger than annual flows, increasing the potential for destabilizing, economically inefficient movements, either across borders or domestically” (p. 9).

**Tanzi, Vito. 1996. "Money Laundering and the International System," International Monetary Fund Working Paper 96/55, May. (Available at: <http://www.imf.org/external/pubs/cat/longres.cfm?sk=2029.0>).**

**Abstract** (from the Introduction)

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 to 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 U.S. \$300 billion to U.S. \$500 billion of dirty money enter the international capital markets 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 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 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.