2. Money laundering and security

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'Money laundering' is the term used to describe the concealment of the profits of crime, as well as of the funds needed to carry out criminal acts that, for reasons of safety, consumption or the need to use the funds, may be transferred across international borders. Today money laundering is seen as a threat to security because it has been connected with the financing of serious international crime, including the narcotics trade, and acts of terror have been organized and funded in a manner that has been entirely undetectable. As Senator Carl Levin has said:

> We live in a post-9-11 world. After the attack on America, we strengthened our anti-money laundering laws, in part, because Osama bin Laden boasted that his modern new recruits knew the 'cracks' in 'Western financial systems' like they knew the 'lines in their hands.' That chilling statement helped fuel a new effort to strengthen our defenses against terrorists, corrupt dictators, and others who would use our financial systems against us. (Levin 2004)

Another view is addressed below, namely that terrorism has been financed by a unique, ancient, Middle East-Asian financial system known as *havala*.

HAVALA, PRIVATE BANKING, CAPITAL FLIGHT AND TERROR

It is claimed that *havala* is a creation of drug lords and terrorists and exists solely to serve them. The following extract from a report in *Time* is an example of this kind of thinking:

> Welcome to the world of hawala, an international underground banking system that allows money to show up in the bank accounts or pockets of men like hijacker Mohammed Atta, without leaving any paper trail. … 'People know that salaries cannot buy the good things,' says Ali … 'You need a little extra.' Even at a cost of enabling crime and terrorism. (Ganguly 2001)

There is no doubt that terrorist organizations have used the *havala* network. This was documented by the 9/11 Commission Report:

> … Al Qaeda frequently moved the money it raised by hawala, an informal and ancient trust-based system for transferring funds … Bin Ladin relied on the established hawala networks operating in Pakistan, in Dubai, and throughout the Middle East to transfer funds efficiently. (9/11 Commission 2004, p. 188)

Yet neither money laundering nor *havala* is the creation of terrorists or drug lords. *Havala*, a system of money transfers that originated in India several centuries ago, far surpasses the international banking system in the efficiency, speed and low cost of its operations. It serves a large population, most of whom are otherwise law-abiding citizens. To attempt to stop *havala* while leaving the formal system of private banks and trusts and tax havens intact would serve no purpose other than to protect the profits of the cartel of international banks (McCulloch and Pickering 2005).

Moreover, *havala* is not the actual mechanism that ensures capital flight. Indeed, that flight has already taken place through a range of mechanisms, including the over-invoicing and under-invoicing of trade. Once the money is overseas, *havala* is only a system of providing liquidity on the back of those funds. Even without *havala*, this money would have departed, and would have been placed in investment projects or money centre banks.

Havala is not the most important way to launder money. It is true that money laundering can assist acts that are criminal in *every* jurisdiction (or country) such as drugs or terror. But there are other crimes such as tax evasion that are treated as criminal in the particular jurisdictions where they originate. It is crimes such as these, which include corruption such as kickbacks for government contracts (Srinivasan 1995) and other theft of public assets, that really drive the vast global business of laundering money.

In fact terrorists are relative newcomers who have skilfully employed widely available services. Terrorists and drug lords use *havala* but they also use the main money centre banks, trusts and tax havens – all of which are effectively unsupervised and not monitored. Yet the United States has been unwilling to entertain the prospect of any meaningful regulation for this entire world of money laundering. Given this, it is worth explaining the United States' position.

MONEY LAUNDERING AND THE UNITED STATES

The United States benefits significantly from funds laundered by companies, banks and financial institutions. Together all this laundering brings in significant capital. This, along with the investments in US instruments (such as United States Treasury securities and corporate stocks and bonds) by the Asian economies, has helped the United States to finance its current account deficit.

> The U.S. net international investment position at yearend 2004 was $2,484.2 billion … largely due to substantial net foreign purchases of U.S. Treasury securities and U.S. corporate bonds … Foreign-owned assets in the United States … increased … to $12,515.0 billion with foreign direct investment in the United States valued at market value. (Bureau of Economic Analysis 2005)

There was significant flight to the dollar when the Soviet Union collapsed and was looted. Raymond Baker, an eminent scholar at the Brookings Institution and author of *Capitalism's Achilles Heel* (2005), has estimated that as much as half a trillion dollars may have left Russia in the 1990s, and a significant part of that migrated to the United States (Baker et al. 2003, p. 5; Senate Money Laundering 1999, p. 85).

The widespread capital flight to the United States has been independently documented in a study that has offered examples of how this works: Russian caviar is exported to the United States at US$3 a kilo and 5642 kg were exported in 1999, while actual market prices have ranged around US$5000. In the same year Russia imported bicycle tyres at US$364 each, when the actual market price outside Russia could not have been more than US$30 (Boyrie et al. 2004). Much the same happened when the Asian economies suffered massive capital fight in the 1990s.

Baker has shown that US multinational banks and corporations developed techniques for mis-pricing, false documentation setting up fake companies and shell banks, and developing business in tax havens and secret banking jurisdictions. They play the important role of funnelling funds to the United Kingdom or the United States. These techniques were subsequently adopted by drug cartels in the 1960s and 1970s and by other criminal syndicates during the 1980s. More recently, terrorists have adopted the same mechanisms originally developed by multinationals.

Baker points out that US law tolerates money laundering when that occurs on the basis of money 'earned' outside the United States:

> Anti-money laundering legislation in the United States identifies more than 200 classes of domestic crimes, called *predicate offenses*. If a person knowingly handles the proceeds of these crimes, then a money-laundering offence has been committed. However, only 12 to 15 of these offenses are applicable if the crime is committed outside U.S. borders, and these have to do principally with drugs, crimes of violence and bank fraud. (Baker et al. 2003, p. 2; House Committee Money Laundering 2000 p. 105)

US regulations do not currently respond to these money laundering systems. Although the United States has a Foreign Corrupt Practices Act (1998) that makes it illegal for Americans to bribe foreign government officials, it is not illegal to handle or solicit funds acquired from corruption committed in any jurisdiction outside the United States (House Committee Money Laundering

2000, p. 106). US regulators have turned a blind eye to the frequent failure by US banks to file 'Suspicious Activities Reports'. In a number of transactions concerning trade deals or government contracts, no matter what the size of the deal, an unvarying percentage of the transaction has been paid out of certain bank accounts to third parties that hold another account in the same bank (ibid, p. 109). This raises suspicion that these may be kickbacks – why else would the identical percentage of the amount of the deal be paid into the account of a third party unless he were some sort of facilitator or commission agent? Such transactions should invite further attention. Indeed, banks are enjoined by regulation to investigate such transactions but they generally have chosen not to do so, because US regulators do not pursue such negligence.

The United States has enacted an Advance Pricing Agreement that makes it difficult for foreign corporations with local subsidiaries in the United States to mis-price trade in order to take tax-evading money out of the country, placing the onus for demanded clarifications squarely on the suspected evader. Yet officials turn a blind eye to mis-pricing that brings tax-evading money from other countries *into* the United States. It has never addressed money being brought into America through transfer pricing, for instance. It is entirely concerned with outflows, not inflows (House Committee Money Laundering 2000, pp. 108–9).

Karin Lissakers has discussed the lending boom to the Third World during the 1970s and 1980s, and the collusion of US bankers in siphoning funds off to the private accounts of the Third World elite. The Edge Act banks were set up in Florida for the specific purpose of laundering Latin American capital flight funds. Capital removed from many developing economies, and now deposited in money centre banks, has frequently matched or exceeded the amounts borrowed by those countries. The money centre banks, with an international presence and important wholesale business, include Citibank and JP Morgan Chase. They are involved in all the important areas of financial activity, namely corporate finance, trading, distribution and portfolio business (Lissakers 1991, p. 7). Lissakers cites a World Bank estimate that Argentina, Mexico and Venezuela, and perhaps other Latin American countries in the 1980s, had private deposits abroad that exceeded their sovereign debt. A large part of these funds were held in the United States. She points out that in 1984 US Treasury Secretary Baker had the withholding tax on non-resident owners of US securities withdrawn, in order, as Rudiger Dornbusch commented, 'for foreigners to use the US financial system as a tax haven' (ibid).

Taxes in the United States are generally withheld at source by the Internal Revenue Service (IRS) on earnings in bank deposits and portfolio investments. But the Reagan Administration amended the law to provide a special exemption to foreign investors in US securities and bank deposits from this tax withheld at source. This exemption continues today. Such foreign investors are in fact

paying no taxes anywhere; in courting them, the United States has become an important tax haven.

As the conservative American business economist Lawrence Hunter has pointed out: 'For nearly two decades, US law has encouraged foreigners to invest in US banks and debt securities by imposing no tax on interest earned on foreign deposits' (Hunter 2002). He gives instances of opportunities for such investment by foreigners

> interest on bank deposits with US banks is exempted (871(i)(2)(A)) … Enacted in 1984, the portfolio-interest exception (section 871(h)) is perhaps the greatest single example of Congress's attempt to attract offshore investment. (ibid)

And why has this been done? It is in the interests of the United States. To quote Hunter again:

> The rationale of the portfolio-interest exception is perhaps the purest example of enlightened self-interest and realism in attracting foreign capital. … analysts generally believe that this provision has attracted somewhat over *$1 trillion* in foreign capital to the United States. Former senior Treasury official, Stephen J. Entin (currently President of the Institute of Research on the Economics of Taxation) estimates that private foreign investment here is $8 trillion, of which about $1 trillion is bank deposits. (ibid, emphasis added by author)

According to Hunter, since America benefits it should assist such flight capitalists in keeping their money inside the United States:

> Non-resident aliens who place deposits in US banks … may be *escaping oppressive tax burdens*, while others may be fleeing corruption and crime. In either event, the *US economy benefits greatly from gaining access to their capital.* … This capital stimulates economic growth and creates jobs, benefiting US workers and business owners. (ibid, emphasis added by author)

This is really a straightforward admission that the purpose of these amendments is to attract flight capital, including the money of those who do not want to pay taxes. The Reagan Administration provided anonymity to foreign owners of US bonds when it converted them to bearer bonds in 1985. Bearer bonds are debt instruments in which the investor need not be registered with any authority in the world and may remain entirely anonymous and transfer such bonds to whomever the investor pleases. They are ideal for the purpose of laundering money. Yet what has been equally important has been the willingness of US authorities to tolerate the enormous expansion of the US private banking industry. Private banking in this case does not merely refer to the general private banking sector, but rather to the highly specialized business of soliciting and managing the deposits of very wealthy overseas clients. These clients keep their wealth in a place other than their domicile

because the money is often criminally or corruptly acquired, or they are avoiding taxes at home.

The private banks serve only 'high net worth' individuals – the very wealthy from all over the world – with a great deal of personal attention and a guarantee of absolute secrecy. In London, for instance, the Bank of America private bank, when I visited it in 1992, was located in the mansion that Charles I gave Nell Gwynn, but is unlisted in the London telephone directory and unknown to most officers of Bank of America London. The 'banques privées' of Switzerland became known between the two world wars as the home of flight capital from other parts of Europe. Essentially, this is the role of the international private banking business. In the United States this grew significantly on Latin American capital flight and was centred on what were called the 'Edge Act' banks, located in Florida (the Edge Act permitted exceptions to the controls on inter-state banking developed during the Depression). These banks handled suitcases of cash from Latin American flight capitalists in the 1970s; they were presumed to be simply stealing their countries' wealth but often turned out to be drug dealers as well. The US private banking business grew rapidly in the 1970s, with the great financial explosion of recycling petrodollars. Since then it has defied effective regulation: it lives on the fear that it might prompt such capital to fly out again.

A dramatic example of public knowledge about money laundering in the United States is provided by the events of the summer of 2004 when the Riggs Bank scandal broke out. The Riggs Bank had been laundering money for many years, with the compliance of officials of the Office of the Comptroller of the Currency appointed to oversee it. Moreover, for years the bank had been advertising its money laundering services on its website in the following manner:

> The Riggs Bank, N.A., of Washington D.C., offers a full range of international private banking services. Our International Service Banking office provides discreet, personalized, and specially adapted activities needed by prominent foreign customers. (Riggs 2000)

As investigations by the Senate Subcommittee on Investigations showed, Riggs was involved in systematic money laundering of the proceeds of crime. This included probably the narcotics trade by General Pinochet, as well as Omar Bongo of Equatorial Guinea, and what investigators suspected was a Saudi contribution to the 9/11 hijackers (Senate Riggs Subcommittee 2004, p. 2).

The case of Riggs was significant: it was no Panamanian hole in the wall but rather the leading Washington DC-based bank, founded in 1836. Among its customers have been 22 American presidents, including Abraham Lincoln and Dwight Eisenhower, as well as prominent personalities such as General Douglas MacArthur. Riggs financed the Mexican War and the purchase of

Alaska and Samuel Morse's invention of the telegraph. It was instrumental in the setting up of the US Federal Reserve. The head of its investment banking division was Jonathan Bush, brother of the former president and therefore uncle of the present one, and formerly head of the family investment bank, J. Bush and Co. The bank and its promoters have had enormous influence and access in the nation's capital. President Bush even stopped during his Inauguration Parade to greet chairman Albritton (Day 2001), and the annual dinner in honour of Confederate General Robert Lee was the first public appearance by President Bush and Vice-President Cheney after the 9/11 terrorist attacks (O'Brien 2004).

Senator Carl Levin, ranking Democratic Senator on the Subcommittee on Investigations and former Chair of this committee, pointed out that, with 60 accounts and US$700 million in them, Equatorial Guinea was the bank's largest customer (Levin 2004). Levin describes how Riggs went out of its way to help the EG president set up an offshore shell corporation in the Bahamas called Otong (ibid). An offshore shell corporation is one that is set up in jurisdictions that levy no income tax and have a minimal investigative regime. This arrangement is also used by many major corporations that are operationally based in the United States or European Union in order to avoid taxation. The headquarters in, say, New York becomes a subsidiary of a Cayman Islands corporation. Obviously, with such shell corporations in the Bahamas, Riggs knew that they were laundering the president's money. At least one of these deposits was personally brought into the Riggs Bank by the Riggs account manager who handled the EG accounts. According to Levin (2004), 'He carried the funds in a suitcase of plastic-wrapped dollar bills weighing 60 pounds or more. If that kind of cash deposit doesn't make a bank sit up and ask questions, I'm not sure anything will.'

US regulators were aware of Riggs' non-compliance with the US anti-money laundering law, but did nothing. Even the possibility that Riggs' negligence and greed may have aided the 9/11 bombers of the World Trade Center did nothing to impart a sense of urgency to federal regulation. Levin is no conspiracy theorist but a mainstream Democrat, known for working closely with Republican Senator McCain in running the powerful Armed Services Committee, as well as the Subcommittee on Investigations with Senator Coleman. As he goes on to say, 'In November 2002, media stories began alleging possible connections between certain Riggs accounts associated with Saudi Arabia and two of the 9-11 hijackers' (Levin 2004). Yet, amazingly, it still took another year for the agencies to impose a US$25 million civil fine on the bank for money laundering.

Another example of the linkages between the highly respectable Riggs Bank and international crime is given by Levin's report on how the bank assisted the Chilean dictator Pinochet, who had been accused of murder,

torture, corruption, and narcotics and arms trafficking. Riggs went out of its way to solicit his business. In 1994 top Riggs officials travelled to Chile and asked Pinochet 'if he would like to open an account at the Riggs Bank here in Washington, D.C.' (Levin 2004). Unsurprisingly, 'Mr. Pinochet said yes. The bank opened an account for him personally, helped him establish two offshore shell corporations in the Bahamas … Mr. Pinochet eventually deposited between $4 and $8 million in his Riggs accounts' (ibid).

Riggs' 'Know your Customer Profile' for Pinochet's business interests states:

> The client is a private investment company domiciled in the Bahamas used as a vehicle to manage the investment needs of a beneficial owner, now a retired professional, who achieved much success in his career and accumulated wealth during his lifetime for retirement in an orderly way (Senate Riggs Subcommittee 2004).

The client is a company, and the term 'beneficial owner', the language of private banking, describes the real client, whose identity is kept secret in all dealings in the bank itself. So Citibank private bank, for instance, will not tell the Citibank investment bank the identity of investors, but only the names of corporations that they own.

'Success in his career' is an euphemism for a trail of murder and torture, which began with Pinochet's overthrow of a legally elected government. The profile provides the following description as the source of wealth and hence the source of funds in the account: 'High paying position in Public Sector for many years' (ibid, p. 25).

In 1998 Mr Pinochet was arrested in London on charges of crimes against humanity. A Spanish magistrate issued an order seeking to freeze his bank accounts. The order, requiring the attendance of Pinochet on trial for murder of Spanish nationals in Chile, was enforced in the United Kingdom under reciprocal arrangements. Riggs ignored the order of the court and secretly helped him move money from London to the United States. The law enforcement authorities were not alerted to these movements. In 2000, after a British newspaper alleged that Mr Pinochet had over US$1 million in accounts at Riggs Bank, Riggs altered the name on his personal account from 'Augusto Pinochet Ugarte' to 'A.P. Ugarte'. The US Office of the Comptroller of the Currency (OCC) did not even consider taking enforcement action when it was made aware of major irregularities. And the OCC examiner-in-charge of Riggs thereafter took a job with Riggs Bank (Senate Riggs Subcommittee 2004, pp. 18–37).

The Riggs Bank example has been cited here because this institution had such a prominent and respectable history. However, it is far from being a lone example of how money laundering works. Most US banks have made no effort

to hide the 'special' laundering facilities that they provide. For example, a brochure for Citibank's private bank advertises the attractions of the secrecy jurisdictions of the Bahamas, the Cayman Islands, Jersey and Switzerland (Senate Money Laundering 1999, p. 7). This brochure goes on to advertise the advantages of using a PIC or private investment corporation. One advantage is: 'your ownership of the PIC need not appear in any public registry' (ibid).

As Levin observes, given that the United States prohibits US banks from setting up 'secret' accounts that cannot be scrutinized by the authorities, the reaction of the US private banks has been to go offshore to destinations where such legal scrutiny does not apply. Being multinational banks, these US banks have no problems in servicing the needs of their clients by managing these offshore financial deposits (Senate Money Laundering 1999, p. 7). Citibank is one American bank willing to provide just this kind of service to its clients. It is the largest bank in the United States, it has one of the largest private bank operations, and it also has the most extensive global presence of all US banks. In the words of Levin, it also had 'a rogues gallery of private bank clients' (ibid).

Given Senator Levin's expertise, it is worth recounting his list of the members of Citibank's rogues' gallery:

- Raul Salinas, brother of the former President of Mexico; now in prison in Mexico for murder and under investigation in Mexico for illicit enrichment;
- Asif Ali Zardari, husband of the former Prime Minister of Pakistan; now in prison in Pakistan for kickbacks and under indictment in Switzerland for money laundering;
- Omar Bongo, President of Gabon; subject of a French criminal investigation into bribery;
- sons of General Sani Abacha, former military leader of Nigeria, one of whom is now in prison in Nigeria on charges of murder and under investigation in Switzerland and Nigeria for money laundering;
- Jaime Lusinchi, former President of Venezuela, charged with misappropriation of government funds;
- two daughters of Radon Suharto, former President of Indonesia, who has been alleged to have looted billions of dollars from Indonesia;
- and, it appears General Albert Stroessner, former President of Paraguay and notorious for decades for a dictatorship based on terror and profiteering (Senate Money Laundering 1999, p. 7).

And these are just the clients we know about. Other banks have similar accounts. When important international criminals have been assisted by the single most important American bank, one can see how unlikely it is that

American regulators will be able to intervene selectively against certain categories of crime.

Levin also discusses Bankers Trust and how its officials feared that they would be murdered by their clients if they revealed their names to the US Government.

> The legal counsel for Bankers Trust private bank asked the Subcommittee not to make public any information about an account of a certain Latin American client because the private banker was concerned that the banker's life would be in danger if the information were revealed. (Senate Money Laundering 1999, p. 8).

Clearly the fact that its business could not be revealed even to the US Senate was an acknowledgement that the bank was participating in criminal activity. This important document gives one an idea of the extraordinary scale of the US private banking business, and how focused it is on Third World elite clients that have often made their fortunes by stealing from their countries. Robert Roach, an investigator, showed how the family of Salinas, President of Mexico, spirited its money out of the country via Citibank, to London and Zurich. The president's brother, later arrested for murder, had no legitimate business that could account for such earnings. There was no curiosity about where this money came from; instead, his banker Ms Elliott wrote to her colleagues in June 1993 that the Salinas account 'is turning into an exciting, profitable one for us all. Many thanks for making me look good' (Roach testimony, Senate Money Laundering 1999, p. 15).

THE PATRIOT ACT AND ITS WEAKNESSES

The Patriot Act, as well as other legislation, seems to make foreign criminal acts illegal in the United States. Yet, as Raymond Baker points out, the Patriot Act's definition of 'specified unlawful activity' provides the loophole needed for money laundering operations. He argues that,

> for crimes committed in the U.S., the definition is very extensive. For crimes committed outside the U.S., it's very restricted, essentially to drug trafficking, terrorism, corruption, bank fraud and some treaty violations. … foreign tax evasion and handling the proceeds of foreign tax evasion is not a specified unlawful activity under U.S. law. (email by Baker to author, 28 April 2005)

Anti-money-laundering legislation in the United States identifies 'predicate offences' where a person knowingly handles the proceeds of any of 200 classes of crime if committed domestically. Yet the proceeds of all but 15 such crimes are exempt by US law, including the Patriot Act 2001, if the crimes are committed overseas. These include such acts as racketeering, securities fraud,

credit fraud, forgery, embezzlement of private funds, burglary, trafficking in counterfeit and contraband goods, slave trading and prostitution. So it is perfectly legal for an American private banker to knowingly solicit the deposit of a South Asian trafficker in women or in illegal immigrants. This amounts to an invitation to those who profit by such crimes to bring their money to the United States.

The definition of what constitutes the 'proceeds of a foreign crime' is given in Section 320 of the Patriot Act (2001), which states that:

> f) There is extraterritorial jurisdiction over the conduct prohibited by this section if –
> (1) the conduct is by a United States citizen or, in the case of a non-United States citizen, the conduct occurs in part in the United States; and
> (2) the transaction or series of related transactions involves funds or monetary instruments of a value exceeding $10,000.

Note that, should the crime be entirely committed outside the US continent, the proceeds of the crime may presumably be safely banked in America. Foreign governments headed by corrupt politicians will not file suit in the United States to test these laws and to curb their own corruption. And the US government does not of its own accord examine whether the proceeds of corruption transit through or are deposited in US banks. The same businesses of private banking, tax havens and other financial services that have sucked in money from around the world to the United States have also enabled such attacks on it that Raymond Baker calls money laundering 'capitalism's Achilles heel'.

UK TAX HAVENS

London is an important financial centre and an important recipient of laundered funds; a significant part of these come from the world's tax havens, led by the Crown Colonies, the offshore possessions of the Queen of Great Britain and Ireland. These are nominally independent, having delegated powers such as the conduct of diplomatic relations to the UK government. In reality, this is a legal fiction as the Channel Islands function as an extension of London and permit the United Kingdom to facilitate money laundering without accepting responsibility for it. The motive of the UK government is identical to that of the United States, namely attracting foreign capital to the national economy.

The Edwards Report has played an important role in exposing the scale of money laundering in the Channel Islands. The Report points out the illusory nature of many of the directorships of the companies listed in the Channel Islands:

> 11.2.2 Although formally Directors, some of these 'nominee' Directors are Directors of so many companies that they could not credibly discharge the proper duties of a Director with respect to all of them, especially in cases where they have no professional or technical support. (Edwards 1998)

Virtually the entire local population seems to be company directors. It is difficult to believe the scale of these money-laundering facilities, so again I quote from the Edwards Report. Para 11.2.3 describes the population of Sark, the capital, and the distribution of the directorships of these companies:

> In Sark itself, where the total population is 575, information fairly readily publicly available in the autumn of last year indicated that:
> - total Directorships held by Sark residents may have been around 15000 or more;
> - 3 residents appeared to hold between 1600 and 3000 Directorships each;
> - a further 16 residents appeared each to hold more than 135 Directorships each; and a further 30 residents appeared each to hold between 15 and 100 Directorships. (ibid)

The Edwards Report concluded that the residents of Sark, the smallest of the four Channel Islands located some 80 miles south of the English coast, were hardly entrepreneurs who were driving global industries. Sark is best known as a tourist destination renowned for its fishing, lovely walks and gardens. Given this, Sark's residents were most probably front men who were acting on behalf of the real clients located in some other country. Para 11.2.5 of the Edwards Report notes that:

> Whatever the precise figures may be, the perception has arisen that many of the Directors on Sark are Directors in name only, not in substance, and the real Directors – or owners of the accounts – are other people altogether. (ibid.)

INDIA AND MONEY LAUNDERING

The United States and the United Kingdom account for the bulk of the world's money-laundering capital movements, but this has depended critically on money-laundering operations in other parts of the world; in particular, India has always been an important conduit for capital flight as discussed below.

One study estimates that several billions of dollars are laundered annually through Indian trade. The authors developed a global price matrix and analysed every single India–United States import and export transaction for the years 1993, 1994 and 1995, to identify where abnormal pricing occurred and the

magnitude of consequent capital flight (Zdanowicz et al. 1996). In the most recent year studied, 1995, capital flight from India to the United States effected through the mis-pricing of trade between the two countries is estimated as being up to US$5.58 billion. Were this maximum figure in the range to hold true for other countries with which India trades today, Indian money laundering through trade would exceed US$50 billion annually, although I do not have any estimate for money laundering and capital flight, either in India or globally. After careful analysis Zdanowicz et al. give examples of the scale of such 'abnormal pricing' (see Table 2.1).

Zdanowicz et al. are internationally accepted as the authorities on the mis-pricing of trade, and the consequent capital flight and revenue loss, having completed authoritative studies on Russia and the United States. Their work is now funded by grants from the US Senate.

What has been the official response to this serious study? No specific data have been disputed in the last nine years, in any published paper. But according to Reddy, now Governor of the Reserve Bank of India (RBI), the variation of prices is caused not by money laundering but the inability of Indians to bargain on the global stage:

> Schneider argues that a more probable interpretation of the results for India based on abnormal pricing model can be that the deviation in unit prices of Indian imports and exports with that of average US/World prices reflects India's *poor bargaining position* [*sic*] in international markets along with other rigidities. (Reddy 1997, p. 5)

Reddy quotes a study by someone called 'Bhatnagar' (no other identification is provided), commissioned by the Planning Commission, which he insists confirms the validity of an equally vague person simply called 'Schneider' (again no other identification is provided). This official publication of the Reserve Bank offers no clue as to the identity of either Schneider or Bhatnagar, despite their importance to Reddy's claims. According to this study, claims Reddy, the reasons exports fared poorly abroad were the 'lack of overseas presence, packing handicaps [sic], lack of price intelligence, poor image of Indian products, incomplete product range, production process not being modern' (ibid).

The lack of Indian competitiveness may make sense in the case of some Indian exports, but does it make any sense when we analyse the price paid for imports of foreign goods into India? Is it true that Indian firms are buying Beechcraft and Grumman Gulfstream corporate jets at appreciably more than the list price because they cannot bargain? Even in the matter of Indian exports, it is doubtful that all cases of low prices are due to poor bargaining. For example, are Indian firms selling tea at lower prices than Kenya because of their ignorance of true prices or poor bargaining power?

Table 2.1 False pricing in Indo-US trade ($US)

US data item	Value of capital flight by over-invoicing US–India *imports*	Value of capital flight by under-invoicing India–US *exports*
New aircraft, passenger transports, non-military, of an unladen weight exceeding 15 000 kg (1994)	$58 379 906	
Used or rebuilt military aircraft, of an unladen weight exceeding 15 000 kg (1994)	$21 088 351	
Spark–ignition reciprocating or rotary internal combustion piston engines for civil aircraft used or rebuilt (1994)	$4 435 698	
New multiple-engine airplanes, non-military, of an unladen weight exceeding 2000 kg but not exceeding 4536 kg (1994)	$3 700 715	
Used or rebuilt aircraft, non-military, of an unladen weight exceeding 2000 kg but not exceeding 15,000 kg (1994)	$3 643 918	
Precious and semi-precious stones (except diamonds), unworked (1994)	$3 536 512	
Turbojet aircraft turbines (engines) for use in civil aircraft, of a thrust exceeding 25 kn (1994)	$3 307 794	
Processing unit, which may contain in same housing 1 or 2 of the following units: storage, input or output, with colour cathode ray tube (CRT) (1994)	$3 283 336	
AC generators (alternators) exceeding 40 000 kva (1994)	$2 796 971	
Digital ADP Mach containing in same housing at least a CPU and an input–output unit whether or not combined without CRT (1994)	$2 599 389	
Radio transceivers, Nesoi, for frequencies exceeding 400 mhz (1995)	$12 100 808	
Insulated coaxial cable and coaxial electrical conductors (1995)	$10 860 447	
Turbojet aircraft turbines (engines) for use in civil aircraft, of a thrust exceeding 25 kn (1995)	$8 447 717	
Precious and semi-precious stones (except diamonds) unworked (1995)	$6 636 407	
Unmounted chips, dice and wafers, for digital monolithic integrated circuits of silicon (1995)	$6 165 775	

Table 2.1 Continued

US data item	Value of capital flight by over-invoicing US–India *imports*	Value of capital flight by under-invoicing India–US *exports*
Digital processing unit which may contain in same housing 1 or 4 of the following units: storage, input or output, with colour cathode ray tubes (1995)	$5 975 521	
Internal combustion engine generators, Nesoi (1995)	$2 818 182	
AC generators (alternators) exceeding 10 000 kva but not exceeding 40 000 kva (1995)	$2 633 722	
New multiple engine airplanes, non-military, of an unladen weight exceeding 2000 kg but not exceeding 4536 kg (1995)	$2 590 995	
Machines for production and assembly of diodes, transistors and similar semiconductor devices and electronic integrated circuits (1995)		$480 352 554
Emeralds cut but not set for jewellery (1995)		$47 558 898
Diamonds except industrial, unworked or simply sawn, cleaved or brutd (1995)		$25 478 963
Rubies, sapphires, emeralds and rock crystals unworked or simply sawn or roughly shaped, not strung, mounted or set (1995)		$18 896 984
Exercise cycles (1995)		$9 226 814
Disc harrows (1995)		$80 757 317
Furnaces and ovens for diffusion, oxidation, or annealing of semi-conductor wafers (1995)		$24 785 810
Rubies cut but not set for jewellery (1995)		$12 755 724

Source: Data extracted from Zdanowicz et al.1996

Indian Weaponry Imports and Money Laundering

There is some evidence of inflated prices in Indian defence deals. This suggests kickbacks and money laundering. I have drawn upon submissions by Rear Admiral Suhas Purohit, former Deputy Chief of Naval Logistics, to explain this procedure. He investigated such over-invoicing and money laundering in Indian naval purchases over a period in the 1990s. Russia and the former Commonwealth of Independent States (CIS) are an important source of Indian

Table 2.2 Samples of Indian naval equipment procurement 1993–98 (Rs)

Item description	Official delegation price	Intermediary or agent price
D (408) B crystal	35	17 805 (500 times) (machinery sales corporation)
Relay PEC-9	95	11 192 (118 times) (HC supplies)
Lower cover 383-1-38	1475	38 725 (26 times) (machinery sales corporation)
Contact 8BC-553-005	145	7755 (53 times) (HC supplies)
LO pressure cut out (M) CT 1.5A	608	27 876 (46 times) (Makalu)
SN-23 pump (complete)	62 569	2 082 556 (13 times) (HC supplies)

Source: Purohit (2004).

defence procurement, replacing India's defence imports from the Soviet Union. A firm called Makalu, controlled by a former Indian Naval Chief of Staff, exploited this market in the CIS states for procuring equipment spares of Soviet-Russian origin. The very same equipment was significantly cheaper when purchased by Indian logistics delegations visiting Russia or the Ukraine, as Table 2.2 shows.

Deals have generally been conducted through intermediaries in London or New York, even though there is no requirement for this, since the goods supplied would come from Russia and the CIS states. However, London plays a role in these procurements because it is an important private banking centre, and important arms dealers are located in London for this reason. Purohit showed that even when suppliers were important Russian equipment manufacturers such as the Baltic Shipyard, the invoices were still routed through firms such as M/S GS Rughani in London.

The United States may also have become important for the same reasons, since it is a major global player in the arms business, as also in non-resident Indian (NRI) finance. A deal from Kiev for the Kamov-28 helicopter was a tripartite one that included the happily named Banking Investment Saving Insurance Corporation, registered in the United States. This third party turned out to be superfluous and only a conduit for kickbacks (Purohit 2004). Purohit made these investigations officially while Deputy Head of Naval Logistics with the rank of Rear Admiral, and it was the fact of his questioning the nature of official procurement that led to his victimization. Procurement that he

organized while in office was significantly less expensive. The government has been unable to reply to his documentation of corrupt deals and has therefore only prevented the petition (filed seven years ago) from coming up for hearing by seeking repeated adjournments. When the nature of Purohit's investigations came to light, he was himself investigated for corruption and his promotion to Chief of Naval Logistics stopped. The investigations revealed no malpractice on Purohit's part and he was cleared of all charges.

Money in, Money out

The economic rationale of international trade suggests that, when the value of a country's domestic currency falls, its exports become cheaper on the global markets and so more competitive. But Indian trade seems to go against this trend. There are several instances of India's exports growing despite the value of the rupee appreciating. One explanation could be that exporters bring back money parked abroad when the rupee is appreciating. When there was a real appreciation in the exchange rate, earnings from exports continued to grow in those very years when they should have declined as exports became uncompetitive. For example, exports rose by 20.3 per cent in 1993–94, even though the rupee appreciated that year. In the 1993–94 period, foreign investment in the stock market boomed, and the 'other capital' account showed a US$2.15 billion inflow. More recently, too, when the rupee has appreciated in real terms, India's exports have boomed.

So we should consider whether sums of hot money have flowed into India by the over-invoicing of exports and in the name of NRI remittances. It should also be asked whether there is any connection with the appreciation and depreciation of the Indian rupee; and whether trade, including the export and import of invisibles, including services and software, performs the important function of moving funds in and out of India for the purpose of speculation. Zdanowicz and others argue that there is significant capital flight. However, they do not examine whether the flow of trade in goods and services significantly serves the purposes of laundering money or speculating on the value of the currency. Also, they have not examined the connection with the depreciation of the currency.

In keeping with such systematic over-invoicing and under-invoicing, very large sums of money have entered India unlinked to any specific transactions. This reverse capital flight is welcomed by the authorities, since it is believed to be the benign obverse of money going out. At first these were treated as capital flows for the purpose of balance of payments accounting. Since they could not be linked to any particular investors, the RBI placed them in the statistical overflow category called 'other' in the capital account. Soon 'other capital' flows became the single largest item in the external capital account of

the Government of India according to official statistics. 'Other capital' grew rapidly till 1995. Then, just as inexplicably, this category declined from 1996 in official records – but 'private transfers' correspondingly grew.

Why this change? The decision to term these unexplained flows 'other' capital flows was arbitrary – if they were returning capital flows, they would go into the capital account but needed to be accurately described. Equally arbitrarily, a former high official in the Ministry of Finance told me, the RBI relocated some of the suspicious 'other capital' to the heading 'private transfers', which comes under the current account. This eliminated inconvenient discussion about the 'other flows' and improved the current account. As we shall see, my analysis, made originally at a time when such flows were significant even in a period of the depreciating rupee, has become even more relevant when the rupee has appreciated over the last three years and unexplained flows have become a torrent (Srinivasan 1995).

Perhaps as a result of shifts in the labelling of suspicious flows, the figures in the RBI annual reports between 1995 and 1998 have been repeatedly revised. For instance, for FY 1997 (in India this is the year 1997–98) 'other capital' flows were originally shown as being +US$0.83 billion in the 1998 Annual Report (Reserve Bank of India Annual Report 30 June 1998, Appendix VI, 1, p. 184). This fell to -US$714 million in the 2001 Annual Report (Reserve Bank of India Annual Report, 28 August 2001, India's Overall Balance of Payments, Appendix VI.1).

Even in the Annual Report for 1998 the figures for as far back as 1994 were marked 'preliminary' (Reserve Bank of India Annual Report, 30 June 1998, p. 184), indicating that they may continue to be changed even though there is no technical reason for such persistent and unpredictable revisions. Data are directly collected from reporting bank branches by the RBI – they do not report to their own head offices. The RBI in turn refuses to answer questions on the nature of these inflows. Now it could be argued thus: to some extent exports might fall immediately after devaluation if many export contracts were fixed in rupee terms earlier (since the contract will now be worth less in dollar terms; indeed, even contracts fixed in dollar terms might be renegotiated by foreign buyers when they learn of the devaluation) and if the nature of demand for other Indian exports is inelastic in relation to price. The 'benefit' of devaluation, in terms of higher exports, would be garnered with a lag (the 'J curve', because it goes down before going up).

But suspicious inflows are now a flood. The category of current account 'miscellaneous' inflows, which rose from a few million dollars in the 1980s[1] to about US$4 billion in the early 1990s, has risen to US$39.83 billion in 2004–05 (Reserve Bank of India 2005b, Table 43 PP S618-9). At the same time, 'miscellaneous' outflows (other than business process outsourcing (BPO) and software) have grown from US$6.10 billion in 2001–02, the first year of

liberalization, to US$24.97 billion last year (ibid). What is this money moving in and out of the country? The RBI provides no explanation. The reporting system of these flows through the banks was one of the first casualties of India's economic liberalization of the 1990s, in which financial liberalization preceded everything else. Also, it was presumed that the fewer questions asked the better concerning foreigners or non-residents sending money into India (Reserve Bank of India 2005a, India's Invisibles, pp. 195–204).

Both Inward and Outward Capital Flows?

It is important to examine whether there are continuous flows of capital flight and reverse capital flight; whether money is taken out of the country for safekeeping, and the assets therefore protected from Indian inflation and income tax, and then re-circulated into India as a foreign inflow of financial institutional investment (FII) or software export earnings or other invisibles or trade remittances. Given that the Indian markets are narrow and shallow and insider trading is effectively unregulated, important investors have earned returns of 50 to 100 per cent in recent years. FIIs are now allowed to invest in real estate by proxy by trading in real estate firms; in the last six months, Bombay real estate shares have risen by 100 per cent. One Calcutta brokerage house offers an illegal debt instrument to FIIs with an assured annual return of 25 per cent. This is well above those in developed markets, providing great opportunities for arbitrage. The 2005 market boom, entirely driven by FIIs, has seen a dramatic rise in the index. Concern has been expressed even in official circles that the Indian markets have been the focus of money laundering.

It should be determined whether this chain is broken (that is, becomes a one-way flow) only when there is some crisis, such as the one of 1991. In that situation, Indian capital/money leaves the country through the *havala* system, but it does not return. Or at least there is no return flow until the domestic economy has resettled and again provides lucrative opportunities for 'foreign investment'. But, as Karin Lissakers (1991, p. 159) has pointed out in the case of Latin America, such 'swallow money' is 'repatriated flight capital invested in very liquid instruments and ready to fly out at the slightest provocation'. It cannot easily be deployed in the long-term development of the Indian economy. Now there is some question as to whether the extraordinary growth of Indian software export earnings also really reflects returning capital flight.

Since the mid 1990s foreign exchange earnings of the Indian software industry have grown at breakneck speed. While there is no doubt that the Indian IT sector has had genuine success, there are indications that software export earnings have been used as a channel for laundering money. The absence of physical exports makes it particularly difficult to differentiate genuine exports from money laundering. At any rate, there is virtually

no attempt at official monitoring, exemplified by the fact that a private-sector body, NASSCOM (the National Association of Software and Service Companies), is the source of all the data on the sector. The government has no independent mechanism for gathering data, including export earnings. Indeed, there are important problems in reconciling data from different sources. The US Department of Commerce figure for India's software exports to the United States in 2002–03 was US$1.6 billion, whereas the Indian data put it at US$6.3 billion (Ravindran 2005). Much of this discrepancy may be explained by the differing definitions of software exports used by US and Indian agencies, whereby services delivered by Indian firms on site in the United States are counted as exports by the latter but not by the former (Reserve Bank of India 2005c). Nevertheless, questions remain and further investigation is certainly warranted. For example, during this very period, 2002–03, NASSCOM figures claimed that software exports from India to all destinations were of the order of US$9.5 billion, whereas the top 20 Indian companies accounted for only US$4.5 billion of this. One respected observer of the sector argues that this is unbelievable:

> What it means is simply this, that the top 20 Indian software companies exported less than half of what the industry as a whole exported. I find this strange because I can't think of any other industry where the top 20 contribute so little. Is the structure of our industry an aberration? (Assisi quoted in Ravindran 2005)

The existence of a large number of unheard-of software exporters raises the possibility that many companies claiming to export software may be doing nothing of the sort; rather they are only recycling money. The top Indian IT companies, such as Wipro and Infosys, are well respected, with transparent accounts. It is market knowledge that many smaller IT companies are not.

THE DAMAGE DONE BY CAPITAL FLIGHT AND MONEY LAUNDERING

It is widely accepted that criminal money laundering involved in narcotics and terror promotes great instability and is an important basis for cooperation between states. But as far as capital flight is concerned, much discussion has been conducted on how tax evasion is as fundamental a right as free speech, and how capital flight should act as a corrective to bad economic management. It has been inadequately understood how capital flight, which we argue uses the same methods as money laundering, has impoverished so much of the Third World. Raymond Baker and Jennifer Nordin (2005) point out that the outflow of 'dirty money' from poor countries far surpasses the inflow of aid:

> Even if foreign aid doubles, as the United Nations and Blair's commission recommend, the outflow of dirty money is still vastly larger. Annual foreign aid totals $50 billion or so, while dirty money is upwards of $1 trillion per year, half of which passes from developing and transitional economies to the West.

Baker provides a graphic instance of the implications of this: 'For every $1 the West distributes in assistance across the top of the table, we take back some $10 in illegal proceeds under the table' (ibid). In fact the impoverishment of many states through such crime contributes to the discontent that contributes to terrorism.

CONCLUSION

The United States and the United Kingdom define money laundering to include funds employed in terrorism and narcotics, but exclude funds involved in tax evasion, capital flight, mis-pricing and transfer pricing in trade, or kickbacks – in order to protect capital inflows to them. As a result, all the international agencies follow suit. The net outcome of such self-serving legislation and 'control' has been that intervention is both selective and useless, since the drug deals, the arms deals and the funds to terrorists cannot be separated from all the other unregulated flow of capital traffic.

In their funding structures and transfer mechanisms, these 'criminal' funds are indistinguishable from so-called 'legitimate' capital flight and money-laundering transactions. Moreover, it is often the same private banks, the same tax havens and the same loopholes which enable the efficient transfer of both 'legal' and 'illegal' funds out of Third World countries. It is easy enough for a private banker to claim: 'I am not laundering money for drugs, just arms deals, or tax evasion money, or corruption.' All this is treated as acceptable. India, for instance, undertakes no surveillance of external money laundering at all, leaving it to the markets to do their work. This is in tune with the global trend – there is no regulation of the private banks, the tax havens, the trusts, or law firms and accountants who serve them.

It is impossible to act against the concealment of wealth which is criminal in *all* jurisdictions unless states are prepared to act against concealment that is criminal in *any* jurisdiction. It is impossible to segregate the range of illegal acts that, when presented as financial transactions, appear identical. The effort to permit one sort of crime while cracking down on another has doomed the entire effort to control crime. If one wants to act against one, one must act against all.

A monitoring of international export and import prices on the lines of the studies we have cited would indicate over-invoicing and under-invoicing and could go a long way towards restricting such capital flight. Customs and income-tax scrutiny and regulation of trade could significantly limit the scope of such concealed flows, as is evident in the success the United States had in its intensive regulation of foreign multinationals, especially Japanese, engaged in transfer pricing to avoid US taxation in the 1980s and 1990s. Global capacity can be built to regulate corruption and money laundering. Anti-money-laundering initiatives are possible. These should include regulation for the legal profession, accountants, the tax havens and the private banks. None of this can be accomplished, however, without substantial international cooperation and the exchange of information on funds that flee any jurisdiction to be concealed elsewhere in some 'safe' haven. This kind of cooperation is being urged in the 'war on terror', but this war has had a limited and misplaced focus – there should be a war on money laundering, capital flight and illegal ways of generating funds. Until this is addressed, money laundering for the specific use of terrorism cannot be controlled or stamped out.

The difficulty in implementing the strategy described above is that those who facilitate money laundering and capital flight services, and employ such funds, constitute a significant lobby, and it may be difficult to win support for a policy of intervention. Opposition to such intervention would include many important multinationals, especially the oil companies that have got used to doing a certain sort of business; large contracting and engineering firms; and many of the world's largest banks (especially those in private banking focused on what they call high net worth individuals across borders) and legal and accounting firms. This is a pretty formidable constituency. Under these circumstances, it may not be possible to act against money laundering and capital flight or against the other criminal activity they facilitate, which includes the trade in narcotics and the financing of terror.

NOTE

1. In older annual reports that I have seen, but the official website has no report predating 1998.

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