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INDICATORS OF INFORMAL FUNDS TRANSFER SYSTEMS: A COMPARISON OF TRADITIONAL AND MODERN SYSTEMS

by

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13. ABSTRACT

Informal funds transfer systems (IFTS) are prevalent throughout the world and are used for various legitimate and illegitimate purposes. There are many variations of these systems that can be generally classified as traditional or modern systems. Traditional and modern IFTS share many of the same characteristics, but that is the extent of the similarities between these two groups. Traditional systems were developed to meet the legitimate needs of businesses and individuals and at times became the formal banking system within the Middle East and South Asia. Conversely, modern IFTS were developed purely as criminal systems and have no legitimate purpose. Whereas traditional systems have predominantly positive effects on the communities in which they operate, modern systems are the exact opposite and have predominantly negative effects. The purpose of this thesis is to analyze the use of traditional and modern IFTS in order to identify the specific macro indicators and conditions responsible for their development and continued use. Identifying these indicators will allow regional, national and international agencies and organizations to detect the emergence or presence of IFTS and focus their efforts to develop effective regulatory policies to limit the illegitimate use while maintaining the legitimate aspects of these systems.

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ABSTRACT

Informal funds transfer systems (IFTS) are prevalent throughout the world and are used for various legitimate and illegitimate purposes. There are many variations of these systems that can be generally classified as traditional or modern systems. Traditional and modern IFTS share many of the same characteristics, but that is the extent of the similarities between these two groups. Traditional systems were developed to meet the legitimate needs of businesses and individuals and at times became the formal banking system within the Middle East and South Asia. Conversely, modern IFTS were developed purely as criminal systems and have no legitimate purpose. Whereas traditional systems have predominantly positive effects on the communities in which they operate, modern systems are the exact opposite and have predominantly negative effects. The purpose of this thesis is to analyze the use of traditional and modern IFTS in order to identify the specific macro indicators and conditions responsible for their development and continued use. Identifying these indicators will allow regional, national and international agencies and organizations to detect the emergence or presence of IFTS and focus their efforts to develop effective regulatory policies to limit the illegitimate use while maintaining the legitimate aspects of these systems.

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I. INTRODUCTION

A. MAJOR RESEARCH QUESTION

The purpose of this thesis is to understand the development of informal funds transfer systems (IFTS). These systems are prevalent throughout the world and are used for various legitimate and illegitimate purposes. There are many variations of these systems that can be generally classified as traditional or modern systems. Traditional systems are based on two primary systems, hawala and fei-chien. Modern systems are primarily based on the Black Market Pesos Exchange (BMPE). The major research question is: Are there specific macro indicators or conditions that can be used to identify the emergence or use of informal funds transfer systems in a particular region?

The hypothesis underlying this thesis project is that the specific macro conditions that lead to the development or continued use of IFTS can be identified. IFTS are a special class within the financial sector and have specific characteristics that can be recognized. By identifying and analyzing current systems, the conditions that lead to their development can be determined.

B. IMPORTANCE

IFTS have gained notoriety and have been the subject of much scrutiny since the attacks of September 11, 2001. Although illegal or unregulated in many countries, prior to September 11 minimal academic research was conducted on these systems and many Western governments paid little attention to them. The knee-jerk reaction after September 11 has swung the pendulum far in the opposite direction and is focusing efforts to regulate IFTS in unrealistic or impractical areas. For example, The Financial Action Task Force (FATF) approach to IFTS has predominantly been to transpose current international anti-money laundering standards for the formal banking sector onto the informal sector. Furthermore, current U.S. policy requires registration at the federal level and licensing at the state level. There are many inconsistencies with these requirements and above all, they do not account for the scale and customer base of IFTS operations.

There are two basic categories of IFTS use, legitimate and illegitimate. While traditional systems have been in existence for centuries and are primarily used in legitimate transactions such as worker remittances, modern systems have been developed for primarily illegitimate purposes including money laundering and tax evasion. It is important to note that even the legitimate use of IFTS can have negative effects. The vast quantity of funds moving through legitimate transactions can be detrimental to the economies of developing countries by circumventing the formal financial sector thereby avoiding taxes and weakening the currency.

The importance of this research derives from the need to understand the necessity for IFTS and the characteristics that make them desirable for both legitimate and illegitimate uses. A firm understanding of this will allow the specific conditions that lead to the development of IFTS to be studied and analyzed. Knowing the specific conditions will then allow for effective regulatory policies to be implemented in order to limit illegitimate use and decrease the economic harm that legitimate use can cause. There is a definite need for traditional IFTS, especially in the developing world were the formal banking system has limited or no capability to address the financial needs of the people. Consequently, the primary desire should not be to close all IFTS operations, but to design policies that will allow effective regulation while at the same time keep the beneficial aspects for legitimate use. Therefore, the goal of this thesis is to establish the first step in this process upon which further research will be able to build towards the ultimate objective of comprehensive and beneficial IFTS regulation.

C. LITERATURE REVIEW

The relatively recent widespread attention given to informal funds transfer systems has created a diverse set of literature on the subject. The fact that this attention was brought about by the terrorist attacks on September 11 only adds to the wide spectrum of views and opinions. In light of this, the current body of knowledge does not necessarily allow for categorizing specific schools of thought; the exception being in regard to the amount of illegitimate use. Instead, much of the research focuses on the different aspects of the traditional and modern systems. The following review highlights each of those areas that will be applicable to this thesis.

1. IFTS Characteristics

Millions of immigrant workers transfer funds through IFTS on a monthly basis to their home countries. While each of these individual transfers are likely to be relatively small, $200-600 per month for immigrants from Central and South America, the total amounts transferred around the world each year are quite significant.[1] IFTS have historically provided fast, secure and low-cost community based options for workers to send money to their home countries. These systems have become essential for many individuals who, for a variety of reasons, are unable to use to the formal banking systems.[2] In addition, the formal banking systems have failed to recognize the needs of this group and supply appropriate services for them. The extremely large number of small transactions generated is simply not compatible with the current banking structures in many parts of the world.[3] For countries with banking systems that do have the capacity to handle these transactions, they cannot compete with the cost and other benefits of IFTS. Seven primary features have been identified that make them attractive for use: speed, convenience, versatility, reliability, anonymity, cost and cultural considerations.[4]

[1] John Page and Sonia Plaza, "Migration Remittances and Development: A Review of Global Evidence," *Journal of African Economies* S2 (2006): 276.

[2] Leonides Buencamino and Sergei Gorbunov, *Informal Money Transfer Systems: Opportunities and Challenges for Development Finance*. United Nations, Discussion Paper of the United Nations Department of Economic and Social Affairs No. 26, November 2002; Jude McCulloch and Sharon Pickering, "Suppressing the Financing of Terrorism," *The British Journal of Criminology* 45 (2005): 479; Shahid Nawaz, Roddy McKinnon and Robert Webb, "Informal and Formal Money Transfer Networks: Financial Service Or Financial Crime?" *Journal of Money Laundering Control* 4 (2002): 331-332; Nikos Passas, *Informal Value Transfer Systems and Criminal Organizations; a study into so-called underground banking networks*, U.S. State Department, http://usinfo.state.gov/eap/img/assets/4756/ivts.pdf (accessed 28 February 2008).

[3] Buencamino and Gorbunov.

[4] Mohammed El-Qorchi, Samuel Munzele Maimbo, and John F. Wilson, *Informal Funds Transfer Systems: An Analysis of the Informal Hawala System*, (Washington D.C.: IMF, 2003), 7-9; Nikos Passas, "Demystifying Hawala: A Look into its Social Organization and Mechanics1," *Journal of Scandinavian Studies in Criminology & Crime Prevention* 7 (2006): 57; Patrick M. Jost and Harjit Singh Sandhu, "The hawala alternative remittance system and its role in money laundering," Interpol, http://www.interpol.int/Public/FinancialCrime/MoneyLaundering/hawala/default.asp (accessed 18 January 2008); Smriti S. Nakhasi, "Western Unionizing the Hawala?: The Privatization of Hawalas and Lender Liability," *Northwestern Journal of International Law & Business* 2 (2007): 483-488.

2. Legitimate and Illegitimate Uses

When discussing the legitimate and illegitimate uses of IFTS, there is an important distinction that must be made regarding which system, traditional or modern, is being used and why the system is being used. Traditional systems are predominantly used for legitimate purposes, although they can also be used for illegitimate purposes.[5] Modern systems, on the other hand, are used for purely illegitimate purposes.

Traditional IFTS have operated for centuries as legitimate and legal systems originally developed to enhance efficiency and security for financial transactions. Although IFTS are currently illegal in many countries, the criminalization of their use has occurred relatively recently from a historical perspective. As formal banking systems developed and became regulated, traditional IFTS remained on the outside as a parallel system operating in an unregulated and undocumented environment. It is the fact that these systems are unregulated and therefore do not pay taxes and do not comply with the formal banking practices and reporting requirements that has made them illegal. Even now as illegal systems, their services are still required for many otherwise legitimate situations. Legitimate use of IFTS includes migrant workers remittances, humanitarian and emergency aid, business necessity, intelligence use, and personal use.

This legitimate use is contrasted by the illegitimate use of traditional and modern systems by criminals and terrorist organizations who are attempting to hide either the original source or the eventual purpose of the funds.[6] The primary criminal concern regarding the illegitimate use of IFTS is the source and purpose of the funds being transferred. While the actual transactions of these funds are also important in that they contribute to the large unaccounted currency flows, the criminal or terrorist acts used to acquire the funds and the future operations for which the funds are intended are a higher

[5] Motoo Noguchi, "Help Needed for the 'Unbanked'," *The Washington Post* Mar 26, 2004, http://proquest.umi.com/pqdweb?did=589630931&Fmt=7&clientId=65345&RQT=309&VName=PQD (accessed 12 March 2008).

[6] Roger Ballard, "Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems: The Operational Dynamics of Contemporary Hawala Networks," *Journal of Banking Regulation* 4 (2005): 344.

priority for law enforcement agencies.[7] Illegitimate use of IFTS includes money laundering, terrorist financing, tax evasion, smuggling, arms and drug trading, and corruption.

Although most use of IFTS is technically illegal, the distinction in criminal nature and intent is important. In the case of legitimate use, the primary criminal aspect is the transaction itself and the fiscal implications since countries cannot track the amount of currency within their economy that is generated by these informal transactions. This amount can be significant, estimated at $1-3 billion in some nations, and therefore can have a large impact on national economic decisions and policies.[8] While there is an obvious need to regulate and account for these transactions, the funds used for these legitimate purposes are usually from a legal source and are intended to be used for a legal purpose by the recipient.[9]

3. Criminal vs. Necessary

Two issues have emerged in relation to the overall use and impact of IFTS: quantity of illegitimate use and macroeconomic impact. First, the predominant debate that has occurred in this field follows from the above section on legitimate and illegitimate uses. With the various uses in mind, the debate has centered on the quantity of traditional IFTS use for each of these. While there is consensus that the majority of IFTS use is for legitimate purposes, two schools of thought have developed regarding the amount of illegitimate use. This debate focuses only on the illegitimate use of traditional IFTS, since there is complete consensus on the criminal nature of modern systems.

Prior to September 11, the small amount of reporting on IFTS often focused on the illegitimate aspects and criminal uses of IFTS. Following the attacks, this view was reinforced and well publicized in the media and academic literature, often referring to

[7] Ballard, “Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems,” 344.

[8] Anand Ajay Shah, “The international regulation of Informal Value Transfer Systems,” *Utrecht Law Review*, 2 (2007): 208; El Qorchi, et al., 35-40.

[9] Maryam Razavy, "Hawala: An Underground Haven for Terrorists Or Social Phenomenon?" *Crime, Law and Social Change* 3 (2005): 287-288.

them as terrorist banking systems.[10] The most frequently cited criminal activity for IFTS is money laundering. The vast majority of literature in this school cites IFTS as a key factor in many money-laundering operations.[11] The characteristics of IFTS, especially anonymity and speed, are the basis for the view of these systems providing a high level of support for criminal and terrorist networks. The beneficial aspects for legitimate users also make these systems ripe for exploitation by criminal and terrorist organizations.[12]

The second school of thought recognizes the potential for criminal and terrorist use of IFTS, but does not see it as a large-scale problem. Instead, IFTS are viewed as necessary systems that play a vital role in the economies of many developing countries. These systems provide financial services to many who have no access to the formal banking system.[13] This school contents that many of the claims of IFTS financing terrorism are baseless and rely on faulty conventional wisdom. One claim in particular is that the September 11 hijackers were financed through IFTS. Although this has been disproved, it was well publicized and perpetuates the myth of IFTS being terrorist systems. No proof exists that IFTS are favored over the formal system by criminal or

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[10] Jonathan Winer, Prepared speech for the Senate Banking Committee Hearing on the Administration's "National Money Laundering Strategy for 2001," September 26, 2001, http://www.fas.org/irp/congress/2001_hr/092601_winer.html (accessed 11 April 2008); *International Narcotics Control Strategy Report, 1999*. Washington, D.C.: U.S. Department of State, Bureau of International Narcotics and Law Enforcement Affairs, 1999, http://www.state.gov/www/global/narcotics_law/1999_narc_report/ml_intro99.html (accessed 7 March 2008); Lisa C. Carroll, "Alternative remittance systems distinguishing sub-systems of ethnic money laundering in INTERPOL member countries on the Asian continent," Interpol, http://www.interpol.com/Public/FinancialCrime/MoneyLaundering/EthnicMoney/default.asp (accessed 28 February 2008); Jost and Sandhu;

[11] Walter Perkel, "Money Laundering and Terrorism: Informal Value Transfer Systems," *The American Criminal Law Review* 41 (2004): 190-191; Bala Shanmugam, "Hawala and Money Laundering: A Malaysian Perspective," *Journal of Money Laundering Control* 8 (2004): 37-38; Larry B. Lambert, "Underground Banking and National Security," SAPRA INDIA Bulletin Article, http://www.subcontinent.com/sapra/bulletin/96feb-mar/si960308.html (accessed 7 March 2008); Ronald M. Rose, "Another deal, another dollar," Security Management 6 (2003) http://proquest.umi.com/pqdweb?did=352493611&Fmt=7&clientId=65345&RQT=309&VName=PQD (accessed 12 March 2008); Douglas Farah, "U.S. Targets Firms Laundering Money; Colombian Cartels Said to use Top Companies," *The Washington Post*, Jun 21, 1999; Razavy, 288; *International Narcotics Control Strategy Report 1999*; Carroll; Jost and Sandhu.

[12] Nikos Passas, *Informal Value Transfer Systems, Terrorism and Money Laundering*, A Report to the National Institute of Justice, November 2003, http://www.ncjrs.gov/pdffiles1/nij/grants/208301.pdf (accessed 12 March 2008); Shah, 202; Perkel, 184; Nawaz, et al., 330.

terrorist organizations. In fact, it has been suggested that the formal system may actually be a better vehicle for criminals to use.[14]

The second issue concerns the macroeconomic impact of IFTS. There is broad consensus from both schools on this issue. Regardless of the legitimate or illegitimate use of IFTS, the vast quantities of currency moving through these systems can have a significant economic impact on a developing country. There has been no reliable data to accurately estimate the amount that flows through IFTS, but current studies put the amount around $100 billion worldwide and $1 to $10 billion in individual countries.[15] Since there is no formal record of these transactions, they are not reflected in a nation's official statistics for assets and liabilities. In addition, IFTS tend to weaken a nation's currency through the use of black market exchange rates by the operators. Lastly, IFTS hurt national economies by avoiding direct and indirect taxes on their transactions.[16]

4. Origins of IFTS

The origination of IFTS will be addressed in two parts; first looking at traditional IFTS, hawala and fei-chien, and second reviewing the modern system of the Black Market Peso Exchange. Contrary to many reports, traditional IFTS were not developed to "circumvent currency controls" nor were they "born out of political turmoil and distrust of banks." Hawala and fei-chien were developed centuries ago for legitimate and practical purposes when formal banking systems did not exist.[17] The development of hawala occurred during the medieval period in South Asia and the Middle East, and is

[13] Roger Ballard, "Hawala: criminal haven or vital financial network?" http://www.arts.manchester.ac.uk/casas/papers/pdfpapers/iiashawala.pdf (accessed 12 June 2008); Noguchi; El-Qorchi, et al., 12.

[14] Nikos Passas, "Hawala and Other Informal Value Transfer Systems: How to Regulate Them?" *Risk Management* 5 (2003): 50; McCulloch and Pickering, 480; Noguchi; Passas, "Demystifying Hawala," 60; Buencamino and Gorbunov.

[15] Buencamino and Gorbunov; Page and Plaza, 266.

[16] Mohammed El-Qorchi, "Hawala: Based on Trust, Subject to Abuse," *Economic Perspectives* September 2004, http://usinfo.state.gov/journals/ites/0904/ijee/qorchi.htm (accessed 18 January 2008); Matt Miller, "Underground Banking," *Institutional Investor-International Edition* 1 (1999), http://libproxy.nps.edu/login?url=http://search.ebscohost.com/login.aspx?direct=true&db=bth&AN=1512975&site=ehost-live&scope=site (accessed 7 March 2008).

[17] Passas, *Informal Value Transfer Systems and Criminal Organizations.*

first seen as a legal concept in 1327. During this time, there was little to no formal systems capable of handling the increasingly complex business transactions. Economic interaction was limited due to varying tribal laws and a continuing shortage of silver coins needed for payment. Security for transporting funds also became an issue as trade routes were expanded.[18] An institutional solution began to emerge which was heavily influenced by the Koran and shari'a. With the development of Islamic law directing financial matters, the unpredictability and complexity of tribal interactions began to disappear.[19] This eventually evolved into the hawala system and became a "complex and geographically limitless network for transferring sums of money" in an efficient and safe manner. The basic pillars of this system have remained unchanged for centuries; close networks, kinship, trust, and religious conviction.[20]

Fei-chien has its origins in the growing commodity trade between north and south China during the T'ang dynasty (618-907 A.D.). As trade increased, transporting large sums of money over long distances became inconvenient and risky. To resolve this, merchants began to pay their proceeds to "memorial offering courts" maintained by the provincial governors in the northern Imperial Capital. These courts would give the merchant a certificate to be redeemed by their local provincial government in the south. The court would then use the funds from the merchant to pay the taxes owed to the central government from the provincial government.[21] Similar to hawala, fei-chien functions on an "overarching social system of rules that govern all social behavior." Violations of trust in this system will result in the offender being a social outcast and "shunned in all circles."[22]

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[18] Matthias Schramm and Markus Taube, "Evolution and institutional foundation of the hawala financial system," *International Review of Financial Analysis*, 12 (2003): 406; Razavy, 281.

[19] Divya Sharma, "Historical Traces of Hundi, Sociocultural Understanding, and Criminal Abuses of Hawala," *International Criminal Justice Review* 2 (2006): 103-104; Shah, 197.

[20] Schramm and Taube, 407; Passas, *Informal Value Transfer Systems and Criminal Organizations*; Nawaz, et al., 333.

[21] William L. Cassidy, "Fei-Chien, or Flying Money: A Study of Chinese Underground Banking," http://www.alternatives.com/crime/flyingmo.html (accessed 12 March 2008); Buencamino and Gorbunov; Passas, *Informal Value Transfer Systems and Criminal Organizations*.

[22] Passas, *Informal Value Transfer Systems and Criminal Organizations.*

Fei-chien expanded when Chinese began to migrate within and eventually outside their home nation. This migration, beginning in the seventeenth century, was the basis for the development of the "split family."[23] The immigrants would leave their families in China, and then establish another family in the province or nation they resided. This arrangement required a system to remit money to support the original family. Expatriate families who owned stores would use the business to facilitate the transfer of funds for all the immigrants in their area.[24]

Contrary to the above traditional systems, the BMPE is a modern system that was developed for criminal use. The purpose was to aid Colombian importers evade currency controls which would reduce their profits.[25] Brokers would purchase U.S. dollars at official rates and then sale them to the importers for a premium. Although they were paying an above market rate for the currency, the importers could still make a large profit because of the taxes and duties they were able to avoid.[26]

As this system was developing, the illegal drug trade between the U.S. and Colombia was increasing. The drug traffickers had essentially the opposite problem as the importers; they had U.S. dollars from the sale of drugs and wanted pesos, while the importers had pesos and needed dollars to pay overseas accounts. The broker now acts as a middleman to conduct an "exchange" between the two parties where the pesos will go to the traffickers and the dollars will be used by the importer to buy more goods within the U.S.[27]

D. METHOD AND OVERVIEW

This thesis will use the comparative case study method to analyze traditional and modern IFTS. Within this framework, the hawala and fei-chien systems will be used to provide the analysis of traditional systems, while the Black Market Peso Exchange will

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[23] Buencamino and Gorbunov.

[24] Cassidy.

[25] Passas, *Informal Value Transfer Systems and Criminal Organizations*.

[26] Ibid.

[27] Rose; Farah; *International Narcotics Control Strategy Report 1999*.

be used for the modern systems. Hawala and fei-chien have been in existence for centuries, while the BMPE is a newer system dating back only a few decades.

Although much of the scrutiny of traditional IFTS, commonly lumped together as “hawala” in the media, has centered on their use as a terrorist banking system, the hawala and fei-chien systems began as legitimate and needed financial systems before the existence of the modern banking system. The effects of globalization have caused these systems to spread around the world and although they do appeal to criminal and terrorist organizations, the data suggests that the vast majority of transactions are conducted for legitimate purposes. Analysis of these systems will provide the conditions under which primarily legitimate future systems may develop.

Conversely, BMPE was established and is used exclusively as a criminal system. Initially developed to bypass currency controls, it now also plays a major role in facilitating money laundering for the international drug trade. Analysis of the BMPE will provide insight into the conditions under which illegitimate future systems may develop.

This thesis will be arranged in five chapters. Following the introduction, chapter two will describe the legitimate and illegitimate use. This chapter will show why these systems are desirable and needed in many parts of the world, and how the global spread of IFTS has affected their use. Chapters III and IV will analyze the traditional and modern informal funds transfer systems respectively. This analysis will focus on the origins of the system as well as the economic and social factors influencing their use. The conclusion will then provide the macro indicators that can be used to identify the emergence or continued use of IFTS. Finally, policy recommendations will be to assist in the development of effective regulation of IFTS.

II. LEGITIMATE AND ILLEGITIMATE USE OF IFTS

A. LEGITIMATE USE OF IFTS

Legitimate use of informal funds transfer systems is predominantly associated with traditional systems. While there can be illegitimate use of traditional systems, there is no legitimate use of modern systems.

1. Migrant Remittances

The advancements in technology and the development of a global economy over the past thirty years would lead some to believe that the use of IFTS should decrease as banks and financial centers become international entities. However, the opposite is actually the case. The growth of the global economy, particularly in the U.S., Europe, and the oil rich Middle East nations, has caused a significant rise in global immigration as migrant workers seek higher wages in the labor markets of the developed world.[28] Many of these migrant workers come from high poverty rural areas in Asia, North Africa, and Latin America. As these workers migrate throughout the world, most will send remittances to their families in their country of origin. Although the individual remittances will be relatively small, averaging $100-300 per month, the combined yearly total is very significant, estimated at up to $100 billion.[29]

The development of the international formal financial system has not accounted for this population and instead is primarily structured to service the needs of corporations and governments. The formal system is not designed or equipped to handle the extremely large number of small transactions that occur on a monthly basis. Even if it could physically handle the transactions, the formal system currently cannot complete most of the transactions in a cost-effective, secure, and efficient manner. In addition, since much of the international system is designed to service corporations and

[28] Ballard, "Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems," 324.

[29] Page and Plaza, 256-257, 276.

governments, most of the offices are located in big cities and have no or limited ability to deliver funds to the rural areas where the recipients live.[30]

The rise in world immigration patterns, and the resultant substantial remittance flow, combined with the inability of the formal financial system to provide adequate service for this population has therefore actually led to a dramatic increase in the use of IFTS instead of a decrease.[31] The use of traditional IFTS by migrant workers to send remittances to their families is not only the largest legitimate use of these informal systems, but it also accounts for the vast majority of all IFTS use.

2. Humanitarian and Emergency Aid

In many situations, humanitarian and emergency aid workers must rely on traditional IFTS in order to accomplish their mission. In weak or failed states such as Afghanistan and Somalia where the formal banking system is either very weak or nonexistent, informal systems provide the only reliable, secure means of moving funds both into and within the country.[32] Without these informal systems, the only option would be to manually transport funds to needed locations. The logistics and security issues of manual transport make this an unrealistic alternative. In addition to nations struck by war or long term civil strife, catastrophic natural disasters can lead to a legitimate need for IFTS. In such cases where the government and formal financial systems are forced to close or operate at substantially lower levels for a period of time, informal systems may be the only way to provide funds to the local population and relief organizations. IFTS can also be used to send humanitarian aid to individual families or groups in areas that are not accessible by relief organizations. One such case was revealed in California where the Catholic Church as well as Vietnamese expatriates were sending money to families in communist Vietnam.[33]

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[30] El-Qorchi, et al., 8-9.

[31] Ballard, "Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems," 324.

[32] El-Qorchi, et al., 12.

[33] Lambert.

3. Business Necessity

Traditional IFTS not only have a legitimate role in the economies of nations where the formal banking system has collapsed or been temporarily shut down, but also for nations with otherwise stable economies that for one reason or another are financially stressed. During these periods, strict government regulations on imports, exports, and foreign exchange usually causes an increase in the use of IFTS which can become a necessity for businesses during these trouble times. Informal systems "definitely play an important role. In times of crisis, it acts as some sort of valve, where all the steam can be released in an effective manner."[34]

An example of where IFTS, specifically hawala, played an essential role for businesses during a financially stressful period was in Pakistan during the late 1990s. After Pakistan tested nuclear weapons in May 1998, it was condemned by much of the world and the International Monetary Fund froze $1.3 billion in loans to the nation.[35] Strict government controls on foreign currency exchange and imports led to a sharp rise in hawala use, for both remittances and businesses. It is estimated that migrant worker remittances through hawala increased $100 million per month. "The authorities destroyed the confidence in the integrity of the financial structure both at home and abroad."[36] On the business side, many small businesses, especially importers, could not get credit or make currency exchanges with the commercial banks. In order to buy products, many of these businesses had to resort to hawala use to continue operations. In some instances, when the formal banks could not guarantee the ability to provide credit to an importer, they actually recommended the use of IFTS and offered to help arrange the transaction.[37]

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[34] Miller.

[35] Ibid.

[36] Ibid.

[37] Ibid.

4. Intelligence Support

IFTS have also supported intelligence agencies both for moving funds and providing actual intelligence. During WWII, the British promoted the use of these systems and even provided some support to systems in Africa. The IFTS were used to send funds to British agents operating in areas occupied by German and Japanese forces. Additionally, British agents would use the IFTS operators as informants to gather information on enemy forces.[38] Another example is of a CIA agent who was engaged in the covert war in Afghanistan against the Soviet forces in the 1980s. From a base in Pakistan, the agent would send "large sums" of cash to the mujahideen commanders in western Afghanistan. Within two days of making the initial transaction in Pakistan, the agent would receive radio confirmation that the proper amount of funds had been delivered. "The system goes beyond anything we can imagine. It is very, very well developed."[39] Of course the overall legitimacy of IFTS use for intelligence depends on the standpoint of the observer. Especially in matters of warfare and intelligence, what is viewed as legitimate by one side is not always considered as such by the other.

5. Personal Use

Many times informal systems are used to transfer funds for "personal expenditures such as travel, medical care, or college tuition fees."[40] While the formal system may be available to conduct these transactions, it is the characteristics of traditional IFTS, especially convenience, which makes them desirable for many personal transactions. Personal use may also be dictated by government policies. When India and Pakistan split in 1947, it became illegal to transport currency between the two countries. Therefore, if a person was taking a trip from India to Pakistan for example, they would use IFTS to convert their currency. This was accomplished by selling the Indian

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[38] Passas, *Informal Value Transfer Systems and Criminal Organizations.*

[39] Miller.

[40] El-Qorchi, et al., 12.

currency to an operator in India and receiving a note which would be exchanged for Pakistani currency when they arrived in Pakistan.[41]

When examining the legitimacy of these uses, it is important to remember the entering position that most of the use of these systems is technically illegal. It is the distinction between the criminal intent of the legitimate and illegitimate uses that is of particular concern. This point is emphasized because some of the legitimate uses, especially business and personal use, can be categorized as illegitimate use based on the situation. In the Pakistan example, some companies really had no choice but to use IFTS if they wanted to stay in business and were even assisted by the commercial banks. However, many businesses also use traditional and modern IFTS when it is not critical to their survival in order to avoid currency controls imposed by the government.[42] Usually these controls are not conducive to businesses, but they also do not threaten their existence. Therefore, in these situations, use of IFTS by a business is clearly an illegitimate use.

Regarding personal use, the particular circumstances of a transfer need to be reviewed to determine legitimacy of the transaction. Convenience alone does not make the transaction legitimate. As with businesses, individuals may also use IFTS for the sole purpose of avoiding currency restrictions which of course then makes the transfer illegitimate.

B. ILLEGITIMATE USE OF IFTS

Evident from the above discussion, legitimacy of traditional IFTS use is not always an easy distinction to make. Not only is legitimacy dependent upon the perspective of the person assessing the case, but the individual circumstances of each case and the environment in which the transaction took place will influence the decision. Illegitimate use can occur with both traditional and modern IFTS and can be sorted into six general categories; money laundering, terrorist financing, tax evasion, smuggling,

[41] Miller.

[42] El-Qorchi, et al., 12.

arms and drug trading, and corruption. The speed, autonomy, and security with which funds can be moved around the world provide significant potential for abuse.[43] Money laundering through IFTS is connected to all the criminal categories listed since the proceeds from many criminal activities are likely to be laundered partially or wholly through IFTS. However, IFTS can also have a distinct role in the operation of each criminal activity, thus each of them will be addressed separately.

1. Money Laundering

The primary advantage of using IFTS for money laundering is that funds can be autonomously transferred to another location and exchanged into a different currency in an apparent legal transaction with little or no records of any of the transactions. These funds can then remain in the new location or be transferred back to the original location through other legitimate transactions.[44] Money laundering schemes can range from small to very large-scale operations. Individuals or small groups may use IFTS in combination with a personally owned small business to launder a portion of their profits to avoid taxation or hide illegal activity. One the other hand, the Black Market Peso Exchange system used in Columbia to launder drug money and provide cheap dollars to importers is extremely large, estimated to launder $3-6 billion per year.[45]

Money laundering is a three-phase process consisting of placement, layering, and integration. Placement involves getting the money into the financial system, which can be the most dangerous part of the process when using the formal financial system. Besides the paper trail of deposits that is generated by the banks, any large amounts, over $10,000 in the U.S., will require a report to be filed by the financial institution. Placement of funds through IFTS involves less risk and little if any paper trail for law enforcement agencies to track to the originator. Most IFTS dealers operate legitimate businesses and therefore can combine legal and illegal funds when making deposits or

[43] Shah, 202.

[44] El-Qorchi, et al., 13.

[45] Rose; *International Narcotics Control Strategy Report, 1999.*

use the illegal funds to pay expenses for the business.[46] Also, IFTS dealers do not report on large sums of money so there is no concern for having to break the deposit into small amounts to avoid the reporting requirements as in the formal system.

To layer the funds in the formal banking system, funds are transferred through multiple accounts and shell companies to obstruct the trail and reduce the possibility that the original source of the funds can be traced. This process presents two primary problems for the launderer, first the transactions may seen as suspicious and then reported, and second a paper trail will be generated, however obscure it might be, that could be deciphered.[47] With IFTS, the funds will be layered through multiple deposits by the IFTS dealer and by separate transfers to other locations. As the original amount is mixed with legal funds then spread across various accounts and countries, very few records will remain that could tie the source of the funds to an illegal activity.[48]

The last phase of money laundering is integration where the funds are returned to the originator in an apparent legitimate form. Through the formal banking system the funds will usually appear as business profit from a shell company or as a loan from an offshore bank.[49] The advantage of IFTS in the integration phase is that since most of the dealers operate or collude with other businesses, especially import and export companies, these systems can transform funds into a multitude of different forms, such as material goods, commodities, precious stones, or foreign currency.[50]

An actual case of money laundering using IFTS and a legitimate business was uncovered in Africa where a family network was used to finance a business with drug money. Small amounts of drugs were bought in Amsterdam each month and then sold in Paris for a profit. The proceeds were laundered through IFTS and the business using a variety of legal and illegal transactions. The clean funds were then used to finance legitimate investments and trade in raw materials in many parts of the world. This case

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[46] Carroll.

[47] Jost and Sandhu; Carroll.

[48] Jost and Sandhu.

[49] Carroll.

[50] Jost and Sandhu.

demonstrates the ability to mix informal and formal financial systems and use a legitimate business to conduct money laundering.[51]

2. Terrorist Financing

The anonymity and unregulated nature of the systems in addition to a lack of clear transaction records make traditional and modern IFTS a potential vehicle for terrorist organizations.[52] The ability of IFTS dealers to conduct multiple transactions and the potential to convert the funds into an array of value assets in order to obscure the original source and amount of funds is an important feature for terrorist use. This feature is obviously essential when the original funds are from an illegal source, but the basic characteristics of IFTS are also attractive when clean funds are to be used for terrorist activity. Legitimately acquired funds could be funneled to terrorists through IFTS to hide the legal origin of the funds and provide relatively secure access to the funds for the recipient.[53] Legitimate funds come from a variety of sources including charities, businesses, fund raisers, investments, and donations, and in many cases the original donor may not know the funds are destined for terrorist activity. The use of clean original funds is one of the key differences with money laundering and provides a significant challenge for law enforcement agencies when attempting to counter terrorist financing.[54]

It was initially alleged that the terrorists for the September 11 attacks were financed through IFTS. Upon further investigation though, these early reports were proven false and it was shown that the attackers actually received their funds through the normal banking system.[55] However, the massive attention given to IFTS after September 11, which highlighted the potential for their use in terrorism, brought the problem to the forefront for many nations. Efforts to counter terrorist financing and reduce the anonymous use of IFTS have become a main component of the U.S. counterterrorism

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[51] Passas, *Informal Value Transfer Systems and Criminal Organizations*.

[52] Razavy, 288.

[53] El-Qorchi, et al., 13.

[54] Passas, *Informal Value Transfer Systems, Terrorism and Money Laundering.*

[55] Sharma, 101-102.

policy. Although IFTS may not have been used for the September 11 attacks, the potential for their use by terrorist organizations is real.[56]

IFTS use to finance terrorism has been documented in some regions. One of the most prevalent areas is South Asia, particularly in India and Pakistan. Officials in both nations acknowledge that the majority, if not all the funding for terrorist operations are transferred by IFTS. Because of the continued and frequent use of informal systems for terrorist activity, some organizations have begun to use only "very trusted or especially dedicated hawala operators for security reasons."[57] Table 1 shows a few of the prominent cases that have been identified in India.

Year	Amount	Recipient	Remarks
1992	$70,000	Daughter of a senior Hurriyat leader	This was revealed by a Hawala operator on his arrest when he went to deliver $1,200 to the woman. This amount was received from Pakistan
1993	$78,000/year	Ikhwan-Ul-Musalmeen (IUM)	Mushtaq Ahmed Khan, Deputy Chief Commander, disclosed that IUM received $78,000 annually from ISI (Pakistan's intelligence agency)
1993	$23,000	All Party Hurriyat Conference (APHC)	Senior leader of Dukhtaran-e-Millat disclosed that APHC received the amount from Pakistani agencies
1993	$72,000	Jamait-ul-Mujahideen (JUM)	Disclosed by Mohammed Ramzan Sofi, alias General Abdullah, Chief Commander of JUM
1997	$217,000	Abdul Majid Dar (AMD)	Interrogation of AMD disclosed that one senior leader of Hurriyat persuaded him to open a cloth shop and accept the amount on behalf of his organization
1997	$108,000 and $65,200/year	Mohd. Nazir and Shafi Mir	Supreme Commander of Hizbul Mujahideen sent the amount to Kashmir via Dubai and through the owner of a carpet company

Table 1. Details of Covet/Overt Hawala Transactions Related to Terrorist Activities[58]

[56] Passas, *Informal Value Transfer Systems, Terrorism and Money Laundering*.

[57] Sharma, 116-117; Passas, *Informal Value Transfer Systems, Terrorism and Money Laundering*.

[58] Sharma, 116.

One of the expected outcomes of the increased visibility on terrorist financing throughout the world and the implementation of more stringent financial controls within the formal sector is an increase in the use of IFTS by terrorist organizations.[59] While this is a logical assertion, there currently is no direct evidence to support this claim. Traditional and modern IFTS are undoubtedly attractive for terrorists; however, the small amounts of money needed to conduct terrorist attacks can easily be transferred through the formal system as well. As seen with the September 11 attacks, the formal system may be just as attractive.

3. Fraud and Tax Evasion

As the global economy continues to grow, so does the quantity and value of the goods being shipped around the world. The rise in trade combined with liberal regulations increases the potential for abuse of the system by criminal and terrorist organizations. Not only is lawful trade susceptible to abuse through invoice manipulation, but illegal goods will also be easier to disguise within the system.[60] Import and export businesses will collaborate and use modern IFTS to avoid customs taxes and tariffs and gain higher subsidies from the government based on a perceived higher volume of trade.[61] Modern systems such as the BMPE, in addition to laundering narcotics money, also serve as a vehicle for businesses to avoid taxes and smuggle merchandise.

Individuals are also known to use traditional and modern IFTS to avoid taxes and currency controls. IFTS allow people to move assets to offshore accounts and hide their value from the government. A growing practice in India is for landlords to request rental payments to be made by IFTS to overseas accounts. The funds are then held in a more

[59] Passas, *Informal Value Transfer Systems, Terrorism and Money Laundering*.

[60] Sharma, 89.

[61] Ding Jianping, "China's Foreign Exchange Black Market and Exchange Flight: Analysis of Exchange Rate Policy," *The Developing Economies* 1 (1998): 28-29; El-Qorchi, et al., 12; Passas, *Informal Value Transfer Systems and Criminal Organizations*; Jost and Sandhu.

stable currency and their value is not taxed.[62] BMPE also supports individuals who wish to evade taxes. Much like the import businesses, people will buy dollars from a BMPE dealer and then hold those dollars in U.S. accounts where they avoid taxes and are hidden from the Columbian government. Columbians have also used the BMPE system to convert foreign pension or retirement checks into U.S. dollars without being subjected to taxes.[63] In areas where there is exchange rate risk due to instability in the country, individuals will use IFTS to transfer funds to more secure foreign currencies.[64]

4. Smuggling

IFTS facilitate the smuggling of a variety of value assets including currency, precious metals, people, and merchandise. The smuggling of merchandise is an integral part of modern IFTS and will be discussed in detail in Chapter IV. The current large-scale use of traditional IFTS for smuggling is thought to have its basis in gold smuggling in South Asia during the 1960s and 1970s. The growing presence of South Asian migrant workers in areas such as the Gulf Cooperation Council states allowed the use of IFTS to become a viable option to transfer proceeds from the illegal sale of the gold.[65] As a result, the smuggling operations became more efficient and at the same time enhanced the system for remittance use by the migrant workers. This also formed the foundation for Dubai to become one of the central hubs in the IFTS networks.[66]

Smuggling of illegal immigrants into the U.S. and other industrialized countries has become a significant problem in the past couple decades. The growth of the global economy has produced a high demand for cheap labor and smuggling networks have

[62] Passas, *Informal Value Transfer Systems and Criminal Organizations*; "From Donor Kidneys to Greedy Politicians, how Hawala Spreads its Web," *Rediff on the NeT*, http://www.rediff.com/news/1996/hawala03.htm (accessed 7 March 2008).

[63] Rose.

[64] El-Qorchi, et al., 12.

[65] Sharma, 107; El-Qorchi, et al., 12.

[66] Ballard, “Coalitions of Reciprocity and the Maintenance of Financial Integrity within Informal Value Transmission Systems,” 333.

capitalized on this need.[67] IFTS have supported these activities by transferring payments from businesses to the smugglers and by moving funds within the smuggling network. Hundreds of millions of dollars are generated by these activities and IFTS are also used to facilitate the laundering of the proceeds. In addition, the illegal workers would also use IFTS to remit funds to their home countries.[68]

5. Arms and Drug Trafficking

Because of the sensitivity of dealing in arms and drugs and potential complexities in their movement, IFTS play an integral part in these transactions. The anonymity, reliability, security, and ability to funnel multiple sources of funds, both legal and illegal, provide an efficient structure for criminals and terrorists to use. The ability of informal systems to convert funds or assets into a wide range of other value assets provides the basis for many of the trafficking transactions.[69] Law enforcement agencies have discovered a number of cases where a whole series of transactions have taken place in the process of buying or selling arms and drugs. These include using a mixture of the formal and informal financial systems and various business transactions to buy, sell or move assets. This series of transactions allows the original value of the funds or assets to be transferred in an almost untraceable fashion and delivered to the recipient in a variety of forms.[70]

The ability of IFTS dealers to provide for some of the legitimate uses discussed above may actually be facilitated by illegal activity. In areas such as Afghanistan and parts of Africa were many NGOs are prevalent and IFTS are the primary means of transferring fund, most payments for goods and services are made in cash. Since physical funds are not moved with IFTS transfers, sufficient supplies of cash must be available for

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[67] David E. Rosenbaum, "U.S . Breaks a Huge Alien - Smuggling Ring," *The New York Times,* November 21, 1998; *International Narcotics Control Strategy Report, 1999*.

[68] Sharma, 107; Jost and Sandhu.

[69] Cassidy; Passas, *Informal Value Transfer Systems and Criminal Organizations*.

[70] Jost and Sandhu; Passas, *Informal Value Transfer Systems and Criminal Organizations.*

the IFTS dealer who will distribute the funds to the recipient. Research suggests that a portion of these funds may be supplied to the IFTS dealer from the proceeds of arms and drug trafficking.[71]

6. Corruption

The anonymity of these systems and the ability to securely transfer funds to offshore accounts makes them a perfect vehicle for bribery and corruption payments. Not surprisingly, many of the high profile cases involving IFTS have occurred in countries with weak financial systems or political instability. The use of informal systems in these countries is usually widespread and accepted, even if technically illegal. Thus, they provide a convenient means for criminals to influence politicians or businesses.[72] One large scale corruption case occurred in India from 1988 to 1991 when many top politicians and businessmen, including two former prime ministers, were paid $15 million through IFTS to manipulate government contracts.[73] Corruption is also a by-product of modern IFTS and can have a detrimental effect on entire regions where these systems are prevalent.[74]

C. SUMMARY

The growth of global migration spurred by the rising global economy has allowed traditional and modern IFTS to become a significant factor in the economies of many countries. There are several consequences as a result of this rise in IFTS use, some beneficial and some not. Although informal banking systems are largely illegal, they can and do provide a legitimate service in many parts of the developing world. Due to instability in much of the developing world along with the formal banking system having largely ignored the financial needs of these areas, IFTS is the only option for many

[71] Passas, *Informal Value Transfer Systems, Terrorism and Money Laundering*.

[72] Sharma, 114-115; Passas, *Informal Value Transfer Systems and Criminal Organizations*.

[73] Ibid.

[74] Carlos Ferreira, Michael Engelschalk, and William Mayville, "The Challenge of Combating Corruption in Customs Administrations," in *The Many Faces of Corruption: Tracking Vulnerabilities at the Sector Level*, ed. J. Edgardo Campos and Sanjay Pradhan (Washington, DC: The World Bank, 2007), 367, 370.

people. In addition to legitimate personal use, IFTS can also have a stabilizing effect in some cases during times of financial crisis. However, the desirable attributes that allow IFTS to function in these areas have also been recognized by criminal and terrorist organizations and the use of IFTS now has many illegitimate aspects as well. These uses not only facilitate criminal activity, but often deprive a nation of significant revenue through violation of customs laws and tax evasion.

While it is relatively easy to classify a specific use of IFTS as legitimate or illegitimate, when the whole system is viewed together, the classification issue is not so clear. In many cases as funds or other value assets are being transferred or stockpiled for future use, legitimate and illegitimate funds may be combined and spread throughout the networks. Due to the many layers involved in some IFTS and the fact that settlement does not take place immediately, multiple sources of funds are used to complete transactions. Therefore, while the vast majority of IFTS use is legitimate and provides a necessary service, it is likely that the large legitimate use itself is what allows the illegitimate use to flourish.

III. TRADITIONAL IFTS

A. ORIGIN

Traditional informal funds transfer systems have evolved over many centuries and were initially developed for legitimate and practical purposes when formal banking systems did not exist.[75] There is actually no clear consensus on when the first use of informal systems occurred; some date their first use as far back as 5000BC. Regardless, their use rapidly expanded with the development of long distance trade in the Middle East and South Asian areas starting in the early medieval period.[76] During this time, there were few, if any, formal systems capable of handling the increasingly complex business transactions occurring with the expansion of trade routes through these areas. Two specific systems developed during this period to solve these problems, hawala and fei – chien. These systems have continued to evolve and adapt over the past 1500 years and are the foundation for most of the traditional IFTS that are seen today, such as hundi (India), padala (Philippines), hui kuan (Hong Kong), and phei kwan (Thailand).

Four specific issues are cited as leading to the formation of hawala and fei-chien; lack of consistent legal practices, corrupt civil servants, limited availability of currency, and insufficient physical security for long distance trade. First, economic interaction was limited due to the various tribal laws. There was no consistent agreement on how business transactions would be conducted and what recourse was available for fraudulent activities. The inherent uncertainty in conducting business under multiple legal systems forced many traders to remain within their own community and thus restricted economic growth. Second, the civil servants who were responsible for establishing regulations and interpreting the law were often corrupt. This only added to the unpredictability and arbitrary nature of the economic system which further discouraged economic expansion

75 Passas, *Informal Value Transfer Systems and Criminal Organizations*.

76 Roger Ballard, *A Background Report on the Operation of Informal Value Transfer Systems (Hawala)*, Red Croft, www.casas.org.uk (accessed 12 Jun 2008); Divya Sharma, 104; Schramm and Taube, 406; Razavy, 281.

and aggravated businesses. Third, business transactions were limited by a shortage of currency. Silver coins were the primary accepted means of payment, but were in short supply due to limited silver bullion at the time. Although an extensive barter system could have been used to alleviate this condition, the nature of such a system was not conducive to the economic conditions of the time. Finally, lack of physical security when transporting the silver and gold that was exchanged between merchants led to continual theft along the trade routes. As the trade routes expanded and covered greater distances, the amount of currency being transported continued to grow and became more lucrative for robbers.[77] All of these issues were occurring throughout the medieval societies of South Asia and the Middle East. Over a period of time, the rising cost and increased risk of conducting business caused institutional reforms and new methods of payment to be implemented.

1. Hawala

In the Arab communities of the Middle East, these changes became heavily influenced by the emergence of Islam. The teachings of the Prophet Mohammed and the tenets of the Quran regarding financial affairs dictated how business would be conducted. With the development of Islamic law directing financial matters, the unpredictability and complexity of tribal interactions began to disappear.[78] As Islam spread the concept of hawala was introduced and implemented into many new trading routes. During the Middle Ages, when Arabs replaced Roman dominance, trade rapidly expanded across the Indian Ocean to East Africa, Malaysia, and Indonesia. Since most of the traders were Muslim, hawala became the normal method of financing long distance trade across the Indian Ocean.[79] The term hawala itself "denotes a "draft" or "bill" and is the cession of a debt through the transfer of a claim, with the term applying to the payment as well as to

[77] Schramm and Taube, 406; Razavy, 281; El-Qorchi, et al., 10-11.

[78] Mian Ahad Hayaud-Din, "The Hawallah Network: Culture and Economic Development in Afghanistan," *International Social Science Review* 78 (2003): 22-23; Sharma, 103-104; Shah, 197.

[79] Ballard, "Coalitions of reciprocity and the maintenance of financial integrity within informal value transmission systems," 325.

the sum paid."[80] The concept began as a simple means of making a payment or transferring a claim. Over time, legal decisions permitted various contractual parameters and allowed for payments and debt transfers to occur through multiple parties in different locations. The principles of Islam allowed for the use of hawala by Muslims anywhere, regardless of physical proximity.

The core foundation of hawala is trust and this trust came from a shared value system. This foundation was further solidified by the ethnic and linguistic links in the Muslim communities. From these, the hawala system evolved and began to serve the financial needs of all the Islamic regions.[81] Hawala allowed the state, businesses, and individuals to make payments and settle accounts without fear of theft or corruption. Eventually it became the "formal" banking system in the Islamic state as it replaced the existing official system of collecting and distributing revenue. Hawala is first recorded as a legal concept in Islamic law in 1327, and has continued to evolved into a "complex and geographically limitless network for transferring sums of money" in a secure and efficient manner. The basic pillars of this system have remained unchanged for centuries; close networks, kinship, trust, and religious conviction.[82]

2. Fei-chien

The growing tea and rice trade in China during the 7th century also necessitated a new form of payment to account for the issues with long distance trade. As commerce grew, problems developed for both the merchants and the government. The merchants had to transport large sums of money after selling their goods along the trade routes. The provincial governments were collecting larger amounts in taxes that had to be transported to the imperial capital in the north. To alleviate these problems and the uncertainty and insecurity in conducting business over long distances in multiple provinces, the system of fei-chien was developed.[83]

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[80] Razavy, 282.

[81] Hayaud-Din, 22.

[82] Schramm and Taube, 407; Passas, *Informal Value Transfer Systems and Criminal Organizations*; Nawaz, et al., 333.

[83] Cassidy; Passas, *Informal Value Transfer Systems and Criminal Organizations.*

Most of the provincial governors maintained “memorial offering courts” in the capital city. When the merchants reached the capital city and sold the remainder of their goods, they would deposit the money with the court representing their province. The courts would then use the money to pay the taxes that were due to the central government. When the merchants deposited the money with the court, they would receive a certificate which would then be presented to the provincial government upon their return to their home province. The local government would then use the tax money which had been collected to pay the merchants the equivalent amount of money that had been deposited with the court in the capital city.[84]

The concept of fei-chien continued to evolve and formed the basis for many of the primitive banks in China. One particular system was the Shansi banks that emerged in the sixteenth and seventeenth century. This evolution was the first use of the fei-chien concept to form courier services.[85] These systems were organized as family businesses and were used to expedite the transportation of money in a secure manner. The merchants that owned these banks would send relatives or business partners to set up new offices along the trading routes and in the major cities. These systems continued the tradition of operating as fiscal agents for the government and further increased the security and ease of transferring funds.[86]

Unlike hawala, fei-chien was not specifically influenced by any particular religion. However, the other factors of close networks, kinship, and trust were integral to fei-chien in providing the security and reliability of the system. The system succeeded because it was able to develop an extensive, nationwide network which was operated by merchants who were connected through close family and business ties. Fei-chien was also endorsed and extensively used by the local and central government which provided validity and stability for the system.

[84] Cassidy; Passas, *Informal Value Transfer Systems and Criminal Organizations.*

[85] Cassidy.

[86] Ibid.

3. Decline and Re-emergence

By the seventeenth and eighteenth centuries, IFTS had reached a very high level sophistication. When European traders first came in contact with the Asian trading routes, the informal transfer systems were the only option to finance business and therefore the European traders had extensive knowledge and experience using these systems. However, as European colonization progressed through the nineteenth century, the newly placed colonial regimes instituted the formal European banking practices which were familiar to them. Many of the informal systems for financing trade were replaced with the heavily bureaucratic banks.[87] In addition, the growing economic dominance of the United States and Britain since the 1800s led to their currencies becoming the standard by which trade was conducted. Their power and influence in the patterns of global trade also led to European style banks becoming dominant in financing the trade.[88]

Those in the formal banking systems saw these developments as the demise of IFTS. While they did reduce the use of IFTS and push them to the edges of the trading world, by no means did IFTS collapse and cease to exist. IFTS continued during this period to provide the necessary financing for smaller trade routes and for the transfer of funds to rural areas not served by the formal banks. The large resurgence of IFTS began after World War II when mass migrations began to flow from former colonies to Europe and America.[89] From the 1970s onward, high oil prices and globalization have continued to fuel the migration of workers from poverty stricken developing nations to the developed world. Labor migration has become a global phenomenon and there are now few areas of the world which are not affected in some manner by its existence.[90] As migrant workers moved around the world, one of the first problems they encountered was

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[87] Roger Ballard, "Hawala Transformed: Remittance-drive Transnational Networks in the post-Imperial economic order" (revised version of a paper originally entitled "Processes of Consolidation and Settlement in Remittance-driven Hawala transactions," presented at ta World Bank/DFID International Conference on *Migrant Remittances: Development impact, opportunities for the financial sector and future prospects*, London, UK, October 9-10, 2003.

[88] Ballard, *A Background Report on the Operation of Informal Value Transfer Systems (Hawala).*

[89] Hayaud-Din, 22-23; Roger Ballard, email message to author, June 13, 2008.

[90] Sharma, 109; Ballard, "Hawala Transformed."

how to send money back to their families in a secure manner without losing a high percentage to transaction costs. Remittances have a high economic and social value to the workers' family and play a vital role in the local economies. These strong economic and social reasons led to a large-scale resurgence in the use of IFTS even in light of the economic liberalization that has occurred and the large growth in the financial sector.

B. CHARACTERISTICS

The evolution of traditional IFTS has given them many advantageous characteristics. These systems have been used in a variety of regions for multiple purposes which have allowed them to adapt to many situations. This ability to adapt to new situations and still provide excellent service is a testament to the beneficial features of these systems. There are seven primary characteristics that have evolved and make traditional IFTS attractive for use; speed, convenience, versatility, reliability, anonymity, cost, and cultural considerations. Cost and cultural considerations will be discussed in the sections on economic and social factors.

1. Speed

The first desirable aspect of IFTS is their speed and efficiency. For transfers between major cities, the transaction can be completed in 6-12 hours. If the money is being sent to a rural area or countries with limited communication capability, the transaction will usually be complete in 24 hours, but may take up to 48 hours. Advancements in telecommunication equipment, such as cell phones, e-mail, and facsimile have helped to reduce the transaction time, but this equipment is not required for the system to work.[91]

On the formal banking side, similar transactions will take up to one week to complete. This is the time required to establish an account and deposit funds, then transfer and deliver the funds.[92] Increased regulations and restrictions on money transfers in some countries can slow the process even further. The post September 11

[91] El-Qorchi, et al., 7.

[92] Jost and Sandhu.

laws imposed by many countries regarding money laundering have created additional layers of bureaucracy that inhibits the formal banking system from competing with the speed and efficiency of IFTS.[93]

2. Convenience

Convenience is the second characteristic of IFTS that make them attractive for use. IFTS operators live and work within the community they are serving and are known by the local population. These operators often provide better availability and are willing to arrange meetings at a convenient location for the customer. Transfers can be set up in minimal time with no requirement to establish an account or provide detailed documentation.[94]

In some situations IFTS are the only way to transfer money. In many developing countries or rural areas the formal banking system cannot complete the transaction because of limited or no ability to conduct business in those areas. Even if the bank has an office in the destination country, it will likely be located in one of the major cities and may not have the ability to courier the money in a secure and timely manner to the desired location.[95] This makes IFTS desirable not only for individuals sending money to family members, but also for companies and non-governmental organizations conducting business or operations in remote areas. Also, since IFTS do not operate within the regulations of the formal systems, there are little or no restrictions on amounts of money that can be transferred or to what location. On the other hand, the formal systems usually have limits on amounts and frequency of transfers. For example, Western Union will only allow an individual to transfer $1000 once every 30 days from the U.S. to Pakistan.[96]

[93] Nakhasi, 484-5.

[94] El-Qorchi, et al., 8.

[95] Nakhasi, 486-7.

[96] Ibid., 487.

3. Versatility

Third, IFTS have proven to be very versatile and adaptable to a variety of situations. Despite factors such as economic crises, overly restrictive regulations, internal or external conflict, and complexity or lack thereof of the national banking system, IFTS have prospered. These systems have adapted to handle most forms of currency exchange, and have been able to operate under many different economic systems regardless of regulatory actions.[97] An example of the versatility of these systems is seen in Afghanistan. The formal banking system collapsed after years of war and cannot provide any commercial services. The banks that do remain are unable to provide any loans, accept deposits, or provide a capability for international or domestic transfers. Businesses and organizations working in the country must either physically move money around the country or use IFTS to conduct business. "Given the security concerns, the system has appeared to be the only reliable, convenient, and cost-effective mechanism for fund transfers."[98]

4. Reliability

The fourth attractive feature of IFTS is the reliability of these systems. The foundations of IFTS are trust and strong social connections. For centuries, these systems have been able to reliably and securely conduct transfers in all manner of economic environments, many of them inadequately regulated. There is little fear of corruption or stealing in these systems and since they operate outside the formal banking systems, they are free of the bureaucracy that hinders many of the formal systems.[99] The operators of IFTS also have a much higher interest in the smooth and reliable operation of their business than do banks. IFTS operators rely on developing personal relationships and a good reputation in order to attach more business. These systems are not covered by insurance nor have any of the other financial "protections" offered to banks; therefore reliability and security are essential for continued business.

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[97] El-Qorchi, et al., 9.

[98] Ibid., 9.

[99] Jost and Sandhu; Nakhasi, 485.

Reliability comes primarily from two aspects of the system, the small number of people involved and self-regulation.[100] The small number of people involved in the transaction prevents the possibility of an information disparity occurring that could be capitalized on by one person or group. Also, the common knowledge of all the details of the transaction by each person involved keeps the system honest. This is illustrated in Figure 1, where client (a) performs a transaction with the local financial intermediary (1) to transfer funds to client (b). A code is given to client (a) who will pass it to client (b) along with the details for receipt of the funds. The code and details will also be passed to financial intermediary (2). When client (b) meets with intermediary (2), the code is presented and if it matches, then payment is made.[101]

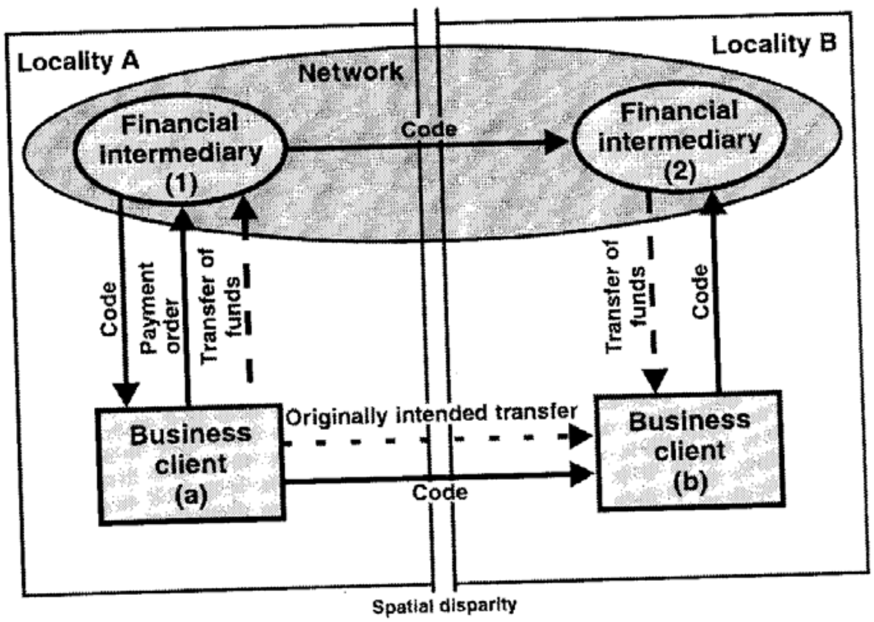

Figure 1. Information Flow and Individual Transactions in IFTS[102]

The system is also self-regulating in that since it is based on personal relationships and trust, information flows rapidly through the network. Any information regarding dishonest behavior will quickly become known and results in a loss of honor

100 Buencamino and Gorbunov.

101 Schramm and Taube, 414.

102 Ibid., 414.

and essentially "economic suicide" for the deceitful individual.[103] These aspects of IFTS promote actions that support a long-term cooperative business mentality and strongly discourage any short-term profit motivations that may be considered corrupt or unfair.

5. Anonymity

Anonymity is the fifth desirable feature of IFTS. Much of the research conducted on IFTS throughout the world has shown that the operators of these systems do not require any identification when conducting business with customers. This is true both for the individual initiating the transfer and for the person receiving the funds.[104] As mentioned above, the inherent trust in the system and the mechanism of using codes negates the need for formal identification and documentation paperwork. There is also a cultural aspect to this mentality that will be discussed later. The research highlights that there is no standard method of record keeping for the transaction itself and in most cases the only documentation that is retained after the transfer is complete is that which is necessary for settlement purposes between the operators.[105] Thus there is no paper trail for audits or investigations, nor is there any capability to accurately measure the extent of these systems and their impact on the economies of the nations involved. An example of the simplistic bookkeeping used by IFTS operators is shown in Table 1. Note that there is no reference to the client with whom the transaction was made.

The benefit of anonymity also provides secrecy for migrant workers who may not have the proper documentation to function in the formal system. In addition, many ethnic minority groups, especially from the Middle East and South Asia, are sensitive to profiling and the additional scrutiny which has occurred since the September 11 attacks and therefore turn to IFTS to conduct financial transfers.[106] Many of these individuals fear that by using the formal banking system, they may attract attention not only to

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[103] Robert E. Looney, "Following the Terrorist Informal Money Trail: The Hawala Financial Mechanism," *Strategic Insight*, November 1, 2002, ttps://www.hsdl.org/homesec/docs/dod/hawala.pdf&code=ce3e4b032501e07840b88e9ee4d4e9b9 (accessed 18 January 2008); Buencamino and Gorbunov.

[104] El-Qorchi, et al., 9; Jost and Sandhu.

[105] El-Qorchi, et al., 9.

[106] Nakhasi, 483-4.

themselves, but their families in other countries.[107] This additional attention could lead to long processing times, denial of service, or worst case, seizure or freezing of assets.

(1) Transaction date	(2) Name of Hawaladar to whom debt is owed[a]	(3) Amount of transaction[b]	(4) Dollar/ rupee exchange rate	(5) Value of transaction (U $)	(6) Mode of payment[c]
16/6/98	Vinod	100,000	37.6	2,659.57	F-1202
16/6/98	Ashish	250,000	39.25	6,369.42	F-1203
16/6/98	Nitin Bhai	350,000	42.3	8,274.23	B-8146
17/6/98	DK	50,000	38.75	1,290.32	F-1204
17/6/98	Suresh Kumar	300,000	39.25	7,643.31	B-8147
17/6/98	Anil	200,000	40.1	4,987.53	S-5428
17/6/98	Vinod	150,000	39.75	3,773.58	F-1205
18/6/98	Manoj	300,000	41.25	7,272.72	B-8148
18/6/98	Vinod Bhai	350,000	42.2	8,293.83	L-2160
18/6/98	Ganesh	200,000	38	5,263.15	५२ती

a It is very common to use partial names (e.g. Vinod, Ashish, etc).
b The chart reflects a tendency to indicate amounts in multiples of 100,000.
c This column indicates the manner in which payment was made. The "F" reflects the name of a bank and the "1202" is the check number. The notation for Ganesh Trading means 52 tolas of gold (tola = 10 gms), possibly paid to a local goldsmith or jeweler instead of remitting money through a bank.

Table 2. Sample IFTS Bookkeeping[108]

C. ECONOMIC FACTORS

There are multiple micro and macroeconomic issues involved in the use of traditional IFTS and the decisions on whether or not to use them. The primary microeconomic issues are the cost of conducting transactions and the effect remittances have on the families living in rural villages. The primary macroeconomic issues affecting the use of IFTS are government policies and regulations, and institutional deficiencies in the global formal banking sector.

[107] Nakhasi, 484.

[108] Buencamino and Gorbunov.

1. Microeconomic Issues

The lower cost of IFTS transactions is the number one cited reason for their use and is also an important factor in decisions on how much to send. The overall cost of a transaction in some cases will be free, however on average a commission will be charged that varies between .25% and 5%.[109] This cost will vary based on location, both sending and receiving, amount being sent, and exchange rate. For comparison, rates in the United States formal banking system range from 5% to 11.75% for sending money to Latin America. In the United Kingdom formal system, rates range from 3% to 37% based on amount and destination.[110] Although the low end of the formal rates may appear to be competitive with IFTS, these rates are only for sending large amounts of money. The average cost for a $200 remittance is 11-13%, and this can significantly increase for those transfers going to more remote or rural areas.[111]

Data on remittance transactions clearly shows the effect of cost on the type of transfer mechanism used. In many countries, such as Mali, Senegal, and Uganda, where costs in the formal sector are high, 70-80% of all remittances are through IFTS. In contrast, in areas such as Latin America, were concerted efforts have been made to control transaction costs, only 5-20% of remittances enter through IFTS. A 1% reduction in transaction cost has increased formal remittances by 14-23%.[112]

The primary reason IFTS can charge such a low rate, if any at all, is because these systems take advantage of differences in exchange rates. IFTS exploit the difference between the official rate and the black market rate. This difference can be significant and provides a major incentive to offer free or very low cost transactions. The larger numbers

[109] Brigitte Unger and Melissa Siegel, *The Netherlands-Suriname Corridor for Worker's Remittances: Prospects for Remittances When Migration Ties Loosen*. Utrecht School of Economics: Study prepared for the World Bank and the Dutch Ministry of Finance, 2006; Passas, "Demystifying Hawala," 57; El-Qorchi, et al., 7.

[110] Page and Plaza, 278-9.

[111] Caroline Freund and Nikola Spatafora, "Remittances, transaction costs, and informality," *Journal of Development Economics* 86 (2008): 358; Looney.

[112] Kalyani Munshani, *The Impact of Global International Informal Banking on Canada*. The Nathanson Centre for the Study of Organized Crime and Corruption, and the Law Commission of Canada, 2005; Freund and Spatafora, 363.

of customers that can be drawn in with free transactions will more than make up for the loss of small commissions that could have been charged. The exploitation of exchange rates is the primary source of profit for IFTS operators.[113]

IFTS operators are also able to keep costs low because of the simplicity of the system. Very little infrastructure or equipment is needed and business can be conducted literally anywhere, from a persons home to a table in a restaurant. An IFTS operator only needs a phone and a notebook to conduct business. Many of these systems are operated out of established businesses, so there are very little additional operating costs. In addition, expenses for accounting, licensing, bank accounts, taxes, wire fees, and courier fees that formal banks need to consider are not a factor for IFTS.[114] These overhead costs can account for well over 50% of total expense for a formal money transmitting business. Therefore, since IFTS operators can operate in a substantially more efficient manner, they gain a competitive advantage over the formal sector and are able to minimize the cost to the customer.[115]

The second microeconomic issue with traditional IFTS is the effect they have on the families who are receiving the funds. Officially, remittances are the second largest inflow of capital to developing nations, totaling about 50% of the Foreign Direct Investment. However, these numbers only account for formal remittances. With estimates of the informal sector being 50-100% of the formal sector, remittances could account for the highest flow of capital in some countries.[116]

Some studies in the past have criticized remittances because they are used primarily for consumption items and not for investments. However, these expenditures are actually very beneficial to the local communities. Consumption items include the basic necessities, such as food, clothing, health care, and education. Expenditures on

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[113] Passas, “Demystifying Hawala,” 57.

[114] Jost and Sandhu.

[115] Dilip Ratha and Jan Riedberg. *On reducing remittance costs*. Washington, DC: World Bank, 2005; Ballard, “Coalitions of reciprocity and the maintenance of financial integrity within informal value transmission systems,” 335.

[116] Cerstin Sander, *Migrant Remittances to Developing Countries, A Scoping Study: Overview and Introduction to Issues for Pro-Poor Financial Services*. Bannock Consulting: Prepared for the UK Department of International Development, 2003.

these items are better viewed as investments in social and human capital.[117] Increased consumption is also directly related to poverty reduction. Furthermore, money spent on consumption items has a strong positive effect on the entire local economy. As the money passes through the local businesses, it is spread among the community and has an actual economic impact close to double what the initial amount was. In all, remittances are a very important part of the local economies in developing nations.[118] They can sustain entire families during periods of economic hardship and improve the standard of living in many areas where the government either cannot or is unwilling to invest in the community.

2. Macroeconomic Issues

Government policies and regulations on currency control, tariffs, taxes, and financial licensing can have a significant effect on the formation and use of traditional IFTS within the country. Although IFTS are used throughout the world, in both developed and developing nations, they tend to flourish in countries that implement highly restrictive economic policies or are in political turmoil. The more restrictive the policies are, the wider the use of IFTS.[119] Whereas the majority of previous issues and factors have primarily affected the individual use of IFTS, changes in government policies and regulations also encourage businesses to use IFTS.

Currency controls affecting foreign exchange rates and the convertibility of a currency are the most often cited governmental reasons for individuals and businesses to use IFTS.[120] When governments try to restrict the flow of capital, or its convertibility, in an attempt to stabilize the economy or improve trade deficits, they create a gap between

[117] Jorgen Carling, *Migrant remittances and development cooperation.* Oslo: International Peace Research Institute, 2005, PRIO Report I/2005; Sander.

[118] Michele Wucker, “Remittances: The Perpetual Migration Machine,” *World Policy Journal* 21 (2004): 37, 43; Carling.

[119] Mohammed El-Qorchi, “Hawala,” *Finance and Development* 39 (2002), http://www.imf.org/external/pubs/ft/fandd/2002/12/elqorchi.htm (accessed18 January 2008); Passas, *Informal Value Transfer Systems and Criminal Organizations.*

[120] Buencamino and Gorbunov; Ballard, *A Background Report on the Operation of Informal Value Transfer Systems (Hawala);* Sander; Carling; Ballard, *Hawala Transformed*.

the official and unofficial rate of exchange. As noted previously, it is this gap in exchange rates that IFTS operators capitalize on, and it is one of the most significant factors in determining the method of transfer people will use. This is because an overvalued exchange rate essentially acts like a tax on anyone who transfers funds through the formal channels. Therefore the overall cost of the transaction increases, which discourages transfers through these channels since cost is an overriding factor. This was shown in a study of six African and European countries where a 10% rise in the black market premium resulted in a 3% decline in transfers through the formal sector.[121]

Pakistan is also a very good case study of the positive and negative effects of government policies. In the 1980s, IFTS were used extensively due to restrictions on foreign exchange and the fact that the state owned banks were in miserable condition and could not provide adequate services. Then in the early 1990s, at the insistence of the International Monetary Fund, Pakistan began to liberalize its economy and remove the currency restrictions. These actions were successful in bringing in millions of dollars through the formal sector and drastically reducing the foreign exchange deficit. However, after the nuclear issues with India in 1998, the government once again imposed strict exchange controls and reversed previous policies. Within a year, IFTS had again become the dominant method to conduct transfers.[122]

Recently, a high emphasis has been put on trying to bring the informal transfers into the formal sector. Given the extraordinary sums of money that are moving through the informal sector, it is natural for governments to want to account for this money in their formal balance of payments. To achieve this, the IFTS operators need to become licensed, report their transactions, and comply with anti-money laundering (AML) and combating the financing of terrorism (CFT) laws. However, coordination at the international, federal and state level has been inconsistent and sporadic. While the vast

[121] Buencamino and Gorbunov.

[122] Jonathan Friedland, "Filling the Vacuum," *Far Eastern Economic Review* 42 (1991): 104; Ballard, *A Background Report on the Operation of Informal Value Transfer Systems (Hawala).*

majority of IFTS transactions are for legitimate purposes, the rush to restrict their use after September 11 has not accounted of the unique nature and circumstances in which these transactions occur.

The Financial Action Task Force (FATF) is the recognized inter-governmental agency to develop national and international standards for AML and CFT. FATF's approach to IFTS has predominantly been to transpose current international AML standards for the formal banking sector onto the informal sector. FATF recommendations also call for in-depth background investigations for all IFTS operators and agents. At the national level, current U.S. policy requires registration at the federal level and licensing at the state level. All money service business (MSB) principal operators, which IFTS fall under, must register with the Financial Crimes Enforcement Network (FinCEN) and enact AML and CFT procedures.[123] Furthermore, the states are inconsistent with their licensing requirements and do not account for the scale and customer base of IFTS. The monetary requirement to start a MSB varies greatly among the states, ranging from $15,000 to $1.5 million. This is true in other countries as well, with regulatory costs ranging from zero in Canada to 2.4 million euro in France.[124] These policies and inconsistencies disenfranchise many ethnic communities and thereby encourage the continued use of IFTS.[125]

The second macroeconomic issue affecting the further use of IFTS is the institutional deficiencies in the global banking system. Little attention was paid to IFTS in the past and only recently has the enormity of their use been recognized. Therefore, the global banking system has not been structured to effectively and efficiently handle these transactions in a low cost manner. Several factors continue to contribute to the deficiencies in the formal sector; individuals conducting these transfers are often low net worth customers and are not considered to be "prime customers", small transfers are more costly for the banks, and formal banking systems are often not trusted and can be

[123] Nikos Passas, "Fighting terror with error: the counter-productive regulation of informal value transfers," *Crime, Law and Social Change* 45 (2006): 325.

[124] Ratha and Riedberg.

[125] Passas, "Fighting terror with error," 328; Ratha and Riedberg.

intimidating for individuals from developing nations.[126] In addition, the more stringent Know Your Customer rules that have been enacted since September 11 have also increased the difficulty for migrants to use the formal banking system. In many cases, in order to send a bank transfer, both the sender and receiver must have an account with the bank. To open an account proof of identity and proof of residence is required. Many migrant workers cannot provide such documentation.[127]

Besides the structural and regulatory issues limiting access to the formal banking system, the physical location of the banks is also a significant deterrent. Transactions are often sent to rural areas which are not serviced by the banks. In most developing nations, the banks are primarily located in the urban areas and have limited ability to transport funds to remote villages. This fact highlights a major contradiction with some of the regulatory efforts in developed nations to close IFTS. Although there is plenty of access to formal systems in the developed countries, the banks often do not have a direct link to a money service provider, much less to a branch of their own in the immediate area of the recipient.[128] Going back to the fact that many banks require both the sender and receiver to have an open account, transfers through the formal system may be impossible because of the lack of banks in close proximity to the recipients. While some banks are beginning to offer courier services from the banks in the urban areas to the rural villages, these are often slow and unreliable. The most prominent policies and regulations affecting the method of transfer from a particular country are those which “shape the availability and access to money transfer services that connect with a service point close to the family back home.”[129]

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[126] Adam Higazi, Ghana Country Study. Oxford, UK: ESRC Centre on Migration, Policy and Society, A part of the report on Informal Remittance Systems in Africa, Caribbean and Pacific (ACP) countries, 2005, RO2CS008; Ratha and Riedberg.

[127] Elizabeth Holmes, Carola Menzel, and Torsten Schlink, *Remittances from Germany and their Routes to Migrants’ Origin Countries, A study of five selected countries.* Federal Ministry for Economic Cooperation and Development, 2007.

[128] Holmes, et al.; Ratha and Riedberg.

[129] Sander.

D. SOCIAL FACTORS

Traditional IFTS have been and continue to be heavily influenced by social issues. Many of the migrant workers originate in areas that place high emphasis on the family unit. In many of these areas, money is not considered to be a personal entity; rather it is to be used by the family as a whole based on needs and availability.[130] Cultural tradition and religion are also very important in dictating the actions of individuals. Although many migrant workers move to areas that are technologically and financially advanced, where they could take advantage of more modern systems, most still use traditional systems. The long-term existence and success of IFTS is due to its "embeddedness in common culture and belief."[131]

1. Culture

Cultural considerations not only encourage migrants to remit money through IFTS, they are also vital to the functioning of the system. Personal relations, ethnic ties, and kinship are the basis for the trust that is the foundation of these systems. The high levels of trust make these systems secure, desirable, and easy to use. Transactions are "easier if the parties believe in each other's basic honesty; there is less need to spell things out in lengthy contracts; less need to hedge against unexpected contingencies; fewer disputes and less need to litigate if disputes arise."[132]

As migrant workers move to various foreign countries, they form close-knit diasporas based on country of origin, common language and religion. As migration continues, the diasporas grow and eventually develop distinct local ethnic communities within the greater community around them. Often multiple generations or even multiple families may live in a single house. Some have claimed that this is due to economic reasons, but it would improper to think that this was the only consideration.[133] Studies of

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[130] Sharma, 112; McCulloch and Pickering, 479; Ballard, *Hawala Transformed*.

[131] C. Kenrick Hunte, "Worker's Remittances, Remittance Decay and Financial Deepening in Developing Countries," *American Economist* 48 (2004): 85; Razavy, 285.

[132] El-Qorchi, "Hawala."; Passas, *Informal Value Transfer Systems and Criminal Organizations*.

[133] Sharma, 109.

the Pakistani and Indian populations in Britain have shown that although most of the individuals in these groups have been in Britain for a relatively long period of time, and are fully acquainted with the British lifestyle, the vast majority still conduct their personal affairs based on the “cultural, moral, and linguistic conventions which are primarily inspired by their South Asian ancestral heritage.”[134] IFTS rely on these social dynamics and function to preserve the cultural traditions.

In addition to the traditional reasons for use of IFTS, there are also some very practical reasons why they are used, especially among new migrant workers. These include language barriers, lower education and literacy rates, fear of unknown banking systems, and illegal immigration issues.[135] The local IFTS operator plays a significant role in alleviating these concerns and meeting the cultural needs of their clients. These operators are usually a mainstay of the local community and develop close relationships with their clients over time. The operators often become part of a larger extended family which serves to fortify the trust in the system.[136]

Another cultural issue concerns the family members living in their home country. Often times, women and children will stay while the men migrate for work. The social norms and traditions in many societies, especially in the rural villages, only allow women to have minimal interactions with people outside their immediate community. Therefore women cannot use banks or the post office to conduct business. In order to transfer funds in these situations, a trusted person from the community is needed to complete the transaction and deliver the funds.[137]

All of these cultural issues that encourage individuals to use IFTS also serve to strengthen the overall system and provide the security and reliability in the system. Since these systems are informal and illegal in most countries, there is no legal entity that individuals can go to in order to solve a dispute. Hence why trust in so important in these systems. IFTS transactions can be viewed as a series of interactions. Depending on the

[134] Ballard, *A Background Report on the Operation of Informal Value Transfer Systems (Hawala).*

[135] El-Qorchi, et al., 8.

[136] Razavy, 285.

[137] El-Qorchi, et al., 8.

amount and destination of a transaction, there may be a couple or many individual interactions that take place to complete the transaction. With each interaction along the way, each person is trusting that the next will fulfill their obligation.[138] Since it is common for IFTS operators to have varying levels of credit and debit with other operators, what ensures that an opportunistic operator will not wait until he has a large store of cash and then disappear with the money?

As noted, IFTS operators are usually part of the local community, and therefore have regular interaction with their clients, whether business or personal. Given this high level of interconnectedness, along with the fact that IFTS operators gain and maintain business through their reputation, the likelihood of cheating is minimal. Because of the close personal connections involved in these systems, information travels fast. Any misconduct would quickly become known throughout the system and the guilty party would face severe punishment. According to one operator, no one cheats because "if one does, then the small gain would not be worth the bigger price…You will lose respect, and for a man, honor is his most important asset."[139]

To further understand the security and reliability in the systems, especially during the interactions that occur with intermediaries who do not have a personal relationship with the clients, the system as a whole can be viewed as a self-enforcing exchange mechanism or as a homogenous economic club.[140] Both of these concepts look at the social cost of operating in the system, and the flow of information through the system. The cultural underpinnings of IFTS do not allow anyone to just become an operator in the system. One must be recommended and brought into the system by someone who is already established. The new member then has initial credibility and a reputation based on the sponsor. The high investment in social capital helps to stabilize the system and gives each member a strong incentive to act in accordance with established norms.[141]

[138] Schramm and Taube, 415.

[139] Razavy, 286.

[140] Emily C. Schaeffer, "Remittances and Reputations in Hawala Money-Transfer Systems: Self-Enforcing Exchange on an International Scale," *The Journal of Private Enterprise* 24 (2008): 2-3; Schramm and Taube, 411.

[141] Schramm and Taube, 412.

The multitude of transactions that occur in the system and the continually changing credits and debits between the operators allow ample opportunity for information to flow through the system. Each operator has an incentive to accurately report on their dealings and on the reputations of others in the system. Any false accusations or attempts to cheat will become known due to the multiple connections among the operators. This rarely occurs due to the threat of being expelled from the system and losing one's social standing in the community. Accurate reporting on the other hand increases one's reputation and improves the chances that others will continue to conduct business with him. Therefore, security and reliability are ensured because of the "social embeddedness of the institutional structure."[142]

2. Religion

Religious concerns are not a consideration for all IFTS, but are significant for some, primarily hawala. Also, given that many migrant workers come from predominantly Muslim regions, even if the particular IFTS they are using in not hawala, it is likely an offshoot of hawala and still influenced by Islamic principles. The hawala system is integral to the social-religious aspects of Islamic society in which decisions about usage of particular institutions is not solely based on financial or economic considerations; "the Koran encourages Muslims to build financial relationships based on trust rather than contract."[143] The Koran and *hadiths*, words and deeds of Mohammed that were passed orally for centuries, legitimize and endorse the concept of hawala and define the conditions or requirements that must be met to validate a transaction. While some of the customs that have been passed down by the *hadiths* may appear to be very different from the practices seen today, religious leaders continue to adapt them and teach the proper methods for the use of hawala so as meet the intent of financial transfers which was endorsed by the Prophet Mohammed.[144]

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[142] Schaeffer, 12, 14-15; Schramm and Taube, 411, 416.

[143] Nakhasi, 488; Schramm and Taube, 416.

[144] Razavy, 283-284.

An important aspect to note with Islamic culture is the view that shari'a law is a supranational code and is above any secular legal jurisdiction. In theory then, shari'a can justify and validate any transaction regardless of borders or secular jurisdictions. For example, in the U.S. financial institutions are required to report transactions greater than $10,000; if a hawala dealer (assuming he is licensed as a money service business) decides to operate under shari'a law, then he is not obligated to report any transaction regardless of the amount. However, in reality, shari'a is limited in its ability to accomplish this because there is no single entity to enforce it and it is not recognized by many economic institutions.[145] Therefore, despite its theoretical claim, shari'a is only enforceable within smaller religious communities that recognize its validity and are willing to abide by its principles.

The notion of shari'a as a supranational code and the validity of hawala as a banking system were reiterated in 2005 by the Grand Ayatollah Ali Seestani. When questioned regarding the legitimacy of hawala within a nation in which it is outlawed, Seestani replied, "it is necessary to observe the law which has been approved by a Hakim-e Shar'a (an Islamic judge)."[146] The level to which hawala is engrained in the Muslim culture and the direct reference to its use in shari'a law helps explain the significant amounts of money that are transferred around the world every year.[147]

In addition to the required use of hawala by the Koran and *hadiths*, there is also a social aspect to its use. According to Islam, Allah controls wealth, and therefore those with wealth are obligated to fulfill a social duty by helping the poor and disadvantaged within the society. This obligation extends to expatriates and encourages them to send remittances back to their families. Fulfilling this obligation is highly valued, and therefore those that do enjoy an elevated social status within their community.[148]

[145] Razavy, 284; Schramm and Taube, 413.

[146] Razavy, 284-285.

[147] Buencamino and Gorbunov.

[148] Hayaud-Din, 22.

E. SUMMARY

The expanding trade routes in the Middle East and South Asia during the medieval period along with the uncertainty and insecurity of conducting business in distant areas provided the basis for traditional IFTS. Although the rise of the modern banking system diminished the use of traditional IFTS for a time, the economic and social factors tied to these systems allowed them to persevere. As the modern banking system continued to develop and spread across the world, it often bypassed the developing nations. This created a significant problem for many workers who migrated to the developed world to provide the labor force for the global economy. The sudden and massive resurgence of traditional IFTS to fill the void left by the formal banking system is an indication of the strong economic and social factors that influence their use. The ability of traditional IFTS to provide low cost, secure, and reliable transfers to remote areas is a significant incentive for their use. When this is combined with the cultural and religious requirements regarding monetary transactions, the overriding importance of these systems becomes obvious.

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IV. MODERN IFTS

A. ORIGIN

Modern informal funds transfer systems developed in the 1950-1970 timeframe. Unlike traditional IFTS, these systems rarely have a legitimate use, especially in their current form. They were originally formed as a response to restrictive government monetary policies. The increasing volume of global trade and the development of parallel foreign exchange markets, combined with technological advancements in communication and banking services, allowed businesses to manipulate trade transactions in order to circumvent currency controls and taxes. In addition to simple trade manipulation to avoid currency controls and taxes, these systems have also become primary mechanisms for conducting money laundering. The International Monetary Fund (IMF) estimates that between 2% and 5% of the global gross domestic product is laundered through these systems, which equates to between $600 billion and $1.5 trillion every year.[149] Modern IFTS have continued to evolve over the past few decades and have become very sophisticated.

There are essentially three methods criminals can use to move money and attempt to hide its origins. First, they can use the financial system to transfer funds through multiple accounts, national and international, using various methods, such as checks and wire transfers. Second, they can physically move currency to different locations and across international borders. Third, they can manipulate trade transactions to transfer value without actually moving any currency. The first two methods have been given considerable attention by FATF and other national and international agencies and

[149] John McDowell and Gary Novis, "The Consequences of Money Laundering and Financial Crime," ed. Jonathan Schaffer, *Economic Perspectives* 6 (2001): 7, usinfo.state.gov/journals/ites/0501/ijee/ijee0501.pdf (accessed 16 October 2008); Miriam Wasserman, "Dirty Money," *Regional Review* Q1 (2002): 16.

organizations over the past decade.[150] Due to the increased risk of detection and capture when using the first two methods, criminals began to move towards greater use of trade manipulation to transfer their funds.

The international trade system has become attractive to criminals for a variety of reasons. The rapid expansion of global trade along with the limited ability countries have to accurately track, verify, and inspect imports and exports have created many vulnerabilities that criminals are capitalizing on. Global merchandise trade exceeds $9 trillion and research has shown that less than 5% of all cargo is inspected by customs officials.[151] The huge volume of trade, combined with the complexity of multiple foreign exchange transactions, limited exchange of customs information between countries, and commingling of legitimate and illegitimate funds has created an environment which is highly conducive to criminal activity.

Trade based IFTS can range the full spectrum from relatively simple transactions between two colluding companies to complex transactions involving multiple criminal, business, and banking entities; the best known of these being the Black Market Peso Exchange system in Colombia. A further distinction can also be made with trade-based systems regarding the criminal intent involved. First, legitimate businesses may use these systems to transfer otherwise legal profits in order to avoid currency controls and taxes. Second, criminal organizations can use these systems to conduct trade-based money laundering in order to disguise the source of their illegal funds.[152]

1. Basic Trade Manipulation

A variety of basic methods can be used by either legitimate businesses or criminals to transfer funds by misrepresenting the price, quantity, or quality of the

[150] *Trade Based Money Laundering*, Financial Action Task Force, 23 June 2006, http://www.fatf-gafi.org/dataoecd/60/25/37038272.pdf (accessed 16 October 2008).

[151] *Report on Money Laundering Typologies 1999-2000*, Financial Action Task Force, http://www.fatf-gafi.org/dataoecd/29/37/34038120.pdf (accessed 16 October 2008); *Trade Based Money Laundering.*

[152] Haemala Thanasegaran and Bala Shanmugam, "International trade-based money laundering: the Malaysian perspective," *Journal of Money Laundering Control* 10 (2007): 431-433; *Trade Based Money Laundering.*

merchandise. Although the purpose for using these systems may be different, tax evasion vs. money laundering, the same methods can be used by either group to accomplish their goals. The most common methods include over- and under-invoicing, multiple invoicing, falsification of invoices, and over- and under-shipments.[153] All of these systems require the collusion of both the import and export company. In addition, the proliferation of large multi-national corporations allows these systems to be used internally to shift taxable income from high tax to low tax jurisdictions. Multiple studies have highlighted the incentives companies have to move income when they are operating in various locations with different tax rates.[154] By over- and under-invoicing imports and exports between affiliate companies, income can be transferred to the lower tax jurisdictions.

An importer can receive value from the exporter by having the merchandise invoiced below market value. Alternatively, an exporter can receive value from the importer by invoicing the merchandise above market value. In the first case, if the importer pays a unit cost of $1 for one million items and the fair value is $2 per item, the importer will have paid $1 million for $2 million worth of goods. When the merchandise is sold, the importer will have a net gain of $1 million. For over-invoicing, the funds will flow to the exporter. In this case, using the same $2 fair price, the exporter will charge $3 per unit and receive $3 million from the importer. After paying the $2 million in initial expenses for the merchandise, the exporter is left with a net gain of $1 million. In a money laundering operation, the remaining $1 million can now be distributed back to the originator through bank accounts or used to buy goods and services on behalf of the originator. By manipulating the trade system, the money now appears to have come from a legitimate source and will be very difficult to track.[155]

This same basic premise used for under- and over-invoicing is used for falsification of invoices and over- and under-shipments. When using the method of multiple invoicing, the importer will pay the exporter multiple times for the same

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[153] Thanasegaran and Shanmugam, 431.

[154] The various studies are referenced and summarized in the *Trade Based Money Laundering* FATF report.

[155] *Regional Typologies – GAFISUD 2005*, GAFISUD, July 2005, http://www.gafisud.org/pdf/english.pdf (accessed 16 October 2008); *Trade Based Money Laundering*.

shipment of goods. By using a variety of payment methods and financial institutions, it becomes very difficult to track these payments to the same shipment. Also, there is no need to misrepresent any of the data on the price, quality, or quantity of the goods. This will further reduce any suspicion about the validity of the transaction.[156] In all of these cases of basic manipulation, the requirement for collusion is obvious. The fundamental premise for the system to work is that both companies understand and agree to the manipulation.

2. Black Market Peso Exchange

Contrary to many recent reports, the Colombian Black Market Peso Exchange did not originate to service the illegal drug industry. BMPE arose in the 19501950s because of overly restrictive monetary policies implemented by the government. These policies raised taxes and tariffs, thereby raising the cost of conducting business, and prohibited individuals and companies from holding U.S. dollars. Businesses had to go through the central bank in order to get a letter of credit to buy foreign merchandise. In order to get this letter, the taxes and fees had to be paid first, which could be 21% to 39% of the total transaction amount.[157] In addition, the government would now have a record of the amount and type of merchandise a business was buying or selling. These records could then be used to audit end of year tax returns to ensure the proper taxes were being paid.[158] These factors led to the creation of an unofficial parallel market, or black market.

To facilitate this black market, peso brokers would act as intermediaries between importers and exporters. Colombian exporters would sell their merchandise in the United States and be paid in dollars by the U.S. companies. However, since Colombians could not hold dollars, the exporters did not want to bring the money back into the country. If the funds were returned, they would have to be deposited in the central bank, and that

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[156] *Regional Typologies – GAFISUD 2005; Trade Based Money Laundering*.

[157] Senate Caucus on International Narcotics Control, *The Black Market Peso Exchange: How U.S. Companies Are Used To Launder Money,* 106th Congress, 1st session, June 21, 1999, 50-51.

[158] Rober Mazur, “A Tidal Wave of Risk on the Horizon: Why Big and Small Businesses Face New Risks Simply by Getting Paid,” *Business Credit* 102 (2000): 34.

would require the taxes and fees to be paid. To avoid this, the exporters would sell their dollars to the peso brokers and then instruct the U.S. companies to deposit the payments into a U.S. account controlled by the broker. The peso broker would then pay the exporter in local currency. This would complete the first half of the process; the exporter now had his money in local currency and the peso broker had dollars in a U.S. account.[159]

In order to continue this business, the peso broker needed a continual supply of pesos. To meet this need, the peso broker would sell the dollars to a Columbian importer. The importer would pay for the dollars using the local currency that was generated from selling the imported merchandise. Once the dollars were purchased, the importer would instruct the broker to make payments to the U.S. companies he had ordered products from. The peso broker would then transfer funds from his U.S. accounts to the U.S. companies. By purchasing the dollars from the peso broker, the importer could now smuggle the goods into the country and avoid all taxes and tariffs. Since the importer did not go through the central bank to fund the transaction, there would be no official record of the imports. The process was now complete; the importer was able to buy the merchandise without the central bank and the peso broker had a fresh supply of pesos to sell to the next exporter.[160]

BMPE continued to grow and became very efficient at transferring funds and smuggling merchandise. It remained primarily a tax avoidance and tax evasion system for the importers and exporters until the early 1980s. As the drug trafficking industry expanded and Colombia eventually became the leading exporter of cocaine to the United States, the traffickers needed a system to retrieve illegal funds held in the United States. The enormous volume of cash that was generated combined with tighter banking restrictions and reporting requirements, made the transfer of funds back to Colombia increasingly difficult.[161] The traffickers recognized the efficiency and utility of the BMPE and began to use it as the primary means of recovering their drug proceeds.

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[159] Senate Caucus, *The Black Market Peso Exchange*, 50-51, 58, 65-67.

[160] Ibid., 50-52, 65-67.

[161] Ibid., 51-52.

The present day system continues to work as described above, except now it is the traffickers that are the primary source of dollars in the U.S., not the Colombian exporters. The peso brokers now buy the dollars from the traffickers and pay them with the pesos that are received from the importers. The primary problem this has caused for the peso brokers is how to place the hundreds of millions of dollars in cash into the formal banking system so that it can be used by the importers. In order to accomplish this and not raise suspicion with the banks, the peso broker may control up to a hundred different bank accounts in the U.S. The broker uses a team of agents in the U.S. to collect the cash from the trafficker's stash houses and deliver it to the banks. By using various methods, the agents are able to place the funds into multiple accounts without raising suspicion or exceeding reporting limits. Some brokers have also begun to collude with U.S. money transmitter businesses to mix the illegal funds with the legal funds that are being transmitted to Colombia. After the funds are commingled in the money transmitter's accounts, the illegal funds are later separated out and transferred to one of the peso brokers U.S. accounts.[162] The Black Market Peso Exchange has grown to be the largest money laundering system in the Western Hemisphere and is considered the "most dangerous and damaging form of money laundering that we have ever encountered."[163]

BMPE essentially consists of two systems, one on the U.S. side and one on the Colombian side. As illustrated in Figure 1, these systems remain separate with the only interaction being the transfer of value from one side to the other. The peso broker is the facilitator of these two systems and orchestrates the transfer of value between them.[164] The individual users of the system, drug traffickers and Colombian importers, are not involved in the specific transfers, which greatly reduces their risk of being tied to the money laundering scheme. In this system, the peso broker assumes all the risk for

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[162] David Marshall Nissman, "The Colombian Black Market Peso Exchange," ed. David Marshall Nissman, *USA Bulletin Money Laundering*, June 1999, http://www.usdoj.gov/usao/eousa/foia_reading_room/usab4703.pdf (accessed 16 October 2008); Senate Caucus, *The Black Market Peso Exchange*, 52-53.

[163] Senate Caucus, *The Black Market Peso Exchange*, 5.

[164] *Colombian Black Market Peso Exchange*, FinCEN Advisory, Issue 9, U.S. Department of the Treasury, Financial Crimes Enforcement Network, November 1997.

performing the transfers, while the users just conduct their individual business and provide a constant source of funds for the peso broker.

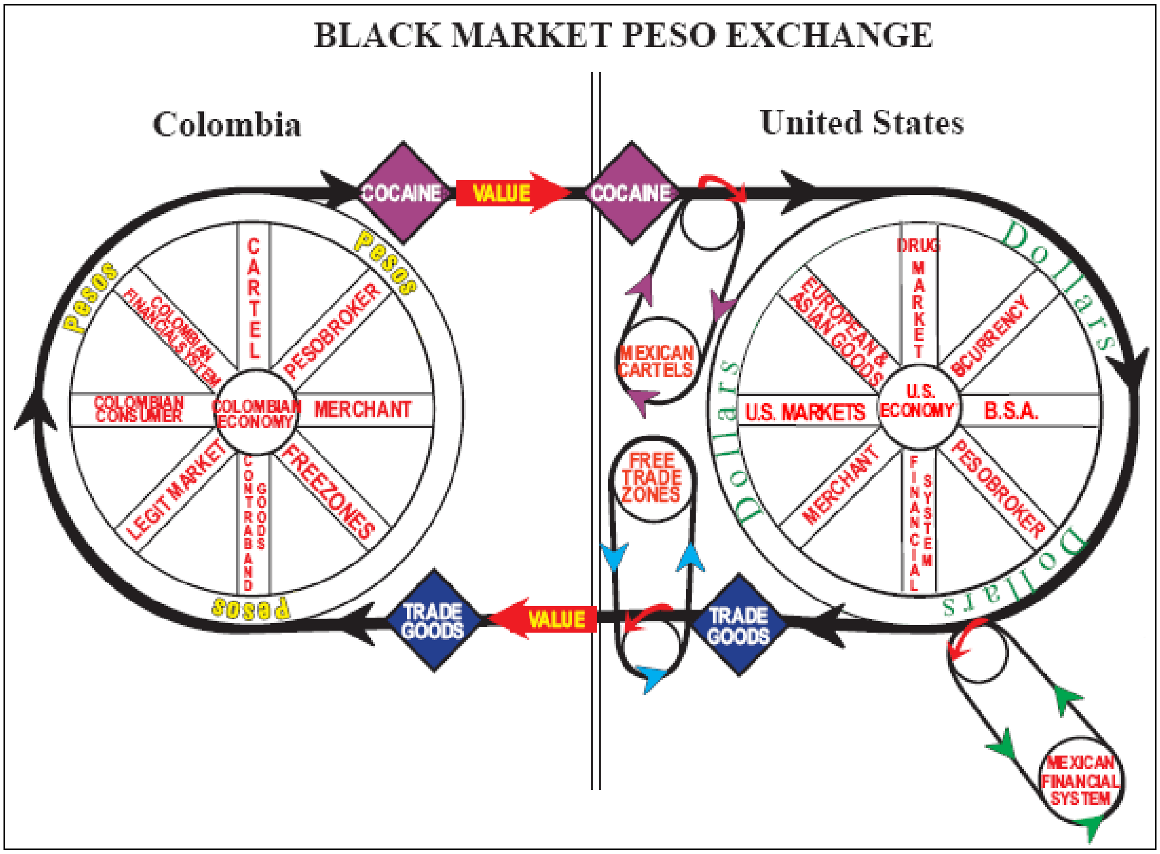

Figure 2. Black Market Peso Exchange System[165]

The interaction of the four main entities in this system, the peso brokers, drug traffickers, Colombian importers, and banks, highlights the two major differences between BMPE and the basic trade manipulation systems. First, BMPE involves a much higher level of complexity in moving the funds. Whereas in the basic systems, funds transfers are initiated through simple manipulation of paperwork; in BMPE, extremely large sums of cash must be placed into the formal banking system without raising suspicion. These funds then must be transferred to multiple companies and appear to come from a legitimate source. Second, in BMPE there is no collusion with the

[165] *Colombian Black Market Peso Exchange*.

exporting companies. The U.S. companies must believe that the funds they receive for payment are from a legal and valid source.[166]

Although BMPE is profoundly different from traditional IFTS, its structure and operation allow it to have many of the same characteristics as traditional IFTS; primarily cost, convenience, reliability, and anonymity. Similar to traditional IFTS, these characteristics are largely based on the trust that is found in the system. Unlike traditional IFTS, however, this trust in not from any cultural or social ties, and it is often enforced with the threat of violence. Nevertheless, there is a high degree of trust with payments often being made to one party or another before all the individual transactions are complete.[167] Also contributing to these characteristics is the fact that the informal and simplistic nature of communication and record keeping seen in traditional IFTS are well established in the process of BMPE.[168]

B. ECONOMIC FACTORS

The primary motive behind modern IFTS is the economic incentive. By avoiding currency controls, taxes, and tariffs, companies not only save money, but they also get a competitive advantage over other companies that abide by the government policies. In theory, these systems could be mitigated with sound economic policies, however, with the introduction of illegal drug money, changes in policy alone are unlikely to control them. The expansion of the international economy, the increase in the global illegal drug market, and the formation of parallel foreign exchange markets have caused modern IFTS to become a global phenomenon. The techniques of basic trade manipulation as well as the principles of the Black Market Peso Exchange have expanded beyond Latin America and are now seen in almost every region of the world.[169]

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[166]Thanasegaran and Shanmugam, 434; *Trade Based Money Laundering*.

[167] William F. Bruton, "Money Laundering: Is It Now a Corporate Problem?" *Journal of Money Laundering Control* 3 (1999): 10; Senate Caucus, *The Black Market Peso Exchange*, 66-67.

[168] Bruton, 13.

[169] *International Narcotics Control Strategy Report, 2008*. Washington, D.C.: U.S. Department of State, Bureau of International Narcotics and Law Enforcement Affairs, 2008, http://www.state.gov/p/inl/rls/nrcrpt/2008/vol2/html/101353.htm (accessed 16 October 2008); *Trade Based Money Laundering*; Bruton, 12.

The basis of most modern IFTS is the creation of a parallel foreign exchange market. Basic trade manipulation can occur without it, but more complex systems such as BMPE require it. These black markets allow for the purchase and sale of foreign currency outside the legal financial system. The principle reason these markets exist is government policies affecting the official currency markets, taxes, and tariffs.[170] When a country has a balance of payments deficit, there will often be an excess demand for foreign exchange. This will be followed by government policies to control the access to foreign exchange in an attempt to conserve foreign reserves and increase the demand for domestic products.[171] While the government must attempt to stabilize the economy and implement policies to reduce the deficit, especially in developing and transition nations, if these policies are not managed carefully they can have significant long term negative effects on the nation. As restrictions are imposed, inflation rates will rise and the official exchange rate will become overvalued, which leads to a further increase in the balance of payments deficit. If this process continues, a black market will emerge.[172] The extent and importance of the black market will depend on the length and severity of the monetary restrictions. If the conditions that caused the situation are not solved or if the restrictions are severe enough, use of the black market can become so engrained in personal and business dealings that it will continue to be used even if the situation is eventually fixed, although probably at a lesser level.[173]

Many developing nations fit this pattern in the 1950-1980 timeframe. Latin America as a whole experienced vary degrees of black markets since that time due to restricted access to foreign currency. In recent years, some countries have managed to control the black markets through economic liberalization and sound monetary policies. In others, such as Colombia and Brazil, the black market became so pervasive that even

[170] Robert E. Grosse, *Drugs and Money: Laundering Latin America's Cocaine Dollars* (Westport, CT: Praeger, 2001), 23-25; Miguel Kiguel and Stephen A. O'Connell, "Parallel Exchange Rates in Developing Countries" ed. Moshe Syrquin, *The World Bank Research Observer* 10 (1995): 21; Robert Grosse, "Peru's Black Market in Foreign Exchange," *Journal of Interamerican Studies and World Affairs* 33 (1991): 136.

[171] Kiguel and O'Connell, 30.

[172] Grosse, *Drugs and Money*, 24-25; Kiguel and O'Connell, 26; Grosse, "Peru's Black Market in Foreign Exchange," 137.

[173] Grosse, "Peru's Black Market in Foreign Exchange," 156-157; Grosse, *Drugs and Money*, 41-42.

with economic liberalization it remained a part of the business culture.[174] Eventually these policies may have significantly reduced the use of the black market, but the introduction of drug money into the system has negated most of the economic policies and ensured that the black market will continue for the foreseeable future.

Access to foreign currency, liberal trade policies, and lower taxes and tariffs should bring many businesses back to the official markets as the incentive to use the black market is reduced. However, when the drug cartels are willing to sell their dollars at a significant discount, 20% - 40% below the official exchange rate, the peso brokers are still able to give the importers a much better deal.[175] Access to essentially limitless amounts of cheap dollars, plus the ability to avoid taxes and tariffs, ensures that modern IFTS will continue regardless of government policies. The continued use and growth of modern IFTS has considerable micro and macroeconomic impacts on a country. Whereas traditional IFTS had positive and negative economic impact, modern IFTS have predominantly negative economic impact.

1. Microeconomic Issues

The primary microeconomic impacts of modern IFTS are the effect they have on communities and small business. Although these systems are mainly used by businesses, they can have a large impact on individuals within a community. Individuals are affected in three ways; by a reduction in basic services, loss of productive employment, and corruption of government officials. The corruption aspect will be discussed further in the section on social factors. The loss of tax revenue at all levels of government puts a severe financial strain on communities. In the case of Colombia, it is estimated that local governments lose approximately $500 million per year in tax revenue due to the smuggling of merchandise. This loss directly affects the government's ability to provide basic services for the population, such as health care, education, sanitation, and social

[174] Grosse, "Peru's Black Market in Foreign Exchange," 155; Grosse, *Drugs and Money*, 41-42; Kiguel and O'Connell, 30-31.

[175] Jaime Ospina-Velasco, "Combating Money Laundering and Smuggling in Colombia," *Journal of Financial Crime* 10 (2002): 153; Wasserman, 17; Senate Caucus, *The Black Market Peso Exchange*, 105, 107.

programs. The high loss at the local level has caused the central government to transfer 54% of the nation's ordinary income to the provinces to help them maintain these services. [176]

The loss of productive employment is associated with the impact these systems have on small business. Legitimate businesses are adversely affected in two ways. First, modern IFTS increase the size and scope of the informal economy. The importers using these systems, and the companies they conduct business with, gain a competitive advantage over compliant companies since the merchandise they are selling is either smuggled or under-invoiced.[177] Second, criminals often establish front companies to help launder their illegal funds, or they establish "legitimate" businesses which they will subsidize with the proceeds from their criminal act.[178] In both of these situations, legitimate businesses are negatively impacted and often they either go bankrupt or are forced to use the IFTS themselves in order to compete.

The detrimental impact of the first scenario involving an increase in the informal economy is clearly seen with the example of the Colombian footwear industry. In 1998 nine million pairs of shoes were "legally" imported. However, two million were claimed to be worth less than $2, five million were valued less than $1, and one million were actually invoiced at three cents a pair. In addition, it is believed that another 30 million were smuggled into the country in the same year. Almost all of these shoes were then sold in the informal economy at greatly discounted prices. The effect of this has been staggering on the footwear industry. Prior to this, during the early 1990s, there were six major shoe factories in Colombia with each one employing approximately 1500 workers. In 1999, there were only two remaining. The other four had gone bankrupt, and the two that did remain were only operating at 40% capacity.[179]

The second scenario regarding the establishment of businesses by criminals involved with IFTS also has harmful effects on the community and business sector in

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[176] Ospina-Velasco, 153; Senate Caucus, *The Black Market Peso Exchange*, 75-76.

[177] Ferreira, et al., 370-371.

[178] McDowell and Novis, 7.

[179] Senate Caucus, *The Black Market Peso Exchange*, 101.

which they are formed. In order to legitimize the funds or protect their proceeds, funds will often be invested in financial activities that are neither needed nor economically beneficial for the area.[180] Criminals are not interested in profit generation at this point, but they do want/need the funds to appear as legitimate as possible. The creation of "legitimate" businesses is one more layer they can transfer the funds through to make them appear to have a legitimate origin. These businesses are harmful because they are being subsidized with illegal funds.[181] The massive amounts of money involved allow the businesses to offer services and merchandise far below market rates. This will eventually drive the legitimate businesses out, creating higher unemployment and further reducing tax revenue. In some countries, these businesses have come to control entire sectors within a community or region.[182]

2. Macroeconomic Issues

The enormous sums of money moving through modern IFTS has vastly expanded the scope of the problem to the point were these systems can have a significant macroeconomic impact on a country. The primary issue with modern IFTS is the negative effect they have on the growth of the national economy. This occurs from the impact these systems have on the national tax system and their expanding use in the business sector. While these two areas are each individually affected by IFTS, there is also a compounding effect since the business use undermines other legitimate businesses and thereby creates a greater tax deficit. Modern IFTS have grown to such sophistication and extent, that if they remain unchecked, they have the potential to "erode the integrity of a nation's financial institutions…and undermine national economies."[183]

A study conducted on 18 industrialized nations found an inverse relationship between GDP growth and the extent of money laundering. The study concluded that "significant reductions in annual GDP growth rates were associated with increases in the

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[180] McDowell and Novis, 8.

[181] Ricardo M. Alba, "Evolution of Methods of Money Laundering in Latin America," *Journal of Financial Crime* 10 (2002): 139.

[182] McDowell and Novis, 7; Bruton, 14-15.

[183] McDowell and Novis, 6.

laundering of criminal proceeds."[184] In addition, some small or emerging market countries may be overwhelmed by the amount of illegal funds in the country. In some cases, these funds can eclipse the entire national budget, which may result in the loss of economic control by the government.

Trade based IFTS severely impact the tax systems of all nations. Studies show that under-invoicing in developing nations from 1977-1983 accounted for 20% of the total export value. Under-invoicing from South America to the United States reached $4 billion in 1995, and over-invoicing of merchandise from the U.S. to Greece in 2001 cost the Greek government $2 billion in lost tax revenue. Further, the United States lost a total of $42.7 billion in tax revenue in 1999 due to trade manipulation. [185] In Colombia, 25% of all imports are estimated to be smuggled. This equates to between 2% and 3.5% of the Colombian GDP. The combined effect of smuggling and under-invoicing created a total tax revenue loss of $840 million in 1998.[186] Besides the direct economic impact of these losses, there is also a residual negative impact. In order to compensate for these losses and to be able to continue to meet the needs of the population, governments will generally impose overall higher tax rates than would otherwise be necessary. This exacerbates the problems at the microeconomic level since the law-abiding individuals and businesses now have to pay an even higher tax rate.[187]

The microeconomic impact of IFTS use in the business sector can expand until it has macroeconomic consequences. This occurs through two primary methods; the continual growth of criminally subsidized businesses and expansion of the black markets for merchandise. First, the criminal based businesses can easily continue to grow because of the volume of money supporting them. Again, they are not attempting to make a profit, only to make the funds appear legitimate. If it is in the interest of the criminals, they can grow the business until it completely controls the entire industry

[184] Peter J. Quirk, "Money Laundering: Muddying the Economy," *Finance and Development* 34 (1997): 9, http://www.worldbank.org/fandd/english/0397/mar97.htm (accessed 15 October 2008).

[185] Thanasegaran and Shanmugam, 431-432.

[186] Senate Caucus, *The Black Market Peso Exchange*, 76; Ospina-Velasco, 153.

[187] McDowell and Novis, 8.

within a given region.[188] Although this alone will have a large negative impact, the real damage is done when the criminals decide they are no longer interested in or need the business. When these businesses are abandoned, the entire sector is likely to fail and cause immense damage to the economy.[189]

An example of this first situation involves a drug trafficker who establishes a business in Colombia to sell goods. Instead of using a peso broker to convert the illegal funds, the trafficker can now use the money in the United States to buy merchandise from a U.S. producer. At this time there are likely other importers who are also buying merchandise from this producer. If those importers are operating legitimately and paying the appropriate taxes and fees, the trafficker will have an immediate advantage for two reasons. First, he is not paying a discount to the peso broker, and second he is smuggling the merchandise into Colombia and avoiding the taxes and fees.[190]

Now the trafficker can sell the goods at the wholesale price, or he may even be willing to take a slight loss on the goods. The other importers who are selling the same merchandise will not be able to compete with these low prices and will be left with three options. They can go bankrupt, begin to use IFTS to evade taxes and currency controls, or they can sell their business to the trafficker. Because of the unfair economic advantage, the trafficker will soon control the majority of this industry. The business will continue to expand as the other importers are forced out of this industry and the trafficker becomes the primary importer of goods from the particular U.S. producer. The region in which the trafficker operates, as well as the U.S. producer, will then be dependent on the trafficker’s business. If the trafficker remains in business, he will hurt the economy by avoiding taxes on the large amount of imports and by increasing unemployment by driving the other companies out of business. If the trafficker decides to abandon the business, the industry will collapse and create economic hardship for those dependent upon that merchandise.[191]

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[188] McDowell and Novis, 8.

[189] Ibid.

[190] Bruton, 15-16.

[191] Ibid.

The second manner in which business use of IFTS can have a macroeconomic impact is through the expansion of the black markets for merchandise. In Colombia, extensive shopping areas know as Sanandresitos rapidly expanded through the 1980s and 1990s. These shopping areas, which are located in most Colombian cities, for the most part only sell contraband merchandise; 26% of the trade GDP comes from these shopping centers. Also, 61% of total sales from the Sanandresitos, totaling $1.2 billion, were from the sale of smuggled goods. The expansion of these areas in recent years shows the tacit approval that the population gives to the illegal activities. Although it is fairly common knowledge as to the origins of the merchandise, people continue to shop and buy products from these black market merchants. To compete with the growing popularity of these areas, many legitimate businesses are now turning to IFTS to avoid taxes and buy contraband merchandise. [192]

Many countries continue to suffer from the economic impact of modern IFTS. From the individual level to the national level, these systems have harmful consequences. In Colombia, IFTS have had a large destabilizing effect on the economy. The extensive use of these systems has created an unemployment rate of 19% and has reduced the ability of the national and local governments to properly provide the basic services for the population.[193] In addition, the vast amounts of drug money have negated many of the economic polices that could have mitigated the use of IFTS. Changes in economic policies alone are no longer sufficient to end the detrimental effects of these systems.

C. SOCIAL FACTORS

Unlike traditional informal funds transfer systems, there are no overriding social reasons to use modern IFTS. Modern systems were born out of business necessity and greed, based on government policies and the ability to manipulate trade transactions. While there are no social reasons to use the modern systems, they do have a social impact. As with the other consequences of modern IFTS, the social impact is also negative. The primary social impact is the corruption that occurs because of these

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[192] Senate Caucus, *The Black Market Peso Exchange*, 83, 109.

[193] Ibid., 75.

systems. Corruption "diverts scarce resources away from public purposes, jeopardizes the ability of governments to achieve their agenda, directly affects the spending on priority sectors such as education and health, and can have a particularly damaging impact on growth."[194] Throughout much of Latin America, the expansion of IFTS in the past two decades and the infusion of the drug cartels have allowed corruption to permeate all levels of society.[195]

The economic power transferred to criminals through the use of IFTS helps to give them a sense of legitimacy and respectability. This immense economic power can have a "corrupting effect on all elements of society."[196] This is seen with the implied approval by the population for the continued use of the black markets. Some claim that this shows a breakdown in public morality and can eventually lead to more serious effects. Once it is acceptable to break one law, it becomes easier to break others.[197] Also, if corruption becomes widespread and the people think the government is no longer protecting their interests, there is little incentive for them to obey the laws. At this point people will begin to look after their own self-interests and tend to migrate away from government services and agencies.[198]

One of the main areas where corruption is rampant and has a considerable effect on IFTS is customs. The customs agency plays a very important role in the economy of a nation. Customs officials have a direct effect on the amount of tax revenue collected and the amount and type of goods that flow into a country. For these reasons, corruption in the customs agency can have a large negative impact on a nation's economy.

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[194] William Dorotinsky and Shilpa Pradhan, "Exploring Corruption in Public Financial Management," in *The Many Faces of Corruption: Tracking Vulnerabilities at the Sector Level*, ed. J. Edgardo Campos and Sanjay Pradhan (Washington, DC: The World Bank, 2007), 267.

[195] Ospina-Velasco, 153.

[196] Neil Mackrell, "Economic Consequences of Money Laundering" in *Money Laundering in the 21st Century: Risks and Countermeasures*, ed. Adam Graycar and Peter Grabosky (Griffith, ACT: Australian Institute of Criminology, 1996), http://www.aic.gov.au/publications/rpp/02/RPP02.pdf (accessed 16 October 2008); McDowell and Novis, 8.

[197] Ospina-Velasco, 154; Quirk, 9.

[198] Emery Kobor, United States Department of the Treasury, Interview by author, 10 September 2008, Washington DC; "Brazil Country Profile," *Business Anti-Corruption Portal*, http://www.business-anti-corruption.com/normal.asp?pageid=238 (accessed 16 October 2008).

Unfortunately, customs is identified as the third most corrupt government agency and is cited as one of the largest barriers to conducting business. Bribes have become commonplace, with the average bribe equaling 30% of the tax due.[199]

Customs corruption, especially when tied to IFTS, can undermine entire sections of the tax system. The value added tax (VAT) system in many countries in dependent on the customs agency to properly assess and collect the tax at the initial stage when the product enters the country. If this is not done then the appropriate taxes cannot be collected as the merchandise moves through the distribution system.[200] Through the use of bribes, many importers bypass the VAT system and sell their products in the black market. Therefore, corruption in the customs agency directly affects the continued use of IFTS and contributes to the loss of tax revenue.

D. SUMMARY

Modern IFTS were developed out of greed in order to circumvent government policies and regulations. Adverse national monetary policies created black markets for foreign exchange which importers and exporters could capitalize on. Over the past few decades two sub-systems have evolved which further exploit the rise in the global trade and narcotics industries. First, basic trade manipulation can occur between two colluding companies to avoid taxes and tariffs. Second, complex systems such as the Black Market Peso Exchange can involve multiple knowing and unknowing entities to launder illicit proceeds and transfer funds. Both of these systems have a severe negative impact on local, regional, and national economies. In addition to the large tax revenue that is directly lost by the use of these systems, the effect is compounded by the competitive advantage given to companies using modern IFTS. This advantage eventually drives legitimate businesses out which further decreases tax revenue and increases unemployment. Furthermore, modern systems promote a certain level of acceptance for corruption and illegal activity. Corruption, especially in customs agencies, can greatly facilitate the use and expansion of these systems.

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[199] Ferreira, et al., 368.

[200] Ibid., 370.

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V. CONCLUSION AND RECOMMENDATIONS

A. SUMMARY

Traditional and modern IFTS share many of the same characteristics, but that is the extent of the similarities between these two groups. Traditional systems were developed to meet the legitimate needs of businesses and individuals and at times became the formal banking system within the Middle East and South Asia. These systems have survived because of the strong economic and social factors influencing their use. Conversely, modern IFTS were developed purely as criminal systems and have no legitimate purpose. These systems have continued due to the enormous amounts of illegal money generated and their ability to effectively launder proceeds form the global narcotics industry. Whereas traditional systems have predominantly positive effects on the communities in which they operate, modern systems are the exact opposite and have predominantly negative effects.

Over the past few decades, access to the modern banking system and the rise of globalization has had a profound effect on both traditional and modern IFTS, albeit in drastically different ways. Whereas the limitations placed on migrant workers by these two factors led to a massive resurgence in the use of traditional IFTS for legitimate purposes; modern IFTS took advantage of these two factors to greatly expand criminal activity.

B. INDICATORS

The purpose of this research was to analyze the use of traditional and modern IFTS in order to identify the macro indicators and conditions responsible for their development and continued use. Identifying these indicators will allow regional, national and international agencies and organizations to detect the emergence or presence of IFTS and focus their efforts to develop effective regulatory policies to limit the illegitimate use while maintaining the legitimate aspects of these systems.

Table 1 lists the macro indicators for traditional and modern IFTS respectively. A brief description is then given highlighting why each of these is a potential indicator of the respective system. Following the description, each indicator is given a degree of confidence based on the analysis of the research material. While any of the high degree of confidence indicators may alone be sufficient to point towards the potential development or use of IFTS, none of these provides a "smoking gun." It will be a combination of these indicators that will provide the best evidence of the emergence or presence of IFTS in a particular region or industry. With this knowledge, investigators can then focus on the specific region or industry and use the micro indicators that have been previously identified in the literature to find the individual system at work.

Traditional IFTS	**Modern IFTS**
Change in Government Monetary Policies	Change in Government Monetary Policies
Access to the Formal Banking System	Extent of Black Markets
Change in Formal Remittance Flows	Third Party Payments to Exporters
Licensing and Regulatory Requirements	Corruption Levels
Size and Development of Diasporas	Negative Regional Economic Factors
Standard of Living in Rural Areas	

Table 3. IFTS Indicators

1. Traditional IFTS

a. Change in Government Monetary Policies

A government's response to a national economic situation will greatly affect the amount of money that will flow through traditional IFTS, for personal and legitimate business use. The overall impact of the government's response will be primarily based on the degree of currency control imposed. Restrictions on access to foreign currency or convertibility will create a gap between the official and unofficial rate of exchange. This gap is what IFTS operators capitalize on and is the main factor in their ability to offer very low cost service. More severe restrictions will cause this gap to increase and therefore encourage greater use of IFTS. *Degree of Confidence: High.*

b. Access to the Formal Banking System

The economic and social "requirement" for individuals and businesses to transfer money for legitimate purposes dictates that there will be a means to accomplish this. Multiple studies regarding the flow of money into developing nations highlight the importance of having a secure and reliable method to conduct the transfer. Although there may be access to the formal system for the sender, this is often no true for the recipient. Without access to a formal system on both sides of the transaction, which is fast, low cost, secure, and reliable, there will be continued development and use of IFTS. *Degree of Confidence: High.*

c. Change in Formal Remittance Flows

While the amount of money moving through informal systems cannot be directly measured, trends can be estimated by using the data on formal remittances and migration patterns to and from specific countries. Given the overall consistency of remittances, a rise or fall in the total amount within the formal system for a particular country, without a corresponding rise or fall in migrant workers, is likely associated with a change in the method of transfer. While the decision to change between formal and informal methods of transfer are probably linked to some of the other factors listed here, there could be additional reasons not brought out by the current research. In this case, the only way to know if an informal system has developed, expanded, or declined may be by monitoring changes in the formal systems. *Degree of Confidence: High.*

d. Licensing and Regulatory Requirements

Licensing and regulatory requirements for financial institutions have evolved around the formal banking sector. These requirements have not taken into account the unique nature and circumstances in which traditional IFTS operate. This issue was further complicated after September 11, with the across the board implementation of higher AML and CFT procedures for all financial institutions. While the government's position is understandable, IFTS have always operated in the informal sector, and therefore, increased regulatory requirements alone are not going to change that. As long as the government continues with a heavy-handed approach towards IFTS operators, the operators will continue to find ways to avoid detection and continue their business in the informal sector. *Degree of Confidence: Moderate.*

e. Size and Development of Diasporas

Common social and cultural backgrounds provide the foundation for the formation of diasporas. As the levels of migration increase, the size and development of diasporas in the developed nations also increase. Barriers to use of the formal banks such as language, legal status, and proof of identity, along with the cultural and religious aspects of handling monetary transactions, ensures that alternative methods of transferring money will be found. As the need for an acceptable method of transfer increases, local businessmen will use the social network of the community to connect with family and friends in their country of origin. Through these connections, IFTS will be formed and operated within the diasporas. The greater the size and development of the diasporas, the higher the probability of IFTS formation and use. *Degree of Confidence: Moderate.*

f. Standard of Living in Rural Areas

Traditional IFTS can have a large impact on the local community in which remittances are received. In some cases, remittances may account for the majority of funds moving into a region. Although remittances are sent to a particular family, as the money is spent it is spread throughout the community and can have a strong positive effect on the entire local economy. Changes in the standard of living can also be affected, either positively or negatively, by many other government, economic, or social factors. Therefore, increases in the standard of living in rural areas may be an indicator of IFTS use within a region, but only when the other factors are accounted for. *Degree of Confidence: Low to Moderate.*

2. Modern IFTS

a. Change in Government Monetary Policies

Government policies affecting the official currency market, taxes, and tariffs are the principle reason for the formation of modern IFTS. Adverse changes in these policies drive the creation of foreign exchange black markets and increase the incentive to manipulate trade transactions. Currency black markets, especially when fueled by a near endless supply of cheap money from the narcotics industry, and invoice manipulation provide a large economic advantage to businesses that use them. The more severe the changes in monetary policy are, the greater the probability of IFTS formation and use. *Degree of Confidence: High.*

b. Extent of Black Markets

Black markets for merchandise are a direct result of contraband merchandise entering the country. Modern IFTS feed these markets with the merchandise that is smuggled in through BMPE and that which is brought in through trade manipulation to avoid taxes and tariffs. The competitive advantage the black market merchants gain eventually drives many legitimate businesses out, thereby increasing the market share for the black markets. Extensive use and acceptance of black markets for merchandise, therefore, is a good indicator of the existence of modern IFTS. *Degree of Confidence: High.*

c. Third Party Payments to Exporters

Importers using the Black Market Pesos Exchange are dependent on third party entities to make payments to their suppliers. These payments are made by a variety of methods, such as wire transfers, cashiers check, or bulk cash shipments. Often the origination of these payments has no obvious connection to the importer. This is because the payments are being initiated by the peso broker on behalf of the importer. Suspicious payments that cannot be directly tied to the importer are a good indicator of IFTS use. *Degree of Confidence: High.*

d. Corruption Levels

The level of corruption within a region, especially in the customs agency, will have a considerable impact on the formation and use of modern IFTS. Criminals rely on being able to bribe officials in order to ease the process of importing contraband merchandise or to not investigate illegal activities. Customs is the third most corrupt government agency and is one the largest barrier to conducting legitimate business. Also, widespread corruption can lead to a breakdown in public morality regarding the need to obey the laws. Individuals and businesses may then feel justified in their use of these systems. Therefore, high levels of corruption are likely associated with the formation and use of modern IFTS. *Degree of Confidence: Moderate.*

e. Negative Regional Economic Factors

Modern IFTS can have a large negative impact on a region by increasing unemployment, increasing bankruptcies, and decreasing tax revenues. Extensive use of IFTS in a region can cause these issues to occur during otherwise stable economic times. While the combination of all three issues could be a strong indicator of IFTS use, each issue alone can also be indicator. Nevertheless, in order to be valid indicators of IFTS use, other government, economic, and social factors that could affect these issues must be accounted for. Therefore, while unemployment, bankruptcies, and tax revenue all have the potential to be indicators of IFTS use, the other factors contributing to these issues must be accounted for. *Degree of Confidence: Low to Moderate.*

C. POLICY RECOMMENDATIONS

1. Traditional IFTS

Current U.S. and international policies regarding traditional informal funds transfer systems are problematic and inconsistent. These systems were automatically demonized after September 11 without having a complete understanding of their use and operation. Although they are vulnerable to criminal and terrorist use, this use has been shown to be extremely small in proportion to the legitimate use.[201] The reaction after September 11 has been to increase regulation and transpose international formal banking requirements on all financial businesses. This reaction is not appropriate for traditional IFTS. Effective regulation must take into account the legitimate use of these systems and the economic and social factors influencing their use. The primary goal of IFTS regulation should not be to prohibit their use or limit accessibility, but rather to formalize the existing process to increase transparency and accountability.

The dynamic structure of IFTS requires consistent regulation to accurately track operators, customers, and transactions. Due to the nature of these systems, traditional Western models of regulation will be ineffective and attempts to over-regulate will only serve to harm relations between operators and authorities.[202] Regulators must understand that the formal banking system cannot meet the needs of many of the customers and therefore IFTS are a "special" class within the financial sector and need to be regulated as such. International standards designed for large financial institutions cannot be hastily imposed upon the informal sector and realistically be expected to be implemented. Following is a list of recommendations which can be used to guide the development of effective, comprehensive, and beneficial policies for traditional IFTS, and to encourage users to move from the informal systems to the formal banking system.[203]

[201] McCulloch and Pickering, 480.

[202] Buencamino and Gorbunov; Passas, "Hawala and Other Informal Value Transfer Systems: How to Regulate Them?" 57; Ballard, "Criminal Haven or Vital Financial Network," 9.

[203] Buencamino and Gorbunov; Passas, "Hawala and Other Informal Value Transfer Systems: How to Regulate Them?" 57; Munshani; Passas, *Informal Value Transfer Systems, Terrorism, and Money Laundering.*

- Conduct outreach and consultation programs with IFTS operators and their customers. Regulation is most effective when those being regulated are involved in the process.
- Institute a special class of license for IFTS operators. Reduce fees and bonding requirements to levels that are appropriate and realistic for these businesses.
- Develop international standards that account for the specific domestic circumstances in which these systems operate.
- Encourage national economic policies that limit the difference between the official and black market exchange rates.
- Increase bank services in the regions where migrant workers are from. Also, encourage banks to implement changes which will increase competition in the areas of cost, speed, and reliability.
- Provide incentives for migrant workers to use the formal system. This may include matching a percentage of the amount deposited into a bank account, providing a higher interest rate for these accounts, and eliminating taxes on remittances.

2. Modern IFTS

Due to the exclusively criminal purpose of modern IFTS, regulatory considerations are vastly different from traditional IFTS. In this case, efforts are needed to completely eliminate the use of these systems and prosecute anyone who is found using them. Effective policies to stop modern IFTS must account for the various elements involved in their operation, including the bank industry, import and export businesses, black markets for currency and merchandise, corruption, and the narcotics industry. Obviously this is a wide range of topics and no single policy will account for all of them. Therefore, it is vital for policy makers to maintain a broad view of the problem and design complementary policies that will work against not only the individual areas, but also against the connections between them.

Since the proceeds from narcotics industry has become such an integral part of many of these systems, special attention to the flow of drugs is needed. While considerable effort has been made on both the supply and demand side to curb the use of drugs, the majority of effort is usually against the supply side. This mentality must be reversed; "never in history has there been a black market defeated from the supply side…as long as demand persists, the market will be served."[204] The drug industry is only one aspect of the problem, but it is the most influential. Following is a list of recommendations which can be used to guide the development of effective policies to target the various aspects on modern IFTS.[205]

- Encourage national economic policies that limit the development of black markets for foreign exchange.
- Greater education for the banking industry and businesses regarding the method of payment involved in BMPE. Increase scrutiny of incoming payments from foreign businesses to ensure they are from a valid source legally associated with the foreign company.
- Decrease corruption in the customs agencies through greater transparency of records and increased supervision.
- Increase the quantity and quality of the data available to customs agents. Encourage greater utilization of programs to track invoice prices versus market prices.
- Increase international knowledge and cooperation against money laundering.
- Greater enforcement against black markets for merchandise.
- Focus narcotics control efforts in the demand countries.

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[204] Munshani.

[205] Steven L. Peterson, "Achieving A Sustained Response To Money Laundering," ed. Jonathan Schaffer, *Economic Perspectives* 6 (2001): 15, usinfo.state.gov/journals/ites/0501/ijee/ijee0501.pdf (accessed 16 October 2008); Grosse, *Drugs and Money*, 23-25; Senate Caucus, *The Black Market Peso Exchange*, 52-53; Dorotinsky and Pradhan, 267; Ferreira, et al., 368.

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