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Economic Consequences of Money Laundering

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I am grateful to the Institute for the invitation to speak at this seminar. It was not too long ago that money laundering was a fringe issue. The diversity of organisations represented at the seminar confirms that this is no longer the case, and that a broad-based and concerted effort is needed to counter the money laundering industry.

For our part, and to avoid any misapprehension, I ought to make it clear that the Reserve Bank of Australia (RBA) lays no claim to expert knowledge of the way money laundering activities are conducted or the extent of money laundering and related criminal activity. However, the Bank does assist the national crime authorities where it can. For instance, our close involvement in cash distribution means that the Bank has a good idea, in broad terms, of the geographic flow of currency. We supply this information to AUSTRAC. We take a close interest in, and contribute to the work of the Financial Action Task Force (FATF) in Australia. The particular perspective we bring to the debate is our experience with the institutional framework of financial institutions through which much of the money flows and of the payment systems they use. I will return to these issues shortly.

The RBA Money Laundry

But first, on a lighter note, I draw your attention to the fact that the RBA runs a genuine money laundering operation of its own in the basements of its branches. Millions of used notes are processed daily to sort unfit notes from those fit for reissue. As you might expect, large denomination notes, those most likely to be used for covert cash transactions, are the least likely to be turned over through the banking system and are the notes we see least of. On average, A$100 notes are returned to the Bank less than once each year while $20 notes for instance are returned, on average, six times each year.

Naturally enough we know precisely the number and value of notes the RBA “launders” each year. Last year it was 1 527 499 627 pieces to a value of A$54 164 993 675; a lot of laundering.

Extent of the Problem

In contrast to that precision we have only a vague idea of the real extent of what this audience understands to be money laundering; either internationally or in Australia. Internationally, estimates range from US$300 billion to US$500 billion annually. In Australia, AUSTRAC recently commissioned a very interesting study that suggested that between A$1 billion and A$A4.5 billion may be laundered in and through our jurisdiction annually, with the most likely figure being around $A3.5 billion.

You could be forgiven for thinking that the economic consequences of an industry on this scale would be obvious. Think of the wool industry in Australia. Last year its exports totalled about A$4.2 billion. On AUSTRAC’s estimates it would seem that the money laundering industry legitimises illicit cash flows roughly equivalent to the annual value of our wool exports. The Australian Council of Wool Exporters could tell us all about the economic consequences of their industry. In contrast, the literature on the economic consequences of the money laundering industry is almost nonexistent. Why is that the case?

Well, obviously enough, an industry that we cannot measure and cannot see, in fact an industry whose inherent primary objective is secrecy and covert operation, does not offer itself as an attractive research proposition. The Australian Bureau of Statistics cannot differentiate between the labour of the honest accountant doing the community's tax returns from a dishonest accountant scheming up new and innovative ways to launder the proceeds of crime. Similarly, the labour of legitimate couriers cannot be differentiated from the labour of couriers carrying illegitimate cargoes. The country's payments system infrastructure cannot tell the difference between a transaction that closes the loop on a money laundering scheme and a standard legitimate transaction. In short, much of the economic activity of money laundering is intrinsically interwoven with corresponding legitimate activity—this after all is what money launderers are trying to achieve.

The question I have been asked to address is whether there are any separately identifiable economic consequences that arise as a result of this transitional activity; consequences over and above those associated with the criminal activity itself.

Obviously it has some impact, for instance, in the cost to the community of implementing anti-money laundering measures—the costs of maintaining AUSTRAC for example. But in the scheme of things these costs are minor.

The broad answer to the question is that from an economic view point there are few separately identifiable economic consequences of any substance. Crime generally—and money laundering is a crime in Australia—is just another business activity. It employs people, skills, technological know-how and capital resources just as any other industry but, to the extent that these inputs are measured, they are not differentiated from similar legitimate activities.

This may be a disappointment to hear. Nevertheless, looking across the economy as a whole and with the hard unfeeling eye of the rational economist with a capacity to abstract from social and emotional issues, the activities of money laundering probably are not having major identifiable economic effects. This would certainly help explain the absence of any substantial literature on the topic

We might now move one step up the money laundering ladder and look at some of the consequences associated with the disposal of proceeds.

Disposal of Proceeds

An AUSTRAC paper (prepared for the Asian Money Laundering Methods Workshop held in Hong Kong in October last year) identified five broad avenues for disposing of proceeds in Australia. They include:

- spending on high living;
- storing for future use;
- purchase of assets (real-estate, bullion, businesses);
- physically transported offshore; and
- placed into the banking system.

It would be an interesting, though somewhat academic, exercise to work through the economic consequences of each of these forms of behaviour and to seek to extract any common threads. For instance, we could trace through the effects on the economy of those who choose to launder the proceeds of crime through an improvement in their own lifestyle, perhaps even a lavish improvement. Those of us who earn our money and pay our taxes on a PAYE basis often suspect where some find their lavish improvement. I would expect that in this expert audience there are some who know exactly where the money goes. But to even the untrained eye, the marinas that fringe Sydney Harbour would seem to contain a percentage of craft that would fall into this category. The so-called "grass castles" with their lavish appointments would also. There is a near endless list of avenues for enjoying the high life.

The very thought of the criminal element enjoying the high life triggers strong reactions and raises social and equity issues with heavy emotional content. But the task for the economist is to be rationally analytical in assessing economic consequences, and step back from the emotion: viewed in that light, the money spent on a luxury holiday on the Barrier Reef by the undeserving has the same flow-on effects through the local and broader economy as a similar holiday that represents five years frugal living. In this sense, spending is spending.

The second avenue that AUSTRAC mentioned for disposal of proceeds was that of storing cash for future use. Our note issue records show that there is about A$1100 in currency notes on issue for every man, woman and child in Australia. About A$500 of that is in the form of hundred dollar notes. It seems intuitively obvious that some of that amount will represent the hoarding of illicit funds. Apart from being a particularly poor investment, having a negative rate of return after the effects of inflation are taken into account and relatively high risk of loss, the economic consequences are unremarkable. The Government, through seigniorage, gets full value for every note as it does for the cash in our wallets. Some of that hoarded money may be lost, or otherwise fail to find its way back into circulation, leaving the government with a "skinner".

There are other issues we could pursue. For instance, the effect on competitive equity of business activities that are used as fronts for money laundering operations competing with legitimate businesses that draw capital funds from the financial markets. We could also consider the consequences, especially for small open economies, of the supposed inherent instability of laundered funds as a capital source and the broader economic instability that is sometimes said to flow from that. It is beyond the scope of this brief discussion to delve into such issues but I would suggest that they might provide a useful research topic for someone, possibly AUSTRAC.

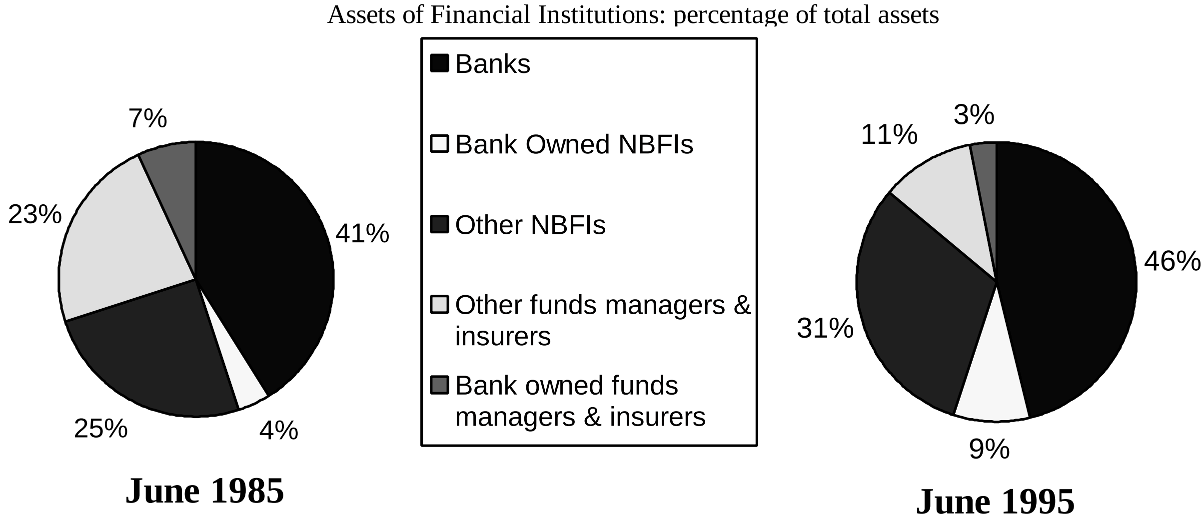
The general point is that money laundering is just another business, and that the economic consequences are relatively unremarkable (beyond those associated with crime itself).

Thankfully, however, the world is not populated with economists alone. Money laundering helps make crime worthwhile. It helps give legitimacy and even respectability to some of the most unworthy in society. It gives economic power to criminals and takes it from the law abiding tax payer. The use and abuse of that economic power raises a whole new range of social and equity issues with which this audience would be only too familiar. It provides for the redistribution of income from the good to the bad. To some, it shows that crime does pay with all the negative consequences that flow from that. In extreme cases we have seen it lead to the virtual take-over of legitimate government. The real consequences of money laundering are more social than economic and are very serious. And well worth the fight.

I will now turn briefly to the financial system and developments that may have consequences in the opportunities they present for money laundering.

I will focus on the institutional framework and some of the newer developments in payment instruments, then briefly touch on recent developments in systems for transferring high value payments both within Australia and overseas.

Figure 1
Assets of Financial Institutions: percentage of total assets



Institutional Framework

A watershed for financial institutions in recent years was the Government's decision to deregulate the financial system, announced in 1984. It gave rise to rapid expansion of the financial sector and competition that has become increasingly effective. It led to a decade where there were winners and losers and sizeable shifts in market share between the main institutional groupings.

Figure 1 shows that the banking sector (including their funds management and insurance subsidiaries) has been a clear winner. After generations of quiet, uncomplicated stability in the banking industry the number of licensed banks in Australia rose from around fourteen to over fifty, and is likely to rise further. We have seen new foreign entrants and some of the larger non-bank financial intermediaries have converted to bank status. Managed funds are also among the winners of the past decade with the merchant bank, finance company, building society and friendly society industry groups losing market share.

A point to note is that we now have a lot more banks in Australia, each with their own networks of domestic and international financial links. We are now much more locked into the rest of the world. Another point of particular interest to central bankers is that the vast bulk of financial institutions now come under the oversight of one of the official supervisory bodies.

In the years ahead, it may be that the next watershed will be seen as having been the Government's decision to promote a retirement income policy actively, drawing increasingly large amounts of domestic savings into superannuation and the managed funds industries. Naturally the banks are working to get further into the superannuation fund business. At the same time, the life offices (which are heavily into superannuation) are working to expand their "banking" business. What we are seeing emerge are financial conglomerates that offer a broader range of financial products.

Payments

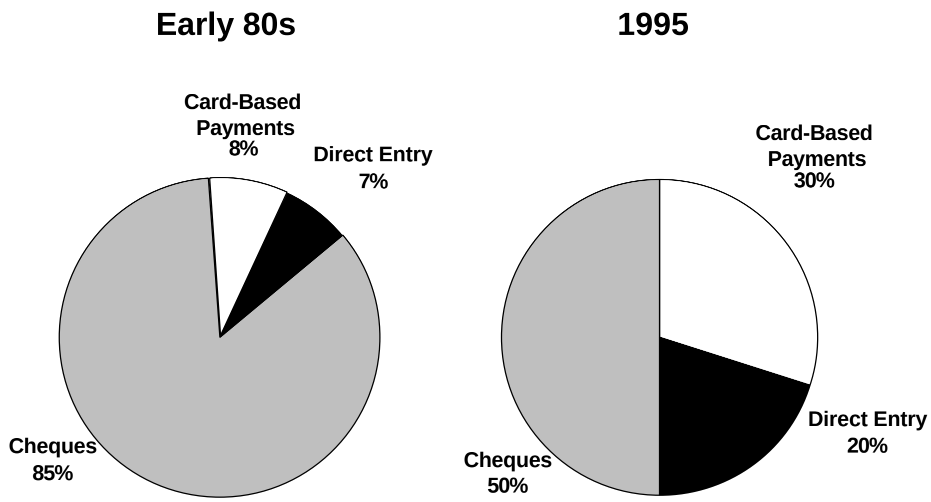
The pattern of payments is also changing. Traditionally payments were made by banks and they effectively controlled the payment system. We are now seeing a range of other institutions getting into the payments business. Last year the Government announced its intention to change the *Cheques and Payment Orders Act 1986* (Cwlth) to allow building societies and credit unions to issue cheques; Australia Post has cemented a number of agency arrangements with banks to effectively turn its widespread branch network into something approaching a financial institution in its own right, with a primary focus on payments. Payments are being recognised as a profitable business in their own right and the banks are meeting very stiff competition on all fronts. Diversity in payment channels is, of course, music to the ears of the money laundering industry.

Payment Instruments

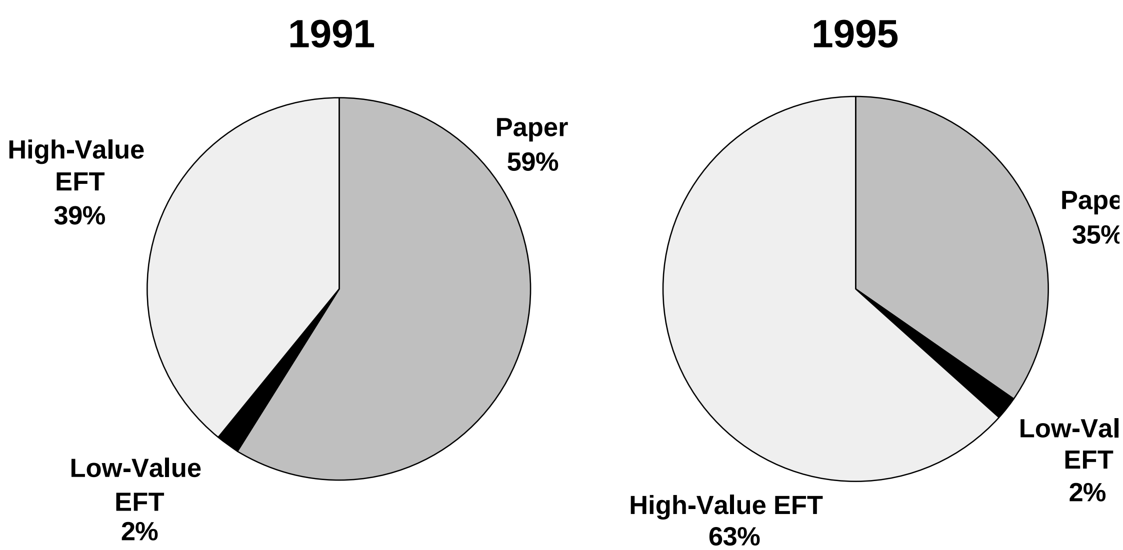
The past decade has also seen sizeable shifts in the way payments are made.

Figure 2 shows, as you would expect, the large sectoral shift from paper payment instruments, mostly cheques, towards electronic payment instruments. On one measure of market share cheques have fallen from 85 per cent to 50 per cent. In absolute terms the use of cash and cheques is not really declining but in relative terms it is. The growth payment instruments have been electronic direct entry, credit card and EFTPOS payments. Direct entry payments are deposited or debited directly into bank accounts. Payroll payments are the usual example. Over 95 per cent of Government payments are now handled this way. EFTPOS and ATM payment mechanisms are taking banking deeper into the community. Financial electronic data interchange (EDI) payments are now emerging mainly for commercial payments.

NUMBERS (8.5 m per day in 1995)



VALUES ($120 billion per day in 1995)



Smart Cards

The payment instruments attracting a lot of interest at the moment are those based around "electronic money". This includes smart cards, or more accurately stored-value cards (SVCs), and some of the more exotic payment instruments of the Internet products like Cybercash and the like. As you know, a number of SVC schemes are being trialed in Australia at the moment. Australia is at the forefront with this form of payment technology, but even so it will be some time yet before they gain widespread acceptance. Mondex is a related, electronic payments system that is being trialed overseas and examined by Australian banks, but as yet there has been no confirmation of Australian banks committing to this system.

These developments are rightfully of concern to the law enforcement agencies. Such products are designed specifically to replace cash for day-to-day transactions. The proposed Mondex scheme, for example, would permit so-called card-to-card transfers of which no durable record would be kept.

The question here is whether SVC systems might be effectively restricted to low-value transactions. It is likely that they can and that such restrictions would not have a substantial cost in terms of the reduced functionality of such stored-value cards. I should point out in passing that the promoters of SVC schemes are well aware of the concerns of central banks about their potential for money laundering and are actively discussing these issues.

In short, the in-principle concerns about money laundering which arise with the innovation of

Figure 2
Methods of Payment

stored-value cards is well recognised, but thinking generally is that these problems can be properly managed and the scope for money laundering severely curtailed.

For instance, SVC cards could have a modest limit on the maximum value that can be stored on them, especially if they are able to be used for card-to-card transfers. There could also be a limit on the life of the cards which would restrict their usefulness for hoarding and money laundering.

Electronic money certainly captures the imagination and will undoubtedly open up new and as yet unknown avenues for laundering money, despite the best efforts of the authorities. But, this will probably remain the domain of the small time players in the international money laundering industry.

Large Value Payment Systems

Developments in Australia and internationally in the large value payment systems are every bit as exciting as those with SVCs and the Internet, but are less obvious because of their lack of mass appeal; being the domain primarily of the finance industry professionals and central banks. Nevertheless it's these systems that are likely to offer greatest scope to the professional money launderer.

Large value payment systems are used by banks to transfer funds between each other, on their own behalf and for customers. Internationally, SWIFT is the best known, linking about 2200 banks around the world. The Asian Money Laundering Methods Workshop I referred to earlier identified SWIFT as one of the main means for moving illegal proceeds between jurisdictions (which is no reflection on the undoubted integrity of SWIFT).

In Australia, we have not had such a widely available system for use domestically. Five of the large banks have been using a system called BITS (Bank Interchange and Transfer System) for transfers between themselves, but, more generally, large value payments have been passed through most of the existing payment channels (cheques, direct entry, and so on). Until recently only a few countries had well developed large value transfer systems in place; countries such as the United States, United Kingdom, and Switzerland.

This is about to change. In Australia, the RBA and the Australian Payments Clearing Association (APCA) have been planning such a system for several years now. We expect it to be up and running late next year. Our primary motivation is to eliminate settlement risk from the large value payment systems, but these developments will bring a range of other benefits to the users of payment services.

Briefly, we will be introducing Real Time Gross Settlement into the Australian financial system, which means that large payments between banks will be settled through accounts at the Reserve Bank as they occur. All banks (and indirectly credit unions and building societies) will be connected directly to the system, and all transfers will be for credit funds (that is real dollars) and completed in real time (that is virtually instantly). Once completed, transfers will be irrevocable. Access to the system will be widespread and the banks have agreed (only at the end of last year) to use SWIFT to access the system, and to scrap BITS.

When the system becomes operational, all banks in Australia will exchange large value funds for value in real time. This will be a major change to the Australian financial system.

Large Value Transfers Internationally

These developments in Australia are broadly in step with developments in a range of other countries. Major development efforts are under way to implement RTGS systems throughout the European community countries, and in our region China, Hong Kong, Thailand, South Korea, Vietnam, New Zealand and others are on similar paths. These developments will change the way large value payments are made in these countries in much the same way they will in Australia. They will bring a quantum leap to the ease, speed and range of options for transferring large value payments between institutions in these countries.

In the next few years these various domestic systems will become operational. Some of these countries are already talking about how they could link their domestic systems together and to the Fedwire (RTGS) system in the United States. For instance, the domestic high value transfer systems of China, Hong Kong and the United States could effectively be linked within the not too distant future.

Conclusion

In summary, money laundering is a serious and growing problem. Its measurable economic consequences are probably well outweighed by its damage to the social and equity values of society. Developments in the financial system in Australia and internationally seem certain to guarantee job security for the law enforcement agencies.