

Money Laundering: What Do We Know?

THE term *money laundering* has several interpretations, but there is broad agreement on the key objective of money laundering: to make possible the legitimate use of the proceeds of crime while maintaining, to the extent possible, the value of the acquired assets. Obviously, this cannot be done in the open; it takes place through means to conceal and disguise the actual origins of the assets. In short, *money laundering* describes the process by which “dirty” money is turned into “clean” money.¹

Although money laundering attracts the most attention when it is associated with trafficking in illicit narcotics, and more recently with terrorist activities, enterprising criminals of every sort—from stock cheaters to corporate embezzlers to commodity smugglers—launder money for two reasons. First, the money trail itself can become evidence against the perpetrators of the offence. Second, money per se can be the target of investigation and action (United Nations 2000). Money laundering may occur almost anywhere in the world, and has become a significant global problem in the past few years, with serious social and economic consequences.

HOW DOES MONEY LAUNDERING WORK?

The process of money laundering is usually divided in three stages: placement, layering, and integration.² According to Spremann (2001), the first and most difficult step involves *placing* illegal funds in both financial and nonfinancial systems. For example, in the case of the former, this might be achieved through creating a series of small cash deposits, each of which is below the minimum level for reporting under money laundering regulations, or by purchasing a series of money orders that are then collected and deposited into accounts in another location. Alternatively, the funds may be deposited in an account supported by an apparently legitimate business transaction. Funds might be placed in the nonfinancial system through real estate purchases

and related transactions. Whatever the method, the aim is to place the funds in the economy in a way that does not arouse suspicion and thus minimizes the risk of detection. Clearly, money launderers who are better at exploiting legitimate financial and nonfinancial transactions are less likely to be exposed (Hampton 1999).

Once funds are in the financial system, *layering* further conceals their origin or ownership, removing them from identification with the launderer and hence disguising any audit trail. This is achieved through a series of normal business transactions in which the funds may be converted into another form or placed in another location. One of the easiest methods involves electronic funds transfer in which funds can be swiftly moved through a variety of bank accounts. It has been pointed out that the development of online banking, smart cards, and electronic cash has created additional money laundering opportunities (Spremann 2001).

After completion of the first two phases, the funds can no longer be connected or traced back to the criminal activity from which they were originally generated. Thus, the funds can be *integrated* in the economic/financial system and appear to have been legally earned by the money launderer. Integration can involve any number of techniques, such as using shell companies to lend the proceeds back to the owner, or through over-invoicing or producing false invoices for cross-border trade.

¹ Money laundering is not a modern phenomenon. In his book *Lord of the Rim*, historian Sterling Seagrave describes how merchants in China concealed their wealth more than 3,000 years ago, moving cash outside the jurisdiction, trading at inflated prices, and converting money into movable assets to avoid banishment. Although the mechanisms and reasons have changed, all these techniques are still used by money launderers.

² However, a simple characterization of the money laundering process is difficult because some may consider a specific action as part of the integration step, and others might include it in the placement or layering step.

WHAT ARE THE ECONOMIC IMPLICATIONS?

Given the clandestine nature of money laundering, it is difficult to assess the size of its economic repercussions. Some estimates calculate that money laundering accounts for between 2 and 5 percent of global gross domestic product (GDP), which amounts to about 1.5 to 2.0 trillion dollars a year (IMF 2001a). Using a similar methodology for Latin America, a rough estimate of money laundering in the region appears to be somewhere between 2.5 and 6.3 percent of annual regional GDP. The methods typically employed to calculate the effects of money laundering on GDP include measuring the following:

- The discrepancy between income and expenditure measures of GDP reported in national accounts statistics, assuming that expenditures are reasonably well reported but that elements of income are concealed or underreported
- The discrepancy between the official and actual labor force, assuming that a decline in participation in the official market may reflect increasing activity in the underground economy
- The discrepancy between official GDP and total nominal GDP (transactions approach), assuming a constant relationship over time between the volume of transactions and official GDP (Fisher's quantity equation)
- The discrepancy between actual or excess demand for money and the demand for money that can be explained by conventional or normal factors (currency demand approach), assuming that cash is the primary means of payment used to settle transactions in the underground economy
- The discrepancy between actual and official GDP estimated on the basis of electricity consumption, assuming that economic activity and electricity consumption move together, with an electricity/GDP elasticity close to one.

It is widely acknowledged that money laundering has four main implications. The first is *economic distortion*. On average, money launderers do not care about profit generation from their investments. They are only interested in protecting their proceeds and disguising their illicit origin. Hence, money launderers may place funds in inefficient activities, and high opportunity costs may impair economic growth.³ Laundered funds may harm private sector development because the investment decisions do not follow common commercial

considerations, but just mingle the proceeds of illicit activity with legitimate funds. Money launderers usually offer products at prices below manufacturing cost, making it difficult for legitimate activities to compete, crowding out the private sector by criminal organizations, and resulting in negative macroeconomic effects in the long term. In addition, monetary instability can cause irremediable misallocation of resources by distorting asset and commodity prices. Furthermore, money laundering can cause inexplicable changes in money demand and greater volatility in international capital flows, interest rates, and exchange rates due to unanticipated cross-border asset transfers. In short, money laundering may result in instability, loss of control, and economic distortion, making it difficult for the authorities to implement economic policy (USAID 2003).

Second, money laundering has important implications for *financial integrity and reputation risk*. Liquidity problems and runs on banks may occur when large sums of laundered money arrive at a financial institution or suddenly disappear. Market factors do not drive these movements. In fact, money laundering activities may cause bank failures and financial crises. Money laundering may also tarnish the reputation of financial institutions. Once a bank's reputation is tarnished, the effect may go beyond the sector, affecting professionals, such as accountants and lawyers. This negative reputation may diminish licit opportunities and attract criminal activities, resulting in negative effects for economic development of the affected country in the global economy (Bartlett 2002; Bair 2003).

Third, money laundering affects *government resources*. Although money laundering and **tax evasion** are closely related, the processes differ. Tax evasion implies hiding the existence of legal earnings; money laundering does exactly the opposite. In fact, money launderers tend to overreport the earnings of their licit businesses in order to mix both legal and illegal profits, although doing so brings a higher tax burden. Money laundering makes tax collection more difficult for the government and diminishes revenue because related transactions frequently take place in the underground economy, which ultimately harms honest taxpayers.⁴ It also may divert public funds to the detriment of expenditure in other significant areas (United Nations 1998; James 2002).

Fourth, money laundering has grave *socioeconomic repercussions*. If left unabated, money laundering allows

³ However, it would not be unusual for some money launderers to have self-sustaining legitimate businesses.

⁴ However, there is an incentive for money launderers to pay taxes in order to legitimize their investments.

criminal activities to flourish, which leads to greater social ills and increases the implicit and explicit costs of enforcement. There is a clear-cut link between the scale of money laundering and the level of corruption at the domestic level (Castle 1999). Thus, an environment that facilitates money laundering helps to expand corruption, which allows economic activity to shift from formal to informal markets, and the socioeconomic undertow of money laundering may even lead to increased poverty. Given the evidence of increasing dirty money flows to markets with poorer financial systems, which are the most vulnerable to organized crime, the potential negative socioeconomic effects of money laundering are multiplied in emerging markets (Dowers and Palmreuther 2003; Drayton 2002).

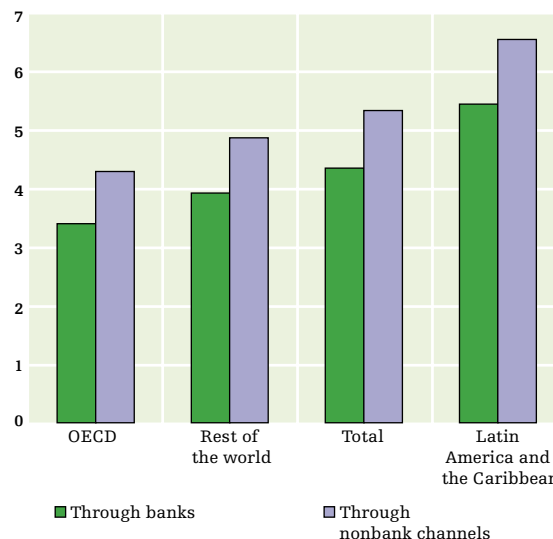
HOW BAD IS THE PROBLEM IN LATIN AMERICA?

If the problem of money laundering were greater in emerging markets than in industrial ones, then the relative position of Latin America and the Caribbean would be unfavorable compared with more economically advanced regions (Lambert 2001). Figure 17.1 provides a comparison of the pervasiveness of money laundering through bank and nonbank channels in Latin America and the Caribbean and other regions.⁵ The data show that money laundering is especially pervasive in Latin America. Although it is not as high as in Asia and Africa, it is considerably higher than in developed countries. On a scale from 0 to 10, Latin America scores 5.46 for bank channels and 6.57 for nonbank channels. Countries in the Organisation for Economic Co-operation and Development have the lowest degree of money laundering pervasiveness, as expected, with 3.41 for bank and 4.31 for nonbank channels.

It is particularly worrisome that among the top 10 countries with the greatest pervasiveness of money laundering via bank channels, six are in Latin America: **Argentina** (6.86), **Colombia** (6.57), **Haiti** (6.43), **Paraguay** (6.43), **Nicaragua** (6.29), and **Bolivia** (6).⁶ The best-rated country in the Latin American region is **Chile** (3.00), which ranks 67th of 80 countries, and is tied with the Netherlands (World Economic Forum 2003). As shown in Figure 17.2, Chile's score is not only much lower than the regional average, but it is also low compared with the second-best-placed Latin American countries in the sample: Uruguay and El Salvador, both of which score 4.29 and consequently rank 40th in the sample.⁷

A similar pattern emerges in the case of money

FIGURE 17.1 Pervasiveness of Money Laundering (Index, 0–10)



Source: World Economic Forum (2003).

laundering through nonbank channels, although the extent of money laundering through nonbank channels is worse. Of the top 10 countries in this category, seven are in Latin America: Colombia (8.0), Haiti (7.86), Argentina (7.29), Paraguay (7.29), Nicaragua (7.14), Guatemala (7.14), and Bolivia (7.0).⁸ Chile again performs best, with a score of 4.0, followed by Uruguay, with 5.14. Figure 17.3 presents the Latin American countries in the sample.

Although conventional wisdom says the prevalence of money laundering in Latin America may be linked to

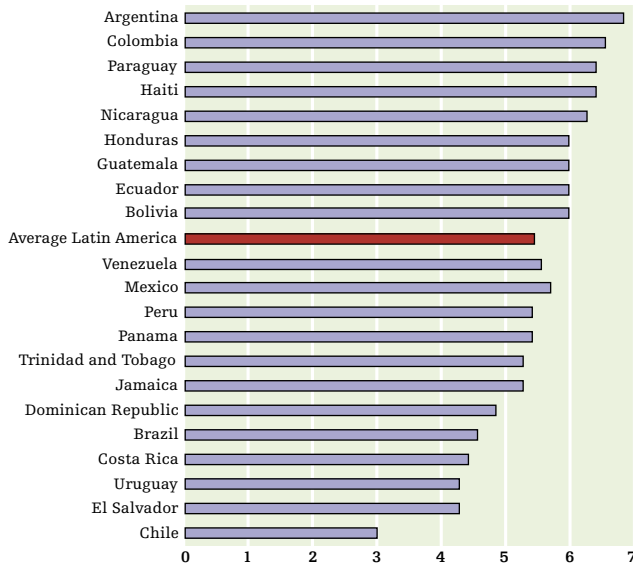
⁵ The World Economic Forum (2003) collected the money laundering data used in this chapter during 2002. It is based on a simple questionnaire that asked a large number of experts around the world to rate the money laundering conditions in their respective countries from 1 to 7, with 1 being the lowest possible score (extremely rare) and 7 the highest (pervasive). For the sake of clarity, the data have been rescaled from 0 to 10. Because the data are subjective, they may contain weaknesses and inaccuracies. However, on average, they should help depict a good picture of this issue in the region.

⁶ Furthermore, Ecuador, Guatemala, and Honduras (each with a score of 6.0) take the next three spots. According to these data, Argentina and Ukraine are tied with the greatest amount of money laundering in the sample.

⁷ The data do not capture recent advances in some countries. For example, El Salvador has made great strides, in particular in training judges.

⁸ Mexico (7.0) and Jamaica (7.0) are tied with Bolivia and thus are also among the top 10.

FIGURE 17.2 Pervasiveness of Money Laundering through Banks
(Index, 0–10)



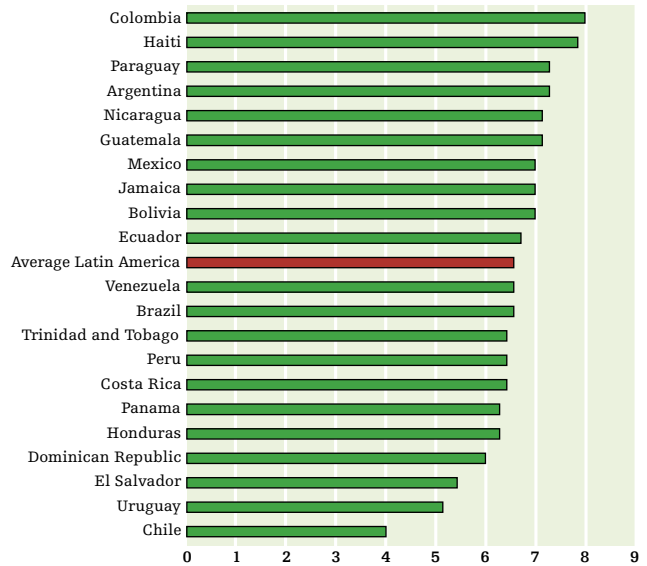
Source: World Economic Forum (2003).

trafficking drugs and financing terrorism (see Box 17.1), those are outcome variables that may reflect structural weaknesses in the region (Ehlers 1998; Ruehsen 2003; Camdessus 1998). In fact, proximity to the United States may be a crucial factor for extensive money laundering in some countries, most notably Mexico. However, the fact that **Canada** shares an even larger border with the United States brings some additional thoughts to the location argument. In addition, **Canada** is the most important commercial partner of the United States and shares its Anglo Saxon culture and language.⁹ In short, in order to better understand why money laundering appears to thrive in Latin America, the analysis needs to zero in on its most likely determinants.¹⁰

WHAT ARE THE DETERMINANTS OF MONEY LAUNDERING?

There is relatively little theoretical or empirical academic research on money laundering. What is available tends to focus on specific issues of money laundering processes and tends to provide little systematic analysis of its determinants. Yet, some available research sheds light on the possible determinants. Analysts have studied the relationships between money laundering and financial development and financial soundness. Some studies show interrelationships among money launder-

FIGURE 17.3 Pervasiveness of Money Laundering through Nonbank Channels
(Index, 0–10)



Source: World Economic Forum (2003).

ing, **tax evasion**, and **offshore financial centers**. Such studies seek to identify those aspects of anti-money laundering and anti-tax evasion policies that could be coordinated across various international regulatory bodies. For example, Alworth and Masciandaro (2004) consider the forms of enforcement in a framework of imperfect information characterized by a multiplicity of jurisdictions.

With respect to the importance of the **underground economy**, some studies provide a framework for analyzing the relationships among the underground sector, money laundering, and the legal economy, considering both the financial and real sides (Masciandaro 2000; Tanzi 1999; Levine 2003; Howlett 2001). By separating legal and underground sectors, these studies show the conditions under which a possible synergy can exist between general anti-crime policies and anti-money laundering regulations. These policies and regulations may have an expansive effect on legal income, depending on

⁹ The score for money laundering through banks is 2.71 in both the United States and **Canada**, and the score for money laundering through nonbank channels is 3.29 in both countries (World Economic Forum 2003).

¹⁰ An important caveat is that although money laundering may be more prevalent in developing countries than in developed countries, most of the laundered money ends up in the latter, not the former. In other words, the integration step takes place mostly in developed countries.

BOX 17.1 | MONEY LAUNDERING AND TERRORISM FINANCE

Interest in developing appropriate mechanisms to reduce the impact of money laundering on financial systems has been a major preoccupation of international financial market entities. The September 11, 2001, terrorist attack on the United States revealed a new dimension to the problem—money laundering to finance terrorism. The response has been an expansion of the efforts to put in place internationally accepted standards to counteract money laundering and hinder terrorism finance. The United Nations has identified links between terrorism, transnational organized crime, the international drug trade, and money laundering and called on governments to become parties to relevant international conventions, including the 1999 International Convention for the Suppression of the Financing of Terrorism (United Nations Office for Drug Control and Crime Prevention). The United Nations Security Council adopted Resolution 1373 (2001), through which it established the Counter-Terrorism Committee, which is mandated to monitor the implementation of the resolution urging governments to prevent and suppress the financing of terrorist acts. The Security Council also adopted Resolution 1377 (2001).

Meanwhile, the Financial Action Task Force (FATF), set up by the Group of Seven in 1989 in recognition of the vital importance of this issue, has agreed on eight recommendations, which, when combined with FATF's 40 Recommendations on Money Laundering, set out the basic framework for detecting, preventing, and suppressing the financing of terrorism and terrorist acts. The eight recommendations are the following:

- (i) To ratify and implement the UN instruments
- (ii) To criminalize the financing of terrorism and associated money laundering
- (iii) To freeze and confiscate terrorist assets
- (iv) To report suspicious transactions related to terrorism
- (v) To promote international cooperation
- (vi) To provide alternative channels for remittances
- (vii) To increase client identification measures in national and international transfers

- (viii) To ensure against the use of corporations—particularly nonprofit organizations—to finance terrorism.

Because of its location, emerging financial systems, and increasing opening up of markets, among other reasons, Latin America plays a crucial role in the international arena in combating money laundering, drug trafficking, and terrorism finance. Therefore, in its Plenary Meeting in Chile in 2001, the South American Financial Action Group (GAFISUD) agreed to join the efforts of the international community in the struggle against terrorism, its accomplices, and the financing of terrorist activities.¹ GAFISUD highlights the importance of the ratification and application of the United Nations instruments against terrorism and its financing, and the adoption of the resolutions of the Organization of American States for strengthening hemispheric cooperation in preventing, combating, and eradicating terrorism.

In order to promote the joint efforts of its members to combat the financing of terrorism, GAFISUD has adopted the Action Plan against the Financing of Terrorism, with the following aims:

- (i) To adopt and apply the Eight Special Recommendations of the International Financial Action Task Force against money laundering to finance terrorism
- (ii) To conduct an evaluation of countries to provide support in applying the new measures in international systems
- (iii) To disseminate guidelines and information for the financial sector on techniques and procedures used for terrorist financing
- (iv) To exchange experiences and knowledge among national experts and with other organizations involved in the struggle against money laundering in order to combine efforts.

¹ GAFISUD is the regional body equivalent to the Financial Action Task Force.

Source: United Nations (1999, 2003a); FATF (1999, 2001, 2002, 2003a, 2003b, 2003c, 2003d, 2003e); GAFISUD (2002); CFATF (1996, 1997, 1998); World Economic Forum (2003).

the effectiveness of the anti-money laundering regulations. Furthermore, distinguishing between the legal and criminal economy in the basic analytical framework introduces a trade-off between increasing quantitative national wealth and safeguarding the law. In short, such analyses emphasize the illegal or informal economy as a possible determinant of money laundering (Masciandro 2000, 2002).

Some economic analyses of anti-money laundering regulations introduce a positive and normative analysis by placing particular emphasis on government regulations and institutional quality issues (Masciandro 1999). For example, work on the link between income **tax evasion** and money laundering opportunities focuses on the extent to which a criminal can determine not only the amount of actual income to declare, but also the amount of undeclared income to launder. Such studies analyze the effects of laundering incentives on evasion and derive guidelines for the optimal design of a joint evasion/laundrying deterrence policy (Yaniv 1999).

In short, the available studies identify at least five crucial factors that help money laundering flourish. These are a weak banking system, an underdeveloped financial system, a large underground economy, poor quality of government institutions, and low corporate governance.¹¹

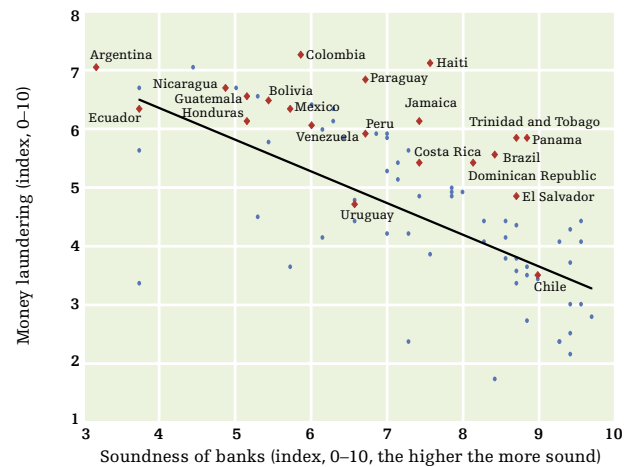
Soundness of the Banking System

Unsound banking systems are clearly exposed to money laundering activities. When the banking sector is not transparent, regulations are not well established, and government monitoring is lax, the opportunities to launder money flourish (Alworth and Masciandro 2004). Figure 17.4 illustrates the powerful link between soundness of the financial system and money laundering. The figure plots the simple correlation between the two variables, controlling for the size of the economy.¹²

Development of Capital Markets

Typical instruments of money laundering are closely related to more developed capital and financial markets. This is the case of financial leasing, money transmission services, administered means of payment, guarantees, trading for own account or customer accounts in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments, transferable securities, derivatives, money brokering, portfolio management, and several other instruments

FIGURE 17.4 Money Laundering and Soundness of Banks



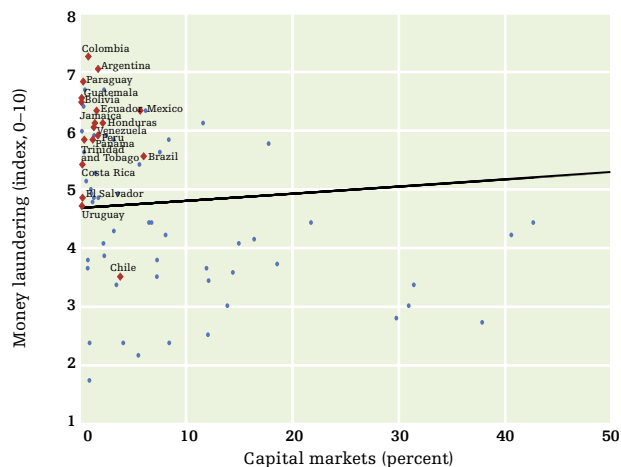
Source: World Economic Forum (2003).

(Council of Europe 1990). At the institutional level, most institutions involved in money laundering tend to be commercial banks, trust companies, savings and loan associations, building and loan associations, savings banks, industrial banks, credit unions, other thrift institutions, establishments authorized to do business under domestic bank loans, brokers or dealers in securities, currency dealers or exchanges, and other institutions subject to supervision by the government, banks, or other financial institution authorities (OAS 1991).

In principle, it is not obvious whether the development of financial and **capital markets** would help or hinder **money laundering**. On the one hand, greater facility for using checks, credit cards, and other noncash instruments for effecting illegal financial transactions makes it more difficult to detect money laundering. Similarly, a greater degree of financial deregulation for legitimate transactions makes it more difficult to trace and neutralize criminal money. Progress toward the **financial services supermarket** in which all manner of financial services can be met in one integrated, multi-divisional institution makes it more difficult to detect money laundering.

¹¹ The United Nations (2003b) has produced a paper that documents the “Ten Fundamental Laws of Money Laundering.” The five determinants identified here summarize the United Nations’ 10 measures.

¹² The variable used to control for the size of the economy is the log of average GDP in the 1990s. Soundness of banks is measured from 0 to 10, with a higher score indicating a more sound banking system.

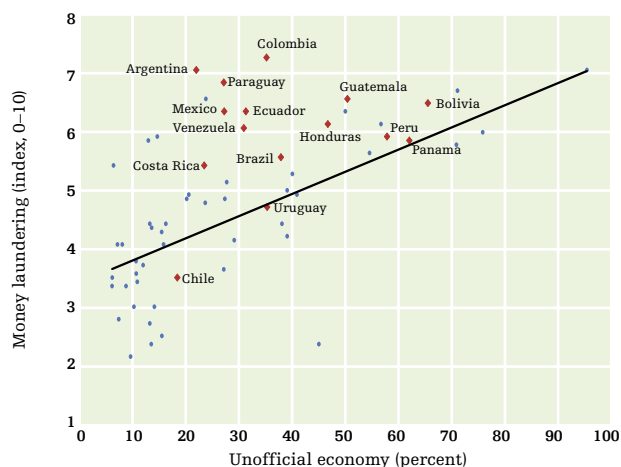
FIGURE 17.5 Money Laundering and Capital Markets

Source: World Economic Forum (2003); Levine (2003).

On the other hand, more developed capital and financial markets will also have better mechanisms of checks and balances that can help detect money laundering processes. Figure 17.5 resolves this ambivalence.¹³ In fact, there appears to be a slightly positive correlation between the development of capital markets and the pervasiveness of money laundering. Furthermore, the actual correlation appears to be positive and statistically significant, as shown in Appendix 17.1. Taking other factors into consideration, money laundering is more pervasive in more developed financial systems. These findings stress the importance of other issues that are typically linked to financial development—such as regulatory and monitoring measures—in the policy-making process. Thus, the challenge is how to develop a financial system that will benefit the economy without also encouraging money laundering processes.

Size of the **Underground Economy**

It is especially difficult to detect money laundering when illegal activities are deeply embedded in the legal economy with little institutional and functional separation. Similarly, it is difficult to separate legal from illegal transactions when small and independent firms or self-employed individuals dominate the business structure of production and distribution of nonfinancial goods and services. As Masciandaro (2000) implies, money laundering is potentially more likely to thrive in the context of an already diffuse sector that is difficult to pinpoint (Figure 17.6).

FIGURE 17.6 Money Laundering and Unofficial Economy

Source: World Economic Forum (2003); Friedman and others (2000).

Quality of Government Institutions

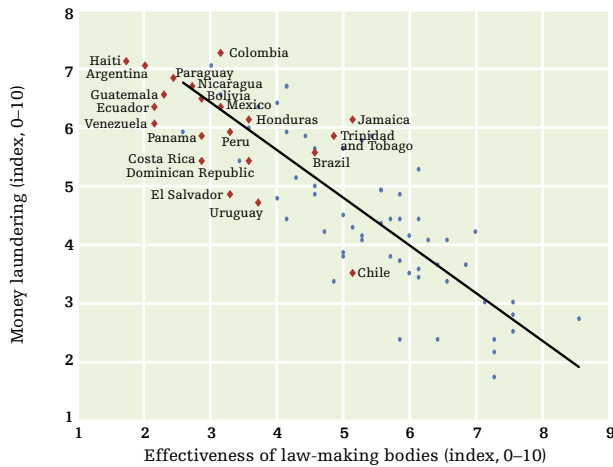
The quality of institutions in a country is fundamental for achieving sustained long-run growth rates. Efficient law-making bodies, good bureaucracies, transparent institutions, and low government corruption are all conducive to a better distribution of resources. The quality of institutions is intimately linked with the quality of the financial sector and, as such, is a particularly important channel by which policymakers may attempt to minimize money laundering. In general, money laundering can be more easily conducted in an environment with weak institutions. By contrast, it is likely that policymakers can better stall money laundering when they have not only a nominal effect, but also an actual effect on how institutions work (Figure 17.7).¹⁴

Quality of Corporate Governance

Recent scandals in several industrial countries and extensive privatization processes in many developing countries have helped policymakers to become much more aware of the importance of corporate governance. In the case of emerging markets, Chong and López-de-Silanes (2004) show that the absence of a good corpo-

¹³ The data on stock market total value traded to GDP are from Levine (2003). Other financial development variables tested show a similar pattern.

¹⁴ The variable “effectiveness of law-making bodies” is rated from 0 to 10, with a higher score denoting a more effective law-making body (World Economic Forum 2003).

FIGURE 17.7 Money Laundering and Effectiveness of Law-Making Bodies

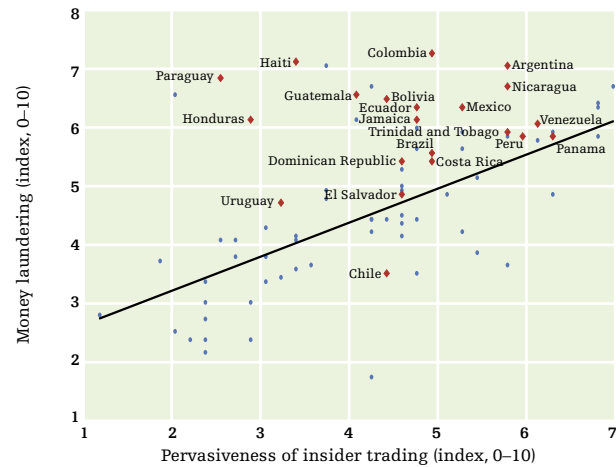
Source: World Economic Forum (2003).

rate governance framework increases the cost of capital, which prevents privatized firms from undertaking the investments needed to operate in a more competitive environment. Before privatization, corporations typically used government banks as a source of financing. Yet most privatization programs turn the banking sector over to private hands. If financing for privatized firms is expected to come from privatized banks, or from any other private credit institution, there is an urgent need to make sure that corporate governance issues are strengthened and streamlined (Chong and López-de-Silanes 2004).

Privatization without a commitment to improve shareholder rights in corporate and securities laws would probably lead to widespread abuse and appropriation of benefits, which would make money laundering much easier.¹⁵ Good corporate governance is essential for preventing expropriation by controlling investors and overall abuse. In fact, Figure 17.8 illustrates a negative relationship between money laundering and the quality of corporate governance, using the pervasiveness of insider trading as the corporate governance variable of interest.¹⁶ The figure shows the positive association between pervasive insider trading and pervasive money laundering.¹⁷

Summary

At least five critical factors are closely related to money laundering: soundness of the banking system, development of the financial sector, size of the informal sector, quality of institutions, and quality of corporate gover-

FIGURE 17.8 Money Laundering and Pervasiveness of Insider Trading

Source: World Economic Forum (2003).

nance. Some of these factors are clearly connected to others. For instance, it is difficult to have a sound banking system in an underdeveloped financial system. Similarly, the quality of government institutions is probably linked with the quality of corporate governance in a country because both depend on legislation. Furthermore, the underground economy may also be connected to the quality of institutions.

All in all, the findings appear to be quite suggestive. Thus, a systematic investigation of the possible determinants of money laundering processes would help in providing a unified framework for analysis. This could serve as a road map not only on what has been done, but also on what should be done in the fight against money laundering (U.S. Department of State 2001).¹⁸

¹⁵ In fact, the failure to institute appropriate securities laws and effective enforcement may be responsible for many of the scandals that are now blamed on privatization in several countries, particularly in some countries in Eastern Europe, where, according to data from World Economic Forum (2003), money laundering appears to be problematic.

¹⁶ Several other corporate governance indicators yield similar results (La Porta, López-de-Silanes, and Shleifer 2000).

¹⁷ The variable “pervasiveness of insider trading” is rated from 0 to 10, with a higher score denoting more pervasive insider trading (World Economic Forum 2003).

¹⁸ Although the variables may be related to each other, the formal econometric exercise presented in Appendix 17.1 shows that it is likely that each variable has an exclusive effect. Most of the variables yield statistically significant relationships with respect to money laundering processes. However, an unsolved issue has to do with endogeneity because the direction of causality is not clear. In addition, omitted variables may be a problem in that another uncovered determinant may be driving the observed results.

WHAT ARE THE EFFORTS AGAINST MONEY LAUNDERING?

The main body in the fight against money laundering is the **Financial Action Task Force (FATF)**, which the **Group of Seven** set up at the 1989 Economic Summit in Paris. FATF helped establish the minimum standards in the 40 Recommendations on Money Laundering, which were drawn up in 1990 and revised in 1996 and 2003. The following points summarize the recommendations:

- Money laundering should be criminalized on the basis of the United Nations Convention on Transnational Organized Crime (The **Palermo Convention**), which requests countries to adopt measures similar to those suggested in these conventions.
- Financial institutions should apply these recommendations by recording the identity of their clients. They should not keep anonymous accounts. They should keep relevant records for at least five years in order to assist possible criminal investigations. This may also be applied in the case of casinos, real estate agents, dealers in precious metals and precious stones, lawyers, notaries, and other independent legal professionals.
- Financial institutions should pay special attention to unusual or suspicious transactions that rise above designated thresholds or involve high-profile individuals. Similarly, institutions should report suspicious transactions to authorities in the case of proceeds related to criminal activity or terrorism finance and develop compliance programs as necessary. In this context, special vigilance should be taken with respect to countries that do not adopt the FATF recommendations in full or in part.
- The authorities should ensure that institutions have adequate money laundering prevention programs, as well as international cooperation that can help provide mutual legal assistance. They should pay attention to measures to detect or monitor cross-border transportation of cash and bearer-negotiable instruments, taking into account the proper use of information and the freedom of movement of capital.

FATF has encouraged countries to create regional organizations based on adopting the 40 Recommendations on Money Laundering. In Latin America and the Caribbean, two groups of this kind have been established—the **Caribbean Financial Action Group** and the South American Financial Action Group (GAFISUD). Although FATF is the main international body and the 40 Recommendations are the most significant stan-

dards, FATF works with these and other international and regional initiatives that share the same objectives. The key logic behind these efforts is that the only way to combat money laundering is by means of global regulations, applying minimum standards in all jurisdictions. In general, international organizations involved in efforts to counter money laundering are concerned with financial and supervisory matters, legal enforcement, and criminal enforcement. Table 17.1 summarizes some key international efforts.

The International Monetary Fund (IMF), the **World Bank**, and the Inter-American Development Bank (IDB) have been helping countries in Latin America strengthen their financial supervision and regulation and thus are contributing to the prevention of financial sector crime and money laundering. In particular, there has been increasing work on strengthening financial supervision through the application of financial standards, including the preparation of the Report on the Observance of Standards and Codes, which overlaps with the financial and supervisory aspects of FATF's 40 Recommendations. In the region and elsewhere, multilateral organizations have contributed in the fight against financial sector abuse and money laundering in the following ways:

- Publicizing the need to put in place the necessary economic, financial, and legal systems to protect against money laundering
 - Recognizing FATF's 40 Recommendations as a standard for anti-money laundering for the operational work of multilateral agencies
 - Intensifying the focus on anti-money laundering elements in the assessment of supervisory standards and producing a detailed assessment that could be published with FATF
 - Working closely with major international anti-money laundering groups
 - Increasing the provision of technical assistance in this area.

In particular, anti-money laundering issues related to financial supervision and regulations are important to the IMF's core responsibilities because of its purpose to promote macroeconomic stability and growth. The World Bank, and to some extent the IDB, have helped countries identify and address structural and institutional weaknesses that may contribute to the lack of market integrity and the potential for financial abuse. There are three main areas in the fight against financial abuse: anti-corruption, governance, and public financial management; strengthening financial systems; and

TABLE 17.1 | **INTERNATIONAL ANTI-MONEY LAUNDERING EFFORTS**

Organization	Operational standard	Legally binding	Membership	Focus	Implementation
FATF ^a	FATF 40	No	Mostly developed countries	Prevention and enforcement	Mutual evaluation
	25 criteria	No	Mostly developed countries	Prevention and enforcement	One-way evaluation
Regional anti-money laundering task forces ^b	FATF 40 Kingston 19	No	Open/regional	Prevention and enforcement	Mutual evaluation
UN Global Program ^c	Treaties	Yes	Most countries	Enforcement	UN General Assembly
	Model laws, other sources	No		Prevention and enforcement	Surveillance and technical assistance
Council of Europe C.E. Committee	Treaty	Yes	Largely council membership	Enforcement	Council of Europe
	Various sources	No		Prevention and enforcement	Technical assistance
EU	Directive	Yes	EU	Mostly prevention	EU Commission
OAS CICAD	Model regulations and country treaties	Yes	OAS members	Prevention and enforcement	Technical assistance
Commonwealth	Model law	No	Commonwealth members	Prevention	Technical assistance
Egmont Group	Financial units	No	Diverse membership	Enforcement	Technical assistance and mutual assistance in investigations
INTERPOL FOPAC	Various sources	No	Most countries	Enforcement	Mutual assistance in investigations
IMF, World Bank, Inter-American Development Bank		No	Most countries	Prevention	Technical assistance

^a The 40 Recommendations on Money Laundering, Monitoring Member's Progress; Reporting Money Laundering Trends and Techniques; the NCCT List; Special Recommendations on Terrorism Financing; Methodology for AML / CFT Assessments.

^b Asia / Pacific Groups on money laundering; Caribbean Financial Action Task Force; Council on Europe - MONEYVAL; Eastern and Southern Africa Anti-Money Laundering Group; Financial Action Task Force on Money Laundering in South America.

^c The Vienna Convention; The Palermo Convention; International Convention for the Suppression of the Financing of Terrorism; Security Council Resolution 1373; Global Programme against Money Laundering; The Counter Terrorism Committee.

market infrastructure and integrity. The World Bank has recently focused its efforts on small developing economies in Latin America and elsewhere that may be especially susceptible to potential financial abuse (IMF and World Bank 2001b).

Two tools have shown dramatic potential in the efforts against money laundering. The first is the **Financial Sector Assessment Program**, which aims at

identifying financial vulnerabilities and development needs. In fact, it reduces the opportunities for financial crime through improved financial supervision and pre-conditions for effective regulation and supervision. The second tool is the Report on Observance of Standards and Codes. It represents a collaborative effort between the World Bank and the IMF in assessing progress in implementing selected international standards and thus

has helped to publicize the advances of countries acting to protect against financial abuse and money laundering. Both institutions as well as the IDB have begun close work with major international organizations and anti-money laundering groups through technical cooperation and further information diffusion.¹⁹

WHAT ARE SOME ADVANCES IN THE REGION?

Thanks to the joint efforts of governments, multilateral organizations, and other donors, several countries in Latin America have been able to proceed with some efforts in terms of financial legislation and regulation. In fact, many countries in the region have already set up comprehensive anti-money laundering systems that meet most, if not all, of FATF's 40 Recommendations. Examples are Argentina, Brazil, Bolivia, Chile, Colombia, Ecuador, Peru, Uruguay, and others. Countries have introduced money laundering offenses in their legislation to explicitly include the fight against illegal economic profits related not only to financial activity, but also to the commercial and service sectors. Several countries now typify money laundering crimes as autonomous, which means that there is no need to prove any preceding crime. Furthermore, in many countries in the region, money laundering constitutes a criminal offense, with a list of related preceding or underlying crimes that includes felonies. A notable feature is that money laundering is punishable even when the preceding underlying offense may have been perpetrated in a foreign country.

The money laundering prevention system is based on the participation of all ministries and public agencies that have responsibilities over this issue.²⁰ The system's instruments include confiscation or seizure, with the possibility of expropriating, attaching, or garnishing any products or instruments used or intended for use in activities related to money laundering. Currently, policymakers are considering additional policies, such as timeliness in adding fraud to the list of offenses preceding money laundering, legal changes required to guarantee that obligated subjects will be released of liability where they report suspicious transactions, issuance of suspicious activity guides to be distributed among subjects involved in the preventive system, and additional training.

In some countries in the region, the banking sector has been one of the areas most affected by money laundering. Policymakers have been considering some additional tools in their fight against this problem,

which has taken place mainly in offshore financial centers. For instance, some countries have or are seriously considering laws to guarantee an efficient anti-money laundering system that is consistent with international standards. The standards apply to all financial institutions, including money exchange offices and value markets. The system requires financial institutions and intermediaries to declare all cash transactions in domestic and foreign currency that are over a certain threshold, and provides for monitoring and detecting cross-border transport of currencies.

Similarly, many countries have set up financial investigation units in order to collect information and issue warnings from the prevention system. Their specialized, high-tech expertise has led to the development of useful tools for the prevention and control of money laundering. In some countries, authorities have been considering the use of a formula to allow definition of preceding offenses in relation to a category encompassing all serious crimes, the development of plans to strengthen trust and cooperation across sectors, improvement in the information mechanisms of the anti-money laundering system, consolidation of relevant operating bodies, and close monitoring of factors that increase the level of circulating cash. In many instances, these are regulatory units that have unlimited access to information from financial entities. In addition, they may share information with international organizations and may actively participate with other relevant institutions, such as the Egmont Group (see Table 17.1). Overall, these units are responsible for defining the policies against money laundering, together with the superintendents of banks.

Finally, many countries have adopted the 1988 Vienna Convention, the United Nations Convention for the Suppression of the Financing of Terrorism (United Nations 1999), and the Organization of American States convention on the same subject. Countries have also signed significant regional agreements with the United States, European countries, and countries in the region.

¹⁹ For instance, the IDB is working with the Organization of American States through the Comisión Interamericana para el Control del Abuso de Drogas, CICAD (Table 17.1).

²⁰ For example, Uruguay's agency includes the Deputy Secretary to the President of the Republic, who chairs the National Drug Board; the Money Laundering Training Center; the Ministry of Economy and Finance and the Uruguayan Central Bank, which controls the superintendent's offices that supervise all sectors; the Financial Analysis and Information Unit; the police under authority of the Ministry of Home Affairs; and the Coast Guard Service under the authority of the Ministry of Defense.

WHAT ARE THE CHALLENGES FOR LATIN AMERICA?

In the context of increased drug trafficking and terrorism finance, the concern about money laundering in the region is high. This concern is not unfounded because money laundering appears to be pervasive in the region, at roughly between 2.5 and 6.3 percent of regional GDP. Furthermore, since money laundering has increasingly become a significant global problem, with serious economic and social repercussions, international cooperation has become a critical necessity in the fight against it. National systems must be flexible enough to detect and stop the process, and to cooperate with other countries in implementing countermeasures.

The region has embarked on international cooperation as well as new or updated legislation to deal directly with the money laundering problem. Many countries in the region are complying with most if not all of FATF's 40 Recommendations; others are following the necessary steps to comply with them. However, despite the legislative advances in several Latin American countries, money laundering is an important threat, especially because some countries are only partially dealing with factors that are potentially linked to the problem. Structural weaknesses in the region contribute to thriving money laundering activities, and as long

as countries do not overcome such weaknesses, purely legislative measures may not suffice.

This chapter has proposed a straightforward but challenging road map. Countries in the region should consider working to achieve progress in five main areas in the fight against money laundering: a sound banking system, greater development of the financial system, improvement in the quality of institutions, good corporate governance, and reduction in the size of the underground economy.

Although specific legislative measures may aim to improve the soundness of the banking system or increase the development of the financial sector, they should also deal with the issue that law-giving is not equal to law-abiding. Monitoring and enforcement are crucial, and training judges and improving the judicial system in general appear extremely important. Rules can potentially make the banking system stronger, but underdeveloped institutions limit the potential for positive results. Similarly, some rules can develop the financial system in a way that increases the risk of atomizing firms and forcing entrepreneurs to move to the unofficial economy, with negative consequences for anti-money laundering efforts. Success in the fight against money laundering in the region and elsewhere requires a comprehensive view of the full picture and an understanding of the pervasiveness of the problem.

APPENDIX 17.1. ECONOMETRIC EVIDENCE OF THE DETERMINANTS OF MONEY LAUNDERING

Appendix Table 17.1 defines the terms used in the analysis. Appendix Table 17.2 presents the results from regressing average money laundering, which includes laundering through banks and nonbank channels, on soundness of banks, effectiveness of law-making bodies (a proxy for government institutions), pervasiveness of insider trading (a proxy for quality of corporate governance), stock market total value traded to GDP (a proxy for development of the financial system), and a measure of the underground economy. The explanatory variables also include the log of per capita GDP and the rate of growth of the economy.

The initial results for the determinants of money laundering in Appendix Table 17.2 are from ordinary least squares estimation. The results show that a sound banking system and effective government institutions

are negatively linked to the pervasiveness of money laundering. The relation is strongly significant for the effectiveness of law-making bodies, but insignificant for the soundness of banks. Money laundering is positively and significantly related to pervasiveness of insider trading and stock market total value traded to GDP. The size of the unofficial economy is positively linked, although it is statistically insignificant (this variable was included in a separate specification because the number of observations drops dramatically due to lack of data). The models were reestimated for the same specifications using an ordered probit method, taking into account the ordered response of the dependent variable. The main result is that countries with highly effective law-making bodies have a lower probability of money laundering. However, for countries with an elevated level of stock market total value traded to GDP, the probability of money laundering increases. For the sake of completeness, the models were also estimated using a Tobit method, which yielded similar results.

APPENDIX TABLE 17.1 | SOURCES AND DEFINITIONS

Variable	Definition	Source
Average money laundering	Simple average of pervasiveness of money laundering through banks and nonbank channels	World Economic Forum (2003)
Effectiveness of law-making bodies	Scale: 1 = very ineffective, 10 = very effective	World Economic Forum (2003)
GDP (ln)	Gross domestic product per capita in constant 1995 U.S. dollars in natural logarithm; average for 1975–91; data not available for Taiwan (China)	World Development Indicators (World Bank)
GDP growth	Annual percentage growth rate of GDP at market prices in constant local currency; average for 1975–91	World Development Indicators (World Bank)
Pervasiveness of insider trading	Scale: 1 = extremely rare, 10 = pervasive	World Economic Forum (2003)
Pervasiveness of money laundering through banks	Money laundering through the banking system; Scale: 1 = extremely rare, 10 = pervasive	World Economic Forum (2003)
Pervasiveness of money laundering through nonbank channels	Scale: 1 = extremely rare, 10 = pervasive	World Economic Forum (2003)
Soundness of banks	Scale: 1 = banks are insolvent and may require government bailout, 10 = banks are generally healthy with sound balance sheets	World Economic Forum (2003)
Stock market total value traded to GDP	Average for 1975–96; data not available for Dominican Republic, Estonia, Haiti, or Nicaragua	http://www.csom.umn.edu/WWWPages/FACULTY/RLevine/Index.html
Unofficial economy		Friedman and others (2000)

APPENDIX TABLE 17.2 DETERMINANTS OF MONEY LAUNDERING THROUGH BANKS AND NONBANK CHANNELS

Independent variable	Ordinary least squares ^a		Ordered probit ^a			Tobit ^b		
	1	2	3	4	5	6		
GDP (log)	-0.244 (0.09)***	-0.249 (0.13)*	-0.383 (0.14)***	-0.459 (0.24)*	-0.250 (0.08)***	-0.260 (0.11)**		
Soundness of banks	-0.094 (0.09)	-0.078 (0.11)	-0.162 (0.15)	-0.135 (0.20)	-0.092 (0.06)	-0.078 (0.07)		
Effectiveness of law-making bodies	-0.555 (0.08)***	-0.518 (0.09)***	-0.876 (0.13)***	-0.923 (0.15)***	-0.564 (0.07)***	-0.525 (0.08)***		
Pervasiveness of insider trading	0.175 (0.08)**	0.182 (0.08)**	0.193 (0.13)	0.277 (0.15)*	0.170 (0.08)**	0.185 (0.08)**		
Stock market total value traded to GDP	1.219 (0.47)**	1.101 (0.42)**	1.899 (0.75)**	1.914 (0.74)***	1.267 (0.64)*	1.161 (0.60)*		
Unofficial economy		0.003 (0.01)		0.005 (0.01)		0.003 (0.01)		
GDP growth (percent)	-0.001 (0.01)	-0.007 (0.02)	0.003 (0.02)	-0.005 (0.03)	-0.001 (0.02)	-0.006 (0.02)		
Constant	9.344 (0.98)***	9.038 (1.36)***			9.444 (0.92)***	9.155 (1.18)***		
Observations	73	58	Observations	73	58	Observations	73	58
R ²	0.79	0.83	Pseudo R ²	0.20	0.22	Pseudo R ²	0.44	0.50
F	89.05	79.38	Wald X ²	133.58	91.11	LR X ²	111.81	100.36
Prob > F	0	0	Prob > X ²	0	0	Prob > X ²	0	0
			Log pseudo-likelihood	-213.96	-163.33	Log pseudo-likelihood	-72.20	-50.94

* Significant at 10 percent.

** Significant at 5 percent.

*** Significant at 1 percent.

^a Robust standard errors are in parentheses.

^b Standard errors are in parentheses.

Note: The dependent variable is average money laundering (see Appendix Table 17.1).

Source: IDB calculations.

Appendix Tables 17.3 and 17.4 present the results from reestimating the same empirical specifications separately for the effects of money laundering through banks (Appendix Table 17.3) and money laundering through nonbank channels (Appendix Table 17.4). The most important difference is related to the soundness

of banks; as expected, in most of the regressions, this variable appears to be statistically significant for money laundering through banks, but insignificant for money laundering through nonbank channels. This may explain why in Appendix Table 17.2, which uses the average of both, this variable is not statistically significant.

APPENDIX TABLE 17.3 | **DETERMINANTS OF MONEY LAUNDERING THROUGH BANKS**

Independent variable	Ordinary least squares ^a		Ordered probit ^a		Tobit ^b			
	1	2	3	4	5	6		
GDP (log)	-0.191 (0.08)**	-0.183 (0.13)	-0.293 (0.14)**	-0.341 (0.25)	-0.191 (0.08)**	-0.184 (0.11)*		
Soundness of banks	-0.165 (0.09)*	-0.142 (0.11)	-0.275 (0.15)*	-0.258 (0.19)	-0.171 (0.06)***	-0.155 (0.07)**		
Effectiveness of law-making bodies	-0.508 (0.07)***	-0.473 (0.09)***	-0.847 (0.13)***	-0.844 (0.16)***	-0.524 (0.07)***	-0.478 (0.08)***		
Pervasiveness of insider trading	0.139 (0.08)*	0.137 (0.09)	0.237 (0.13)*	0.314 (0.14)**	0.140 (0.08)*	0.145 (0.08)*		
Stock market total value traded to GDP	1.391 (0.50)***	1.320 (0.50)**	2.361 (0.83)***	2.365 (0.87)***	1.499 (0.63)**	1.368 (0.61)**		
Unofficial economy		0.006 (0.01)		0.008 (0.01)		0.005 (0.01)		
GDP growth (percent)	0.017 (0.02)	0.005 (0.02)	0.032 (0.02)	0.016 (0.03)	0.017 (0.02)	0.007 (0.02)		
Constant	8.805 (0.91)***	8.327 (1.37)***			8.915 (0.91)***	8.423 (1.19)***		
Observations	73	58	Observations	73	58	Observations	73	58
R ²	0.78	0.81	Pseudo R ²	0.22	0.25	Pseudo R ²	0.44	0.48
F	64.37	56.33	Wald X ²	116.3	84.04	LR X ²	109.98	96.01
Prob > F	0	0	Prob > X ²	0	0	Prob > X ²	0	0
			Log pseudo-likelihood	-189.29	-139.86	Log pseudo-likelihood	-70.38	-51.32

* Significant at 10 percent.
** Significant at 5 percent.
*** Significant at 1 percent.
^a Robust standard errors are in parentheses.
^b Standard errors are in parentheses.

Note: The dependent variable is average money laundering (see Appendix Table 17.1).
Source: IDB calculations.

APPENDIX TABLE 17.4 DETERMINANTS OF MONEY LAUNDERING THROUGH NONBANK CHANNELS

Independent variable	Ordinary least squares ^a		Ordered probit ^a		Tobit ^b			
	1	2	3	4	5	6		
GDP (log)	-0.297 (0.10)***	-0.3149 (0.13)**	-0.398 (0.14)***	-0.480 (0.21)**	-0.303 (0.09)***	-0.339 (0.13)***		
Soundness of banks	-0.024 (0.09)	-0.0138 (0.11)	-0.069 (0.13)	-0.085 (0.19)	-0.022 (0.07)	-0.009 (0.08)		
Effectiveness of law-making bodies	-0.601 (0.10)***	-0.5624 (0.10)***	-0.830 (0.13)***	-0.879 (0.15)***	-0.610 (0.08)***	-0.592 (0.10)***		
Pervasiveness of insider trading	0.210 (0.09)**	0.2265 (0.10)**	0.201 (0.14)	0.275 (0.15)*	0.205 (0.09)**	0.245 (0.10)**		
Stock market total value traded to GDP	1.047 (0.53)*	0.8831 (0.44)**	1.510 (0.64)**	1.552 (0.66)**	1.098 (0.73)	1.113 (0.71)		
Unofficial economy		0.0006 (0.01)		-0.001 (0.01)		-0.001 (0.01)		
GDP growth (percent)	-0.021 (0.01)	-0.0217 (0.02)	-0.020 (0.02)	-0.024 (0.02)	-0.020 (0.02)	-0.019 (0.02)		
Constant	9.8830 (1.13)***	9.7483 (1.50)***			9.989 (1.05)***	9.973 (1.39)***		
Observations	73	58	Observations	73	58	Observations	73	58
R ²	0.76	0.81	Pseudo R ²	0.20	0.22	Pseudo R ²	0.38	0.42
F	83.85	66.95	Wald X ²	144.53	99.13	LR X ²	103.64	90.55
Prob > F	0	0	Prob > X ²	00		Prob > X ²	0	0
			Log pseudo-likelihood	-193.48	-146.89	Log pseudo-likelihood	-81.73	-60.39

* Significant at 10 percent.

** Significant at 5 percent.

*** Significant at 1 percent.

^a Robust standard errors are in parentheses.

^b Standard errors are in parentheses.

Note: The dependent variable is average money laundering (see Appendix Table 17.1).

Source: IDB calculations.