

# The negative effects of money laundering on economic development

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The following is an extract from a comprehensive report for The Asian Development Bank, Regional Technical Assistance Project No.5967, titled Countering Money Laundering in the Asian and Pacific Region.

Although too large in both size and scope to publish in this forum, Platypus considers the subject of sufficient value and interest to the Australian Federal Police to present this extract. Members interested in studying this report in detail can contact [Brent\\_Bartlett@DBLLP.com](mailto:Brent_Bartlett@DBLLP.com)

**T**he negative economic effects of money laundering on economic development are difficult to quantify. 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 centres (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 develop-

ment, 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, it erodes financial institutions themselves. Within these institutions, there is often a correlation



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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, long-standing 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, jewellery, 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 organisations can transform productive enterprises into sterile investments by operating them for the purposes of laundering illicit proceeds rather than as profit-maximising enterprises responsive to consumer demand and worthy of legitimate investment capital.

Money laundering also facilitates crime and corruption within developing economies, which is the antithesis of 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



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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-recognised 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 centres to major money-centre 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 centres (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 cost almost nothing to establish and therefore competition among them for customers is severe.

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Second, because notional OFCs provide little value-added services, such centres 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 labour 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 work force to support their value-added activities.

This distinction between notional and functional offshore financial centres becomes critical to assessing the economic effect of money laundering on such centres 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 ones – the very type 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 a centre 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 establish-

ment of an OFC, the strategy must adopt measures to control money-laundering activity through the centre.

Moreover, International Monetary Fund studies suggest that smaller countries can become favoured 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.

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<sup>1</sup> and even those few studies that have considered money laundering's economic consequences have focused on the global financial system rather than on individual economies.

#### 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.



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The defence of the inaction policy is based on three interrelated arguments, each of which is flawed:

- “Money-laundering funds flow from developed economies to developing economies, and therefore result in a flow of capital to developing countries.” — This argument is not supported by data and, indeed, it can be shown that money laundering facilitates illicit capital flight from developing economies.
- “To the extent that money laundering encourages economy-depressing crime, that crime occurs in developed economies, and developing-country governments should not be spending their limited resources on preventing crime in developed economies.” — The data suggests 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.

Although money laundering does not require the use of formal financial institutions, reviews of money-laundering typologies consistently indicate that banks, equity markets, and non-bank financial institutions (NBFIs), such as insurance companies, are a favoured means of laundering illicit funds both internationally and within developing countries.

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

Perhaps more important than the weaknesses of the three arguments for policy inaction individually, is the fact that they do not account for what might be considered the other side of the balance sheet – the other negative effects (unrelated to the inaction defence) that money laundering has on economic development.

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

Money laundering reduces the cost of doing business for the criminal element, thereby increasing the level of crime. As we have discussed, just as

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an efficient financial sector is essential to other productive processes in a developing economy – such as manufacturing – efficient money-laundering 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 or active the criminal element will be, just as in any industry or business.

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 recognised 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.

## 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 available 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 off-shore financial centres 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.

## Reference:

<sup>1</sup> 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.