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DRUG MONEY IN A CHANGING WORLD:

ECONOMIC REFORM AND CRIMINAL FINANCE

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INTRODUCTION

Over the past decade, a virtual consensus on the market has emerged. While debate continues between differing schools of thought, hardline critics of liberal economic ideology have grown reticent due to the discrediting of the socialist model of economic growth. One reflection of this trend is the embrace of market reforms by developing and formerly socialist countries. The ongoing transfer of allocative influence to the market has exposed a need to ensure that reliance on market forces is not exploited by actors involved in illegal activities. This paper examines one such kind of actor: the drug-trafficking organization. It explains why the welcome reforms introduced by governments throughout the world could be exploited by those who have profited from the international drug trade. The need to safeguard the reform process from criminal elements has never been greater.

The aim of this paper is to explain why drug traffickers may be attracted to short-term investment opportunities in economies undergoing reform. It is widely accepted that drug trafficking organizations have considerable cash reserves at their disposal. With the advent of tighter banking controls, drug traffickers face increasing difficulty in laundering those funds for use in the legitimate economy, particularly in traditional money-laundering "safe havens." It is thus significant that in reforming economies, governments have sought to achieve stability by reducing money supply growth and reining in public expenditures; as a result, both consumers and companies in these reforming economies may find difficulty in conducting business as usual. The wealthy drug trafficker faces a sectoral niche with high profit potential.

With regard to the structure of the paper, Chapter I considers how drug traffickers, who face increasing difficulty in laundering their earnings in established safe havens, could exploit macroeconomic stabilization and structural adjustment programmes.

Chapter II is a case study which uses the concepts developed in Chapter I to examine the initial phase of Russian economic reform, which began in 1992.

I. Macroeconomic Stabilization, Structural Adjustment and Criminal Finance

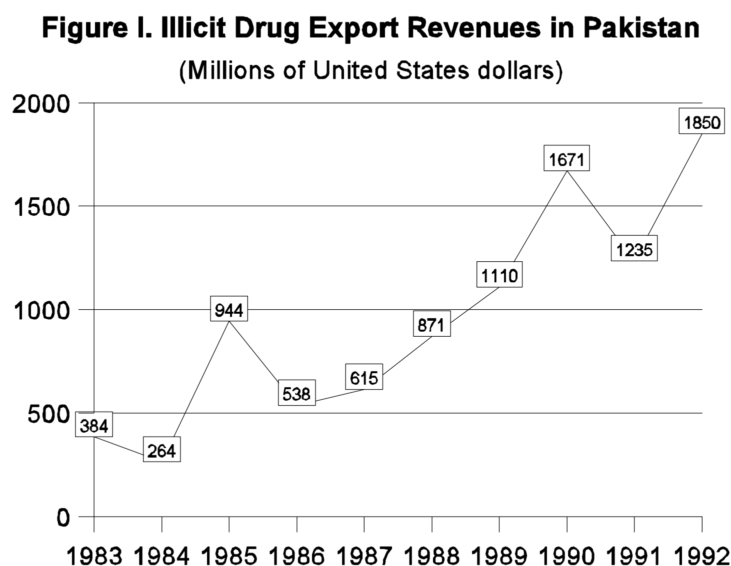
Together, liquidity from the drug trade and reform-induced austerity go far in explaining the supply side and demand side of the transactions investigated in this paper. Anecdotal evidence indicates that illicit drug revenues represent a substantial portion of the financial reserves available to criminal organizations. A 1993 study by the Organization of American States concluded that about $US250 billion laundered annually derives from the illicit drug trade.[1] The Financial Action Task Force, established by the G-7 Summit in Paris of 1989, estimates that the illicit sale of cocaine, heroin and cannabis amounts to about US$120 billion annually in the USA and Europe, of which US$85 billion could be available for laundering.[2] The United Nations, in a study highlighting the relationship between drugs and development, asserts that the annual turnover in the drug trade could be as high as US$500 billion.[3] Conservative estimates place the volume of the illicit drug trade at $100 billion.[4]

It is necessary to clarify at the outset that the concepts described in this paper apply to countries with a narrowly defined profile. The entity in which the macroeconomic effects of criminal finance are most likely to be felt is a small, open economy in which there is a large volume of drug-related financial activity. Granted, the number of countries which fit this narrow profile is small indeed. At the same time, it should be pointed out that while the macroeconomic effects of criminal financing may be limited, the actual practice of criminal financing will most likely become an increasingly prominent activity in countries with liberal, market economies.

Studies have sought to document the level of drug-related earnings at the country level. For example, it is estimated that in 1993, expenditure on drugs amounted to 3.3 percent of Pakistan's gross domestic product.[5] Illicit retail drug transactions amounted to about Rs 33 billion, or about US$ 1.1 billion dollars. In terms of revenues generated by the export of heroin in Pakistan, it is estimated that between US$800 million and US$1.8 billion (see figure I).

Figure I. Illicit Drug Export Revenues in Pakistan

(Millions of United States dollars)



Source: UNDCP, International Monetary Fund, State Bank of Pakistan

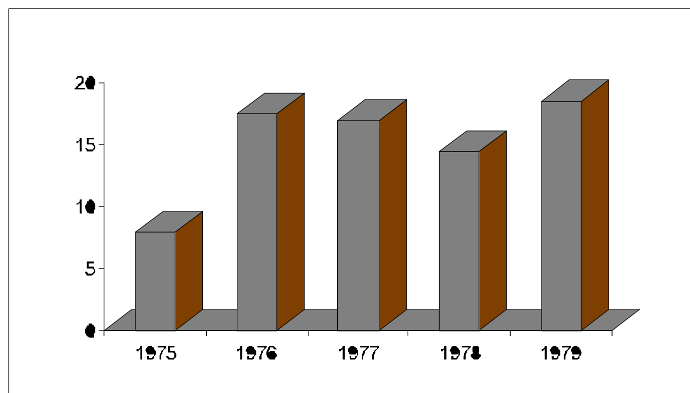
Table 1 (and figure II) below presents one estimate of the volume of drug-related earnings in the Colombian money supply from 1975-1979. It should be emphasized, however, that the estimate is unconfirmed.

Table 1. Drug-Related Capital Inflows as a Percentage of Colombian Money Supply, 1975-1979

Year	*United States dollars (millions)*	*Colombian pesos (billions)*	*Percentage of money supply*
1975	150	4.6	7.9
1976	400	13.6	17.5
1977	450	16.6	17.0
1978	500	19.6	14.5
1979	600-700	25.6-29.8	16.4-19.7

Source: Diego Asencio, United States Ambassador to Colombia; in report to the Illegal Narcotics Profits Hearings of the Ninety-sixth Congress, Senate Committee on Governmental Affairs, Permanent Subcommittee on Investigation, 12 December 1979 (see Pino Arlacchi, *Mafia Business* (London, Verso, 1986), p. 22).

Figure II. Drug Money as percentage of Colombian money supply, 1975-1979



According to the chart, drug-related inflows in Colombia in 1979 amounted to some US$600-700, or about 20 percent of the domestic money supply. In addition to the volume of drug money, it is also significant that much of the wealth accumulated by drug traffickers is in the form of United States dollars. If all outstanding US currency notes were held domestically in the United States, the typical American family of four would have currency holdings of US$4,600 at any given time, which is clearly not the case.[6] More likely, the bulk of the US$300 billion of US currency is held abroad, much of it by drug traffickers. These dollar holdings can represent a major problem. For central bank authorities, the basis on which to assess the demand and supply for local currency - an important factor in setting interest rates - is distorted. At the aggregate level, the increase in the level of foreign monies will create a source of monetary expansion which could offset reductions from stricter control of the money supply.

One factor which may motivate criminal organizations to expand lending operations in reforming economies is that, by directly lending hard currency to domestic borrowers, the repayment in local currency

allows the drug-trafficker to launder drug monies without going through the formal banking system. Cash-holdings smuggled into the reforming economy will probably have a high premium because of the rapidly depreciating local currency. As financial authorities develop and enforce money laundering laws, this direct-lending option will become increasingly attractive to criminal organizations.

Macroeconomic Stabilization

Two inter-related problems are commonly addressed in macroeconomic stabilization programmes: persistent balance of payments (BOP) deficits and high inflation. Efforts to achieve BOP stability often aim to reduce the external deficit by reducing the level of domestic consumption. Macroeconomic stabilization often requires a reduction in expenditure by government and/or the private sector.

In situations of reduced money growth, an infusion of hard currency can bolster a country's foreign reserves, ease the hardship associated with expenditure-reducing policies, and moderate foreign indebtedness. Drug money could in this light be perceived as a potentially stabilizing force, a source of capital without the strings of conditionality attached. Clearly, there are "benefits" which accrue to countries which serve as reservoirs of the revenues from the international drug trade. But there are also myriad costs involved. One difference between official borrowing and criminal hard-currency investment is that the former can be controlled by government. Whereas government can regulate the use of hard currency borrowings - perhaps to finance essential imports - criminal financing flows along hidden channels far beyond government control. Spending behavior becomes influenced not only by the official money supply but by the infusion of informal credit as well. In turn, the demand for money in the official banking system reflects only a part of domestic economic activity. Interest rates become less useful as a barometer of money demand and government has less accurate information on which to base fiscal and monetary policies.

In an unstable economy, local currency may be rapidly losing its value to hard currencies such as the US dollar. In many such economies, foreign monies may be the preferred means of transaction. Funds introduced by the drug trafficker will ultimately be exchanged for local currency, thus allowing central authorities to fix the parity between the two currencies. But that point in time may well come long after myriad transactions have been made possible because of, and with, the foreign monies. Indeed, when criminal money fills the void left by reduced money growth, high inflation may persist due to the carry-over of earlier spending behavior. In the short term, criminal money can act as a proxy for domestic currency.

While there is little empirical proof suggesting the large-scale presence of criminal financing arrangements, informal and sometimes illegal credit markets have been known to operate in the past. When economic reforms create unmet credit need among firms, innovative, unofficial, and illegal means of financing proliferate. Tun Wai (1978) has found that during periods of credit rationing, the role of informal sources of liquidity in China rises.[7] A tight monetary policy imposed on and off since 1988 has contributed to a situation in which collecting receivables for many firms has become a major problem.[8] As a result, triangular debt arrangements have proliferated as indebted state companies, unable to pay creditors, miss payment to lenders, which pass on cash flow problems to suppliers. This trend has coincided with a gradual loosening of the banking industry. Inter-bank lending to the commercial banks' affiliates has become a primary vehicle for irregular lending practices.[9] Increasingly, cases are being exposed in which funds are used not for short-term balancing purposes but for fixed asset financing, real estate purchases, and working capital.[10] In the country's expanding capital markets, bond issuance has also become an increasingly prominent instrument for illegal fund-raising.[11] It was reported that in 1993, some state and private companies took advantage of the more liberal economic climate to issue unauthorized bonds and divert money from the Treasury's fund-raising efforts.[12]

In Viet Nam, the number of informal credit cooperatives has grown rapidly since 1988, due to the failure of the state-run banks to channel credit to non-state enterprises. A brief summary of events demonstrates the powerful influence of credit cooperatives in the country. In 1989, despite government declarations to end preferential treatment, most official credit continued to go exclusively to state enterprises.[13] Non-state enterprises had few options to turn to, other than informal credit cooperatives. Informal credit cooperatives offered deposit rates as much as four times those offered by the banks, and it eventually became clear that they could do so only because they were operating pyramid schemes. When this came to light, there was a run on the cooperatives, and an estimated 2,000 quickly went bankrupt. So great was the fallout that there was a sudden slowdown in the growth of private enterprises which had quadrupled from 318 new firms to 1,284 from 1988-1989 only to fall back to 770 in 1990. Private sector growth fell from 30 percent to 0.2 percent, due to the collapse of the informal credit coops.

In Russia, as well, informal financing arrangements have appeared in response to structural economic change. Shelley explains that due to the absence of three elements - effective banking regulation, a functioning stock market, and a legitimate system of venture capital -illegal financing arrangements are believed to have emerged in the former Soviet Union.[14] Russian legislation introduced in the late 1980s legalized private cooperatives to organize and run enterprises like restaurants. The 1988 Law on Cooperatives asserted that shares in enterprises could be owned by individuals employed by coops. However, in response to runaway inflation, and contraction in Russian output, many cooperatives have been forced to turn to illicitly acquired resources, estimated by Shelley at 20-25 percent of all privately held assets.

Informal financing arrangements can in theory prolong the adjustment process because of their impact on inflationary expectations. The effect on prices can be seen from both a supply and a demand side. On the demand side, criminal money can keep nominal income high - that is if the economy in question is small, relatively open, and inundated with criminal funds. In addition to the high demand for goods and services, continuing consumer demand for money balances keeps interest rates high. One obvious way in which criminal organizations can trigger this turn of events is by way of expanding loan-sharking operations. They can also invest by buying up assets which individuals may not be able to unload through official channels. Otherwise unappealing property or enterprises may be purchased because they provide an outlet for criminal organizations to increase their share of the local market. In Colombia, it is believed that the Medellín group in the late 1980s bought large tracts of land, pushing up prices from about US$500 to US$2,000 per hectare.[15]

Financial Market Liberalization

Financial liberalization generally implies a process by which the government relaxes its managerial control over banking activities. This entails freeing commercial interest rates to reflect the true cost of money, discontinuing selective lending to politically favored industries, and allowing new entrants into the industry as well as bankruptcies. Cameron describes the rationale for liberalization in this light:

> "If a banking system is to be effective in contributing to industrial capital formation, the government must assure minimal conditions of both financial and political order and refrain from ad hoc interference that increases uncertainty for long-range investment planning. Where banking is left most free to develop in response to the demand for its services, it produces the best results. Restrictions on freedom of entry almost always reduce the quantity and quality of financial services available to the economy, and thus hinder or distort economic growth. Competition in banking, on the other hand, acts as a spur to the mobilization of idle financial resources and to their efficient utilization in commerce and industry."[16]

Financial liberalization - or reform of the domestic banking industry - appears to have three recurring effects in many diverse economies. Financial liberalization:

a) Curtails the availability of loans.

b) Raises the cost of borrowing.

c) Reduces the returns which savers receive on deposits.

In Poland, reform of the banking industry was launched in 1989 when the central bank relinquished 99 percent of commercial activities to private sector. Subsequently, the presence of western banks expanded, from 25 to 100 by January 1993.[17] Unlike foreign subsidiaries, many domestic banks were burdened by non-performing loans to state industry. A study on the banking industry found bad debt problems were concentrated in 11 percent of Polish enterprises which accounted for 61 percent of total bank debt[*]. Market reforms brought with it the need to improve productivity and competitiveness. Bank training and computerization costs rose accordingly. Banks responded by reducing lending to the private sector, choosing to invest deposits in less risky but lower-margin government bonds.

In Hungary, reform of the banking sector was launched in 1987 with the introduction of a two-tier banking system which abolished the monopoly of National Bank.[18] In October 1990, foreign banks were allowed to set up retail services. By 1991, there were 37 Hungarian commercial banks, 16 with foreign participation. In early 1992, a new law took effect requiring a minimum risk-weighted capital adequacy ratio of at least 8 percent for all banks; this coincided with passage of a harsh bankruptcy law stipulating that any private firm which defaulted on payments for more than 90 days would be automatically declared bankrupt. This resulted in a severe weakening in the loan portfolios of commercial banks. About 70 percent of outstanding commercial loans were non-performing. The result was that banks severely cut back lending: what followed was a major reduction in credit, with high borrowing rates.

Mexico's 18 state-owned banks were privatized between 1991-1992.[19] Private investors paid $12.4 billion for the banks but optimistic forecasts on growth turned out to be wrong. Loan losses increased sharply and profitability began to fall as measured by return on assets or equity. Bank's previous lending went almost completely to government, but after liberalization, lending to private sector began to rise, despite inexperience in lending to individuals and firms. Despite rapid growth in private lending (327 percent from 1989 to 1992), the spreads between lending and borrowing remain high. Typical spreads of 10-12 percentage points are common.

In China, reform of the financial system is underway but the banking industry is still dominated by official intervention. The government directs bank lending to state enterprise with tight control on competition. As the system has grown more sophisticated and complex over the past five years, the inherent flaws in state-run banking have become more obvious. Up to 30 percent of bank loans to state enterprises are believed to be non-performing.[20] The biggest problem facing commercial banks is the extensive volume of debt held by weak state enterprises. One third of state-owned industries are registering losses.[21] There has been a mushrooming of illegal lending to non-bank financial institutions due to lax regulation and lack of competition for deposits. Unrestrained lending by banks has been one of the key factors fueling domestic inflation.[22]

The examples just described allow for a few generalizations. Heavy state intervention and/or over-

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[*] Reported in "Financial Times Survey: Poland", The Financial Times, 17 June 1993, regarding study by Stanislaw Gomulka of the London School of Economics

generous lending terms are common attributes in pre-reform economies. Furthermore, in an inefficient financial market, transaction costs can rise to levels which are untenable in a competitive market. A major component of high transaction costs consists of the loss due to loan repayment delays, delinquency, and default. This loss is often due to permissive and state-controlled lending policies. In 1986, the World Bank found that financial institutions in uncompetitive markets frequently make inadequate provisions for loan losses[*]. Domestic banks may face of a back-log of non-performing assets and thus may not have the capital base necessary to make loans in a competitive market. As a result, there is a tapering-off of lending volume. Borrowers - both creditworthy and not - suffer the consequences as banks reassess and gradually restructure lending portfolios. Lending rates rise since banks have greater discretionary authority to control the rates they charge. It is conceivable that banks could simply make up their losses by raising rates, given that the demand for credit is inelastic. However, there is also the enhanced competition to consider: the interest rate elasticity of demand for credit has risen. Raising lending rates is constrained since borrowers have more freedom to exploit market-determined interest rates.

For many borrowers-in-need, the only alternative is to retrench and ride out the storm as lending portfolios are restructured with greater attention to the creditworthiness of borrowers. When the market-clearing deposit rate is not sufficiently appealing, depositors may decide not to use banks at all, purchasing financial assets like securities.

Reduced lending volumes leave liquidity-strapped firms and individuals with three options; seek government support, reduce operations, or seek informal credit. These three options offer official credit institutions no market opening. Informal lenders can claim a significant share of the money market.

Criminal lenders enjoy distinct advantages over their legal counterparts:

a) The criminal lender does not carry a backlog of non-performing loans which burden the lending portfolios of domestically-based banks. Thus, their transactions costs are lower.

b) The criminal lender can freely discriminate among borrowers, i.e., he may impose differing lending rates in order to extract the maximum amount of "rent" from each borrower.

c) The criminal lender can play borrowers off against one another in order to extract personal information on borrowers' creditworthiness. With such information, the criminal lender can avoid making bad loans.

d) The criminal lender can use violence to ensure repayment.

In assessing the advantages of the criminal lender, it is relevant to ask why established international banks seek to set up subsidiaries in economies-in- transition. In these economies, the inability of domestic suppliers to provide the good in question - in this case loans - leaves both demand and prices- in this case, interest rates - high. Like international banks, incoming criminal lenders do not suffer the heavy costs of non-performing loans which burden domestically-based banks. In the short term, therefore, until domestic lending-portfolios are restructured, the new entrants will enjoy a distinct advantage: they can "free-ride" by profiting from the higher lending rates while offering depositors more appealing deposit rates. As long as average costs

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[*] The World Bank calculated that the average return on assets for its sample group would have been negative had default costs been accounted for. It found that the median arrears rate for loan repayment was 41 percent for its target group (see World Bank, World Development Report 1986, (New York: Oxford University Press, 1986)).

remain below the lending rate, profits are to be made, and this will attract new entrants. Until domestic banks recover, or until the level of credit rises to bring down the market interest rate, those rates will remain high due to scarcity. For those incoming lenders willing to endure the political risk involved, there are considerable profit margins.

What this implies is that the criminal lender has access to an untapped market characterized not only by high-risk, "morally-hazardous" borrowers, but by credit-worthy firms and individuals as well. This has certain implications for the way in which criminal lenders can influence the interest rate in the informal market. That some borrowers are no less of a credit risk than those receiving loans in the formal credit market means that there is no need to impose a risk premium. In other words, the rates charged by criminal organizations may be at or near the level charged by formal lending institutions. By offering rates slightly below the obtaining market rate, the criminal organization can still earn substantial profits.

But even at the obtaining market rate, the criminal lender will earn more profit than official lending institutions. This is so for several reasons. First of all, the criminal lender's costs will be lower than locally-based credit institutions for the reasons mentioned above. In addition, given that the informal market does not have the legal constraints confronting formal lending institutions, the criminal lender has the freedom to discriminate among borrowers, exacting the maximum amount of rent from each. In the legal credit market, laws prevent banks from charging differing rates to individual customers based on customer-specific criteria. In the illegal market however, such laws do not exist. The criminal lender may discriminate if the three prerequisites for effective price discrimination are fulfilled: customers are dealt with separately, they are ready to pay differing prices, and the criminal lender has the market power to exploit this willingness. The criminal organization enjoys two other advantages which allow it a high profit margin. These advantages are its ability to acquire better credit information on the borrower and its ability to use violence to ensure compliance with the terms of the loan. In many reforming economies, the costs of information regarding prospective borrowers is extremely high; access to personal credit histories, a basic element of money markets in developed economies, is expensive. By relying on personal contacts which are familiar with the would-be borrower, criminal organizations will be able to minimize the volume of bad debt. Both advantages allow the criminal investor to minimize the "moral hazard" facing other credit institutions.

Capital Account Convertibility

Capital account convertibility means that the reforming economy is opening its borders to the two-way flow of finance. Recorded levels of private investment into reforming economies have more than doubled since 1990. The reason for this trend is the following; many countries are putting their macroeconomic houses in order.

Like other investors, criminal organizations will increasingly invest in developing and formerly socialist countries. Throughout the 1990s, real aggregate net resource flows to developing countries have reached their highest levels for decades, due in large part to the tremendous growth in private flows (bond issues, foreign direct investment, and equity portfolio investment).

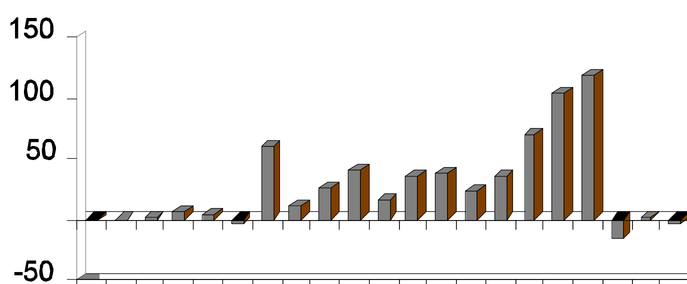
Between 1990 and 1993, private capital flows to the developing world rose more than 250 percent, for the first time surpassing the volume of official flows.[23] FDI flows were estimated at more than US$56 billion in 1993, with China attracting by far the largest share, approximately US$15 billion. Much of the resource flows were directed to a comparatively small number of countries (mainly middle-income countries)[*]. Several

[*]Regionally, East Asia is by far the main recipient, followed by Latin America. Sub-Saharan Africa has received negligible inflows, and when commercial bank disinvestment is taken into account, the figure is

factors explain why, including: improved macroeconomic performance, the poor investment climate in industrialized economies, increasing global and regional trade integration, and flourishing privatization.

The improved macroeconomic environment in reforming economies is captured also by the reversal of capital flight flows. For 1989-1991, flows of repatriated flight capital are estimated to have reached US$21 billion. The following graph demonstrates the sharp reversal in flows of capital flight which has coincided with the improving macroeconomic environment in developing countries.

Figure III. Capital flight from developing countries, 1971-1991
(Billions of United States dollars)



Source: World Bank, *World Debt Tables* 1993-1994 (Washington, D.C., 1993), p.5).

There are two points to emphasize. First, the effectiveness of capital controls in stemming outflows from weak economies has been questionable at best. Second, the reason for this hinged on the allocative influence of perceptions regarding the host country's macroeconomic stability and domestic market potential. The reversal in the macroeconomic scenario in many countries is the main attracting force for capital inflows. This is due in large part to the reversal in perceptions regarding opportunities for profit. It is unlikely that drug trafficking organizations will fail to recognize the promising investment opportunities which have emerged in the developing world.

As macroeconomic disequilibria triggered capital outflows in the past, so repatriated capital flight could be attributed to improvements in the domestic macroeconomic environment. In some cases, capital account convertibility can, in itself, create incentives which would appeal to the criminal investor. These incentives include

(a) A real exchange rate appreciation, which would allow the value of the domestic currency (and the value of the illegal investment in that currency) to rise during the lifetime of the investment**.

negative (World Bank, World Debt Tables, 1993-1994 (Washington, D.C., 1993),p.5).

**A real exchange rate appreciation takes place when the value of the domestic currency rises at a pace which outstrips the domestic inflation rate. In effect, a given unit of currency can buy more goods as time

(b) Higher real interest rates, which make the costs of borrowing very high for domestic investors. This would allow the criminal lender to profit from by offering competitive rates in the informal sector.

Empirical evidence points to an interesting correlation between capital flight and macroeconomic disequilibrium. Mathieson and Rojas-Suarez (1992) found that the variable of capital controls had only a weak correlation with the stock of capital flight.[24] They concluded that rather than capital controls, it was default risk perceptions held by domestic money-holders which had the closest correlation with the stock of capital flight. In other words, public perceptions of the stability and sustainability of economic activity (in particular, the ability of government to sustain the level of its debt commitments) was a crucial factor affecting outflows.

When macroeconomic imbalances remain, one result from liberalization is capital flight. In the Southern Cone of the 1970s, for example, Argentina (1976), Chile (1976), and Uruguay (1974) opened up their capital accounts without fully or effectively addressing macroeconomic disequilibria like inflation. As a result, their currencies appreciated rapidly in real terms as inflation surpassed the scheduled rate of depreciation.

Mexico, in the late 1980s reacted differently to the waning credibility of its reform programme. After a large devaluation in December 1987 and a smaller one in 1988, it fixed the nominal value of the peso for the rest of 1988. However, similar to the other three countries cited, the peso continued to appreciate in real terms even though inflation had been reduced sharply.[25] Furthermore, there was a sharp increase in the peso-US dollar interest rate spread in favor of peso-dominated assets, auguring a further appreciation. Mexico responded by announcing a fixed rate of depreciation at 1 peso per day from January 1989 to May 1990, together with an intensification of its fiscal adjustment. Beneficial debt-reduction agreements lent further credibility to the reform programme, allowing a fall in real interest rates. With a lower perceived default risk, policy credibility was maintained. The key was that, until the pressure was renewed in late 1994, the Government was able to restore public confidence in its ability to adhere to macroeconomic targets.

Like multinational corporations, criminal organizations will recognize the importance of macroeconomic variables. Perceptions of present and future trends in interest rate differentials, exchange rates, and inflation affect the decisions of all successful international portfolio investors. In the context of incentives, we turn to several other important findings of the Mathieson and Rojas-Suarez study. They identified two common consequences of capital account liberalization. First, they found that liberalization was often associated with a real exchange rate appreciation. The appreciation occurred despite major differences between countries in their exchange rate arrangements, the speed of liberalization, and the ultimate sustainability of the open account. Even the question as to whether there was a net inflow or outflow was statistically irrelevant. Second, they found that capital liberalization frequently gave way to high real interest rates. The World Bank as well cites the concern of host-country policymakers regarding the possibility of real exchange rate appreciation.[26] The Bank warns that the over-reliance on sterilized intervention can lead to a rise in interest rates, providing an incentive for capital inflows.

Privatization

According to the World Bank, foreign direct investment from privatization amounted to nearly US$15 billion from 1988-1992, amounting to nearly 10 percent of all FDI into reforming economies.[27] Privatization has been particularly important as a catalyst for FDI in Europe, Central Asia, and Latin America and the Caribbean. In fact, in Eastern Europe and Central Asia, it has been the principle instrument to attract foreign

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goes on, and thus, its "real" value has risen.

investment, amounting to nearly 40 percent of the total FDI in 1992*. When privatization efforts are undertaken without adequate screening measures, criminal organizations can participate like any other buyer.

Segments of the economy dominated by criminal entrepreneurs would be insulated from market-oriented stimuli. Whereas legal enterprises normally make their allocative decisions in response to such stimuli; the criminal entrepreneur may not**. The criminal enterprise will act in response to stimuli other than conventional business indicators. But the criminal entrepreneur will use distinct means to maximize profit. The criminal proprietor will occasionally shift output and pricing patterns according to non-economic factors - like fleeing a police crackdown or changing investment locations because of the passage of constraining legislation. In addition, the criminal proprietor will exploit inherently illegal means of conducting business, including violence and extortion. These divergences from purely economic motivations suggest that the market mechanism will not function as effectively with a large-scale criminal presence in the economy. Criminal entrepreneurship in the local economy also introduces a parasitic, anti-competitive approach to doing business. The Italian mafia has demonstrated three strengths which apply to most criminal organizations. Arlacchi (1986) argues that the mafia's "success" in the South of Italy was due to three reasons. First, the mafia demonstrated an exceptional ability to use intimidation as a kind of non-tariff barrier.[28] The intimidation factor is explicit at early stages of criminal establishment. Once the mafia's ability to coerce is recognized by local competitors, violence becomes less prominent as a bargaining instrument. Reuter distinguishes between the effectiveness of violence in a competitive versus a non-competitive environment.

> "If the market is perfectly competitive, violence can only arise from miscalculation. Lacking pricing discretion or territoriality, no competitor will have an incentive to act against another entrepreneur on these grounds, since the elimination of a single competitor will not add significantly to his market power. For non-cartel oligopolies the case for continued competitive violence is clear. Elimination of a rival will add significantly to the market share and profitability of the aggressor. Only to the extent that it will lead to either increased law enforcement efforts or to defensive combinations by other oligopolists, will there exist a structure-specific disincentive to the use of competitive violence."[29]

Adam et. al studied seven reforming economies and found that many of the enterprises privatized were in fact dominant. Their findings led them to the following conclusion:

> "On competitiveness, much of the debate takes the privatization of monopolies as the exception to the norm. In many smaller developing economies, however, the nature of the domestic private sector and the limits to foreign competition mean that the converse holds: across a wide range of economies, state-owned enterprises are either

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*In East Asia and Sub-Saharan Africa, privatization has contributed minimally to overall FDI flows, amounting to 1.5 percent and 2.7 percent, respectively. (World Debt Tables 1993-1994, p.61 .

**Neoclassical price theory fails to provide any rationale as to why private ownership should lead to efficiency gains over public ownership. This void is filled by the so-called property rights school, which is concerned with the relationship between ownership rights, incentives, and economic efficiency. It asserts that in a classical firm which operates in a highly competitive atmosphere, the property rights of owners are clear-cut, strong, and direct. The discretionary decision-making ability of the firm manager is limited. Managers are prevented from diverting resources to their own ends. On the other hand, in a large, limited-liability corporation, the property rights of the owner do not have such a direct influence on managerial decision-making. Managers have more freedom to further their own interests. Privatization, by establishing a closer link between management and ownership, is expected to lead to greater efficiency.

the dominant firms in their markets or between them wield considerable oligopoly power."[30]

In fact, the study found the following statistics indicating a strong concentration of market power in the hands of relatively concentrated group of manufacturers:*

The findings in the table are significant in one respect: they demonstrate that at least insofar as the manufacturing sector is concerned, there is a high degree of market concentration in several reforming economies. The study concluded that privatization often failed to dilute this market concentration.

Table 2. Size of, and concentration in, the domestic manufacturing sector
(percentages)

Country	*Share of manufacturing in GDP*	*Capacity utilization*	*EPR*[a]	*Employment*[b]	*Market concentration*[c]
Jamaica	22	60	75	16	-
Kenya	11	40-90	30	13	65
Malawi	11	45	140	8	89
Malaysia	24	85	14	18	16
Papua New Guinea	9	-	-	10	80
Sri Lanka	16	-	100	12	90
Trinidad and Tobago	10	-	-	13	57

Sources: Cristopher Adam, William Cavendish and Percy S. Mistry, *Adjusting Privatization: Case-Studies from Developing Countries* (London, James Curry Ltd., 1992).

[a]Effective protection rates based on average rates across all sectors.
[b]Manufacturing employment as percentage of total.
[c]Market concentration ratios defined as proportion of employees in firms with less than 50 employees (Malaysia, Papua New Guinea, Sri Lanka); sales concentration ratios based on Hirfindahl index (Kenya, Malawi, Trinidad and Tobago).

The second competitive advantage of the mafia was its ability to repress wage rises. This was possible through the evasion of social security and insurance contributions as well as the lack of overtime pay commitments. Arlacchi examined various mafia-run firms and found that the typical medium-sized or small firm was characterized by constant monitoring of the workers' lives even after working hours.[31] This served to discourage any kind of wage-related protest; for example, mafia-hired olive-workers were found to receive 50 percent less than the contractual rate.[32] With regard to the workforce, Arlacchi explains that,

*It should be pointed out that the last column of the table showing market concentration is based on two divergent measurements. For Malaysia, Papua New Guinea, and Sri Lanka, market concentration is defined as proportion of employees in firms with less than 50 employees. Therefore, of the three, Malaysia shows the *highest* degree of market concentration. The other countries Kenya, Malawi, and Trinidad & Tobago) use the Herfindahl index for which a higher number shows a degree of market concentration.

> "In many firms, a good proportion of the company personnel consists of common criminals, people bound over by the police, those under special surveillance, and ex-convicts: these people are either members of the same [kin] as the mafioso-entrepreneur, and thus share close bonds of mutual interest, or they are linked to him by the fact that only he will give them work...The mafia firm, then, being very often a cohesive rather than conflictual group, is very well adapted to compete in the market."[33]

The third competitive advantage was the mafia's access to financial resources. Rather than turning to the banking system for its financial needs, the mafia was able to rely on its treasure-chest of illegal revenues:

> "The considerable capital sums acquired in the course of the mafia's illegal activity did in fact tend to be transfused into its legal entrepreneurial operations. By far the greater part of these sums was made in operations conducted outside the market in which the mafia firm traded. (The mafia) had access to a reserve of its own finance capital that far exceeded the firms's own present dimensions -and far exceeded what was available to non-mafia firms, which often found themselves squeezed by lack of credit and therefore subordinated to finance capital."[34]

There is reason to believe that criminal purchase of state-owned assets is well-underway. Criminal involvement in Cali has led to one crucial yet rarely noted development: the perceptions among the public have changed markedly in support of the criminal investors which are seen as the harbingers of prosperity for the communities which they infiltrate. One study asserts that the main effect of the illicit drug industry in Colombia "has been its catalytic impact that accelerated the delegitimation process".[35]

II. Case Study: criminal exploitation of economic reform in the Russian Federation

In the Russian Federation, domestically-based criminal organizations have staked out particular niches - car thefts, prostitution, etc. - in the illegal market. Competition in the illegal market is most likely too extensive for expatriate organizations to start-up operations without at least establishing an alliance with a local counterpart. In terms of liquidity, given the rampant extortion throughout the urban centers of Russia, it is likely that these organizations already have access to sizable cash reserves. It was recently reported that most retail trade booths, stores, cafés and restaurants in Moscow paid protection money to criminal groups.[36] Given the expanding drug-trafficking networks in the region, criminal reserves will continue to grow. In order to grasp the potential for criminal finance in Russia, it may be useful to recount some of the major events in the Russian economic reform process. There are three distinct phases in the reform programme of the Russian Federation:

(a) The pre-1992 phase, when macroeconomic trends reached the point of crisis.

(b)The period from winter 1992 to fall 1993, when the government embarked on a pseudo-reform programme which tended to aggravate rather than soothe the Russia's macroeconomic problems.

(c) The period from fall 1993 to fall 1994, during which the government, began to tighten monetary and fiscal policy.

Phase 1: pre-1992

An important phenomenon in the late 1980s was the growth in nominal income which far outpaced productivity advances and price increases.[37] This trend resulted in shortages and the accumulation of undesired money holdings. By 1990, average real wages were 27 percent higher than 1987 levels.

The year 1991 is therefore a good starting point, for that is the year when the then-Soviet leadership began to experiment with market-oriented concepts. By 1991, the divergence of nominal incomes from prices had become extreme. In January 1991, the government shifted many prices from the fixed to the "contractual" category, which were to some degree negotiable. In other words, the first stage in Russian price liberalization was launched. In addition to producer prices, some consumer prices were also quietly liberalized. Retail prices began to rise rapidly in April 1991.

Phase 2: January 1992 - October 1993

The government of the Russian Federation that entered office in November 1991 prepared a major liberalization plan which was, after some modification and postponement, launched on January 2, 1992. About 90 percent of retail prices and 80 percent of producer prices were then freed. Producer prices rose on average by 500 percent in January 1992, after having more than tripled in 1991. The overall rise meant that the producer price index had risen by about 3.4 times the consumer price index.

With higher input prices, firms were faced with mounting pressure to meet wage costs and inter-enterprise commitments. Inter-enterprise arrears began to rise in the first half of 1992 from less than 3 percent of broad money to more than 150 percent, or about 3 trillion roubles (R). By comparison, total outstanding credit to the banking system of the economy, except for credit to the government, was only about R2 trillion by the end of June 1992.

This buildup of arrears took place in steps. From December 1991 to March 1992, the level rose to R 640 billion while bank debts rose as well as tax arrears. Then, on April 1, 1992 the Russian Central Bank (CBR) set a new requirement that thereafter, all payments would have to be processed through its cash settlement centers. The subsequent slowdown in clearing payments triggered a surge in inter-enterprise arrears to a total of R 1.8 trillion. Furthermore, throughout early 1992, in order to fight rising inflation, the monetary authorities tried to reduce credit expansion and restrict increases in commercial bank borrowing from the CBR. As a result, many banks faced severe liquidity constraints, reducing the level of credit available to firms. The expansion in cheap official credit had two significant consequences.

(a) It fueled inflation and in this regard, even though the reform programme began in early 1992, Russian credit policies throughout 1992 actually worsened the macroeconomic problems at hand.

(b) Enterprises failed to adjust to the intended adjustment effect of price liberalization; with the provision of extra government credit, necessary adjustments were merely postponed.

An IMF report asserts that about one third of the overall rise in arrears was due to the continued rise in producer prices which confronted firms with an inability to finance production.[38] Inflation also provided a reason to delay payments. But an equally significant factor was the widely-shared expectation that monetary authorities would step in and settle all arrears in order to prevent far-reaching default. The absence of bankruptcy laws made it unlikely that the government would threaten bankruptcy or foreclosure, further fueling expectations of a bailout. The rise in firms' foreign currency holdings in 1992 provides further reason to assume that suspension of payments was nothing less than deliberate.

The expectation was that the government, as it had done in the past, would come to the rescue. In fact, in July 1992, the CBR instructed commercial banks to identify and meet unmet payment obligations of Russian state enterprises as well as other state enterprises within Russia. The level of arrears had reached R 3 billion by then. In turn, the Central Bank embarked on a massive four-month "bail-out"after which inter-enterprise arrears had been reduced to approximately R 450-480 billion. In the third quarter of 1992, bank credit rose by more than 100 percent and the final quarter, it rose further by 65 percent, due to an expansion of CBR lending to commercial banks. In 1992, the CBR provided a total of R 2.8 trillion worth of credit.

With cheap credit, firms were able to pay employees and meet many of their payment obligations - restructuring was in effect, made unnecessary. There was no sufficient incentive to adjust production and employment levels to new market conditions.

Phase 3: October 1993-October 1994

In late 1993, the CBR tightened credit by raising the discount rate charged to banks at a rate above inflation. In mid-1994, the rate was 13 percent a month for rouble borrowing from the Central Bank - double the rate of inflation.[39] Few commercial banks were borrowing at such high rates, translating into a liquidity vacuum for many firms. At August 1994, the Central Bank lending rate was 150 percent per year.[40] Commercial banks became highly selective in lending their own funds. They provided mainly short-term loans at high interest rates.[*]

In the last quarter of 1993, the average monthly growth of money as measured by M2 was reduced 12 percent, the lowest level since the reform programme was launched in 1992.[41] Money supply jumped in

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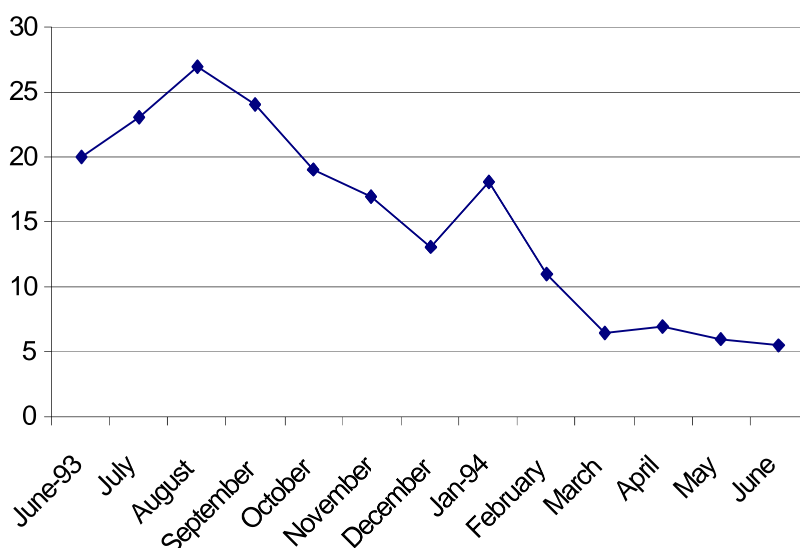
[*]Lending rates rose from 63 percent in July 1992 to nearly 100 percent at the end of 1992 to 105 percent in February 1993.

December 93, but fell sharply to 5 percent in January 1994.[42] M2 rose by 15.9 percent in March, but on average for the first four months of 1994, money supply grew by 10 percent a month.[43] In the first quarter, subsidies to inefficient firms were slashed from 12.5 percent of GDP in 1992 to 7.4 percent.[44]

Progress in fighting inflation was not cost free, as reflected in the precipitous decline in industrial output and GDP in the first half of 1994 (see figure IV)*. Official unemployment remained low - at 1.4 million or 2 percent of the active labor force[45] - but there was much speculation about a pending unemployment crisis.

Figure IV. Inflation rates in the Russian Federation, June 1993-June 1994
(Percentage)



Source: OECD, "Economic Surveys. The Russian Federatio,"
(Paris: Organization for Economic Cooperation and Development, 1996)

A rise in unemployment could be expected - but many firms postponed major restructuring. With more companies threatened with bankruptcy, there will be more companies turning to the informal credit market for financing requirements. This will be particularly so if the government brings the emerging inter-enterprise debt crisis under control.

Lending rates charged in the informal market, even if below formal lending rates, could attract criminal organizations. Capital flight from Russia totalled US$ 10 billion in 1993.[46] Despite instability, however, foreign investors turned cautiously towards Russia. About US$140 million was invested in the first quarter of 1994 and approximately US$1-1.5 billion was expected for all of 1994.[47]

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*Respectively, 27 per cent and 18 per cent (The Economist Intelligence Unit, Country Report: Russia, Third Quarter 1994 (London, 1994), p. 25).

Outlook

Three reasons suggest that criminal finance may grow as a source of informal credit in the economy of the Russian Federation.

First, as the inter-enterprise debt overhang is addressed by the government, there will be a demand for other sources of informal credit.

One difference between Russian firms and households is that the latter faced hard budget constraints after the 1992 price liberalization. Firms did not. As a result, in the first quarter of 1992, household expenditures in real terms fell to 42 percent of their 1987 level due to the fall in real money balances.[48] Some recovery did occur, but during the second quarter of 1992, real expenditures were still at only one-half their 1987 level.[49] Consumers were forced to adjust in ways which the enterprises could ignore. Real money balances declined by almost 75 percent due to the January price rise.[50] The fall in consumer expenditure should have compelled producers to adjust to the lower level of demand. However, the expansion in inter-enterprise debt and cheap credit allowed firms to continue to raise prices and accumulate inventories of unsold output. Inter-enterprise debt grew by a factor of 1000, from less than Rb40 billion in January 1992 to Rb3.2 trillion in June 1992.[51] As evidenced by the 1992-1993 phase of reform, enterprises did not adjust to macroeconomic trends due to expectations that the government would bail them out. Ultimately those expectations were self-fulfilled. The rise in the volume of debt accelerated after the spring 1994 agreement between the Russian authorities and the IMF; estimates of the total start at Rb30 trillion.[52] Oleg Soskovets, deputy prime minister and chairman of a commission asked to resolve the inter-enterprise arrears crisis, reportedly said that level of inter-enterprise debt has risen to Rb90 trillion.[53] As the government confronts the inter-enterprise debt problem, many firms may turn to one of the few remaining sources of available credit, i.e., criminal finance.

Second, the financial system is being overhauled, and domestic institutions will have problems meeting the need for finance capital.

Criminal lending operations, it will be recalled, depend on the structure of the domestic financial system. In Russia, in January 1992, ceilings on interest rates were removed. Barriers to entry in the banking industry were lowered for domestic entrants. Though foreign banks could open branches in Russia, they were limited to handling accounts of non-residents, preventing them from any share of the Russian business and personal market.[54] Price liberalization has considerably reduced the value of commercial bank assets - possibly by more than half.[55] A report released by the European Union in March 1996 predicts that some 1,500-1,600 out of the 2,285 commercial banks active in Russia will go bankrupt over the next few years.[56] Should this prediction be borne out, commercial and personal borrowers will find it increasingly difficult to secure loans in the formal banking sector.

Third, the presence of organized crime in the Russian market is well-established.

The government's privatization efforts may have allowed criminal organizations an initial foothold in certain sectors of the Russian economy. Viktor Ilyukhin, chairman of the security committee of the Duma, was reported to have claimed in 1994 that criminals controlled 81 percent of the voting shares in privatized enterprises.[57] In addition, an official at the Moscow criminal inspectorate recently estimated that about one third of Russia's new private entrepreneurs are linked to the drug trade.[58] High interest rates will ensure that commercial loans remain a marginal source of credit.

III. CONCLUSION

In pre-empting the emergence of large-scale financial activities by organized crime, control efforts must focus on both the supply and demand sides of the transactions in which criminal organizations have a role to play. The following measures could be expected at least to serve as a hindrance, if not an absolute deterrent, to criminal finance.

Transparency in financial records. Enhancing transparency in record-keeping on financing sources would allow authorities a clearer picture of the status of financing for any given firm. It would also provide one disincentive for firms to borrow from illegal or informal sources.

Bankruptcy laws. The case of Russia demonstrates that the absence of bankruptcy laws may lead debt-ridden enterprise to ignore the need for restructuring. Firms may in fact be encouraged to run up large operational deficits in the assumption, or expectation, that the government will provide the necessary liquidity for restructuring. Bankruptcy laws will make explicit the risk of failure.

3. *Anti-racketeering laws.* Criminal financial activities should be clearly defined in law. Recriminations against those who choose to engage in illegal financial activities should be elaborated in explicit terms. In Japan, the introduction of such laws since 1993 has had a paradoxical effect; it has put newfound pressure on criminal organizations active there, leading some to retaliate with violence against those who threaten to press charges. In other parts of the world, particularly, the Caribbean, so-called "international business companies" (IBC) are often used as fronts by criminal organizations because funds channeled through them cannot be traced.[59] The problem is that some countries, for example the British Virgin Islands, earn substantial revenues by hosting IBCs.

4. *Social safety net.* To erect barriers against criminal financing means that it will be nothing less than crucial to provide firms and individuals with other viable options to restructure and if necessary shift into other areas of activity. Without an adequate social safety net, applying tight money policies can only lead to enhanced resistance to restructuring.

5. *Information exchange.* The "international community" lags far behind its criminal counterpart in the establishment of close operational ties for cross-border trade and finance. The exchange of intelligence on criminal trends and in particular cross-border financing must become a more fundamental aspect of anti-crime efforts. In addition, the heretofore non-overlapping dichotomy between economic and crime-related organizations must be replaced with wider recognition that as global interdependence advances, these two areas of analysis will increasingly converge.

6. *Internationalization of drug control.* International crime feeds on the revenues from the drug trade. And yet, despite encouraging progress, the perception lingers that drug control is exclusively a country-level concern. Drug control efforts at the international level must become a more central means of tackling drug-trafficking organizations; until they do, the revenues accruing to crime will continue to grow, and with it, the threat of criminal finance will become an ever greater thorn in the side of economic reform. The need for regional efforts in particular represent the most realistic alternative; bringing together governments in regions experiencing an expansion in drug-trafficking and related crimes is crucial.

The experiences of many reforming economies demonstrate that in the end, the market can often be used to serve the ends not only of consumers and suppliers but of non-market actors as well. The welcome process of liberalization and reform can lead to negative consequences if regulatory actions are ignored. The experiences of countries like Russia - or Italy, where a newfound commitment to tackle organized crime has reaped extraordinary benefits for firms throughout the country - demonstrate that the costs of indifference to

market-exploitative crime can far outweigh the costs of introducing market-friendly safeguards.

Containing the influence of organized crime will however require governments to focus on criminal organizations' livelihood, i.e., the illicit drug trade. Until now, the illicit drug trade has been deemed undesirable for two reasons. First, the activities associated with it are against the law. Second, people hurt themselves when they abuse drugs. The perceived absence of an economic dimension has been one major reason why drug control is still relegated to a relatively low position on the priority agenda of many governments. This paper has highlighted this economic dimension: when people have to pay more because of the inflationary impact of drug money, when economic policies are misshaped because of the distorting effects of criminal finance, when legitimate firms suffer a competitive disadvantage because of organized crime's access to drug-generated wealth, then the drug problem becomes not just a legal or health issue, but an economic and political one as well.

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