

# *Crime and Corruption*

1<sup>st</sup> EDITION

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REPUBLIC OF MACEDONIA

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## *Slush Funds*

According to David McClintick ("Swordfish: A True Story of Ambition, Savagery, and Betrayal"), in the late 1980's, the FBI and DEA set up dummy corporations to deal in drugs. They funneled into these corporate fronts money from drug-related asset seizures.

The idea was to infiltrate global crime networks but a lot of the money in "Operation Swordfish" may have ended up in the wrong pockets. Government agents and sheriffs got mysteriously and filthily rich and the whole sorry affair was wound down. The GAO reported more than \$3.6 billion missing. This bit of history gave rise to at least one blockbuster with Oscar-winner Halle Berry.

Alas, slush funds are much less glamorous in reality. They usually involve grubby politicians, pawky bankers, and philistine businessmen - rather than glamorous hackers and James Bondian secret agents.

The Kazakh prime minister, Imanghaliy Tasmaghambetov, freely admitted on April 4 to his country's rubber-stamp parliament the existence of a \$1 billion slush fund. The money was apparently skimmed off the proceeds of the opaque sale of the Tengiz oilfield. Remitting it to Kazakhstan - he expostulated with a poker face - would have fostered inflation. So, the country's president, Nazarbaev, kept the funds abroad "for use in the event of either an economic crisis or a threat to Kazakhstan's security".

The money was used to pay off pension arrears in 1997 and to offset the pernicious effects of the 1998 devaluation of the Russian ruble. What was left was duly transferred to the \$1.5 billion National Fund, the PM insisted. Alas, the original money in the Fund came entirely from another sale of oil assets to Chevron, thus casting in doubt the official version.

The National Fund was, indeed, augmented by a transfer or two from the slush fund - but at least one of these transfers occurred only 11 days after the damning revelations. Moreover, despite incontrovertible evidence to the contrary, the unfazed premier denied that his president possesses multi-million dollar bank accounts abroad.

He later rescinded this last bit of disinformation. The president, he said, has no bank accounts abroad but will promptly return all the money in these non-existent accounts to Kazakhstan. These vehemently denied accounts, he speculated, were set up by the president's adversaries "for the purpose of compromising his name".

On April 15, even the docile opposition had enough of this fuzzy logic. They established a People Oil's Fund to monitor, henceforth, the regime's financial shenanigans. By their calculations less than 7 percent of the income from the sale of hydrocarbon fuels (c. \$4-5 billion annually) make it to the national budget.

Slush funds infect every corner of the globe, not only the more obscure and venal ones. Every secret service - from the Mossad to the CIA - operates outside the stated state budget. Slush funds are used to launder money, shower cronies with patronage, and bribe decision makers. In some countries, setting them up is a criminal offense, as per the 1990 Convention on Laundering, Search, Seizure, and Confiscation of the Proceeds from Crime. Other jurisdictions are more forgiving.

The Catholic Bishops Conference of Papua New Guinea and the Solomon Islands issued a press release November last in which it welcomed the government's plans to abolish slush funds. They described the poisonous effect of this practice:

"With a few notable exceptions, the practice of directing funds through politicians to district projects has been disastrous. It has created an atmosphere in which corruption is thought to have flourished. It has reduced the responsibility of public servants, without reducing their numbers or costs. It has been used to confuse people into believing public funds are the "property" of individual members rather than the property of the people, honestly and fairly administered by the servants of the people.

The concept of 'slush-funds' has resulted in well-documented inefficiencies and failures. There were even accusations made that funds were withheld from certain members as a way of forcing them into submission. It seems that the era of the 'slush funds' has been a shameful period."

But even is the most orderly and lawful administration, funds are liable to be mislaid. "The Economist" reported recently about a \$10 billion class-action suit filed by native-Americans against the US government. The funds, supposed to be managed in trust since 1880 on behalf of half a million beneficiaries, were "either lost or stolen" according to officials.

Rob Gordon, the Director of the National Wilderness Institute accused "The US Interior Department (of) looting the special funds that were established to pay for wildlife conservation and squandering the money instead on questionable administrative expenses, slush funds and employee moving expenses".

Charles Griffin, the Deputy Director of the Heritage Foundation's Government Integrity Project, charges:

"The federal budget provides numerous slush funds that can be used to subsidize the lobbying and political activities of special-interest groups."

On his list of "Top Ten Federal Programs That Actively Subsidize Politics and Lobbying" are: AmeriCorps, Senior Community Service Employment Program, Legal Services Corporation, Title X Family Planning, National Endowment for the Humanities, Market Promotion Program, Senior Environmental Employment Program, Superfund Worker Training, HHS Discretionary Aging Projects, Telecomm. & Info. Infrastructure Assistance. These federal funds alone total \$1.8 billion.

"Next" and "China Times" - later joined by "The Washington Post" - accused the former Taiwanese president, Lee Teng-hui, of forming a \$100 million overseas slush fund intended to finance the gathering of information, influence-peddling, and propaganda operations. Taiwan footed the bills trips by Congressional aides and funded academic research and think tank conferences.

High ranking Japanese officials, among others, may have received payments through this stealthy venue. Lee is alleged to have drawn \$100,000 from the secret account in February 1999. The money was used to pay for the studies of a former Japanese Vice-Defense Minister Masahiro Akiyama's at Harvard.

Ryutaro Hashimoto, the former Japanese prime minister, was implicated as a beneficiary of the fund. So were the prestigious lobbying firm, Cassidy and Associates and assorted assistant secretaries in the Bush administration.

Carl Ford, Jr., currently assistant secretary of state for intelligence and research, worked for Cassidy during the relevant period and often visited Taiwan. James Kelly, assistant secretary of state for East Asian and Pacific Affairs enjoyed the Taiwanese largesse as well. Both are in charge of crafting America's policy on Taiwan.

John Bolton, undersecretary of state for arms control and international security, admitted, during his confirmation hearings, to having received \$30,000 to cover the costs of writing 3 research papers.



The Taiwanese government has yet to deny the news stories.

A Japanese foreign ministry official used slush fund money to finance the extra-marital activities of himself and many of his colleagues - often in posh hotel suites. But this was no exception. According to Asahi Shimbun, more than half of the 60 divisions of the ministry maintained similar funds. The police and the ministry are investigating. One arrest has been made. The ministry's accounting division has discovered these corrupt practices twenty years ago but kept mum.

Even low-level prefectural bureaucrats and teachers in Japan build up slush funds by faking business trips or padding invoices and receipts. Japanese citizens' groups conservatively estimated that \$20 million in travel and entertainment expenses in the prefectures in 1994 were faked, a practice known as "kara shutcho" (i.e., empty business trip).

Officials of the Hokkaido Board of Education admitted to the existence of a 100 million yen secret fund. In a resulting probe, 200 out of 286 schools were found to maintain their own slush funds. Some of the money was used to support friendly politicians.

But slush funds are not a sovereign prerogative. Multinationals, banks, corporation, religious organizations, political parties, and even NGO's salt away some of their revenues and profits in undisclosed accounts, usually in off-shore havens.

Secret election campaign slush funds are a fixture in American politics. A 2-year old bill requires disclosure of donors to such funds but the House is busy loosening its provisions. "The Economist" listed lately the tsunami of scandals that engulfs Germany, both its major political parties, many of the Lander and numerous highly placed and mid-level bureaucrats. Secret, mainly party, funds seem to be involved in the majority of these lurid affairs.

Italian firms made donations to political parties through slush funds, though corporate donations - providing they are transparent - are perfectly legal in Italy. Both the right and, to a lesser extent, the left in France are said to have managed enormous political slush funds.

President Chirac is accused of having abused for his personal pleasure, one such municipal fund in Paris, when he was its mayor. But the funds were mostly used to provide party activists with mock jobs. Corporations paid kickbacks to obtain public works or local building permits. Ostensibly, they were paying for sham "consultancy services".

The epidemic hasn't skipped even staid Ottawa. Its Chief Electoral Officer told Sun Media last September that he is "concerned" about millions stashed away by Liberal candidates. Sundry ministers who coveted the prime minister's job, have raised funds covertly and probably illegally.

On April 11, UPI reported that Spain's second-largest bank, Banco Bilbao Vizcaya Argentaria (BBVA), held nearly \$200 million hidden in secret offshore accounts, "which were allegedly used to manipulate politicians, pay off the 'revolutionary tax' to ETA - the Basque terrorist organization - and open the door for business deals, according to news reports."

The money may have gone to luminaries such as Venezuela's Hugo Chavez, Peru's Alberto Fujomori and Vladimiro Montesinos. The bank's board members received fat, tax-free, "pensions" from the illegal accounts opened in 1987 - a total of more than \$20 million.

Latin American drug money launderers - from Puerto Rico to Colombia - may have worked through these funds and the bank's clandestine entities in the Cayman Islands and Jersey. The current Spanish Secretary of State for the Treasury has been the bank's tax advisor between 1992-7.

The "Financial Times" reported in June 2000 that, in anticipation of new international measures to curb corruption, "leading European arms manufacturers" resorted to the creation of off-shore slush funds. The money is intended to bribe foreign officials to win tenders and contracts.

Kim Woo-chung, Daewoo's former chairman, is at the center of a massive scandal involving dozens of his company's executive, some of whom ended up in prison. He stands accused of diverting a whopping \$20 billion to an overseas slush fund.

A mind boggling \$10 billion were alleged to have been used to bribe Korean government officials and politicians. But his conduct and even the scale of the fraud he perpetrated may have been typical to Korea's post-war incestuous relationship between politics and business.

In his paper "The Role of Slush Funds in the Preparation of Corruption Mechanisms", reprinted by Transparency International, Gherardo Colombo defines corporate slush funds thus:

"Slush funds are obtained from a joint stock company's finances, carefully managed so that the amounts involved do not appear on the balance sheet. They do not necessarily have to consist of money, but can also take the form of stocks and shares or other economically valuable goods (works of art, jewels, yachts, etc.) It is enough that they can be used without any particular difficulty or that they can be transferred to a third party.

If a fund is in the form of money, it is not even necessary to refer to it outside the company accounts, since it can appear in them in disguised form (the "accruals and deferrals" heads are often resorted to for the purpose of hiding slush money). In light of this, it is not always correct to regard it as a reserve fund that is not accounted for in the books. Deception, trickery or forgery of various kinds are often resorted to for the purpose of setting up a slush fund."

He mentions padded invoices, sham contracts, fictitious loans, interest accruing on holding accounts, back to back transactions with related entities (Enron) - all used to funnel money to the slush funds. Such funds are often set up to cover for illicit and illegal self-enrichment, embezzlement, or tax evasion.

Less known is the role of these furtive vehicles in financing unfair competitive practices, such as dumping. Clients, suppliers, and partners receive hidden rebates and subsidies that much increase the - unreported - real cost of production.

BBVA's payments to ETA may have been a typical payment of protection fees. Both terrorists and organized crime put slush funds to bad use. They get paid from such funds - and maintain their own. Ransom payments to kidnappers often flow through these channels.

But slush funds are overwhelmingly used to bribe corrupt politicians. The fight against corruption has been tilted against the recipients of illicit corporate largesse. But to succeed, well-meaning international bodies, such as the OECD's FATF, must attack with equal zeal those who bribe. Every corrupt transaction is between a venal politician and an avaricious businessman. Pursuing the one while ignoring the other is self-defeating.

# *Corruption and Transparency*

## *I. The Facts*

Just days before a much-awaited donor conference, the influential International Crisis Group (ICG) recommended to place all funds pledged to Macedonia under the oversight of a "corruption advisor" appointed by the European Commission. The donors ignored this and other recommendations. To appease the critics, the affable Attorney General of Macedonia charged a former Minister of Defense with abuse of duty for allegedly having channeled millions of DM to his relatives during the recent civil war. Macedonia has belatedly passed an anti-money laundering law recently - but failed, yet again, to adopt strict anti-corruption legislation.

In Albania, the Chairman of the Albanian Socialist Party, Fatos Nano, was accused by Albanian media of laundering \$1 billion through the Albanian government. Pavel Borodin, the former chief of Kremlin Property, decided not appeal his money laundering conviction in a Swiss court. The Slovak daily "Sme" described in scathing detail the newly acquired wealth and lavish lifestyles of formerly impoverished HZDS politicians. Some of them now reside in refurbished castles. Others have swimming pools replete with wine bars.

Pavlo Lazarenko, a former Ukrainian prime minister, is detained in San Francisco on money laundering charges. His defense team accuses the US authorities of "selective prosecution".

They are quoted by Radio Free Europe as saying:

"The impetus for this prosecution comes from allegations made by the Kuchma regime, which itself is corrupt and dedicated to using undemocratic and repressive methods to stifle political opposition ... (other Ukrainian officials) including Kuchma himself and his closest associates, have committed conduct similar to that with which Lazarenko is charged but have not been prosecuted by the U.S. government".

The UNDP estimated, in 1997, that, even in rich, industrialized, countries, 15% of all firms had to pay bribes. The figure rises to 40% in Asia and 60% in Russia.

Corruption is rife and all pervasive, though many allegations are nothing but political mud-slinging. Luckily, in countries like Macedonia, it is confined to its rapacious elites: its politicians, managers, university professors, medical doctors, judges, journalists, and top bureaucrats. The police and customs are hopelessly compromised. Yet, one rarely comes across graft and venality in daily life. There are no false detentions (as in Russia), spurious traffic tickets (as in Latin America), or widespread stealthy payments for public goods and services (as in Africa).

It is widely accepted that corruption retards growth by deterring foreign investment and encouraging brain drain. It leads to the misallocation of economic resources and distorts competition. It depletes the affected country's endowments - both natural and acquired. It demolishes the tenuous trust between citizen and state. It casts civil and government institutions in doubt, tarnishes the entire political class, and, thus, endangers the democratic system and the rule of law, property rights included.

This is why both governments and business show a growing commitment to tackling it. According to Transparency International's "Global Corruption Report 2001", corruption has been successfully contained in private banking and the diamond trade, for instance.

Hence also the involvement of the World Bank and the IMF in fighting corruption. Both institutions are increasingly concerned with poverty reduction through economic growth and development. The World Bank estimates that corruption reduces the growth rate of an affected country by 0.5 to 1 percent annually. Graft amounts to an increase in the marginal tax rate and has pernicious effects on inward investment as well.

The World Bank has appointed last year a Director of Institutional Integrity - a new department that combines the Anti-Corruption and Fraud Investigations Unit and the Office of Business Ethics and Integrity. The Bank helps countries to fight corruption by providing them with technical assistance, educational programs, and lending.



Anti-corruption projects are an integral part of every Country Assistance Strategy (CAS). The Bank also supports international efforts to reduce corruption by sponsoring conferences and the exchange of information. It collaborates closely with Transparency International, for instance.

At the request of member-governments (such as Bosnia-Herzegovina and Romania) it has prepared detailed country corruption surveys covering both the public and the private sectors. Together with the EBRD, it publishes a corruption survey of 3000 firms in 22 transition countries (BEEPS - Business Environment and Enterprise Performance Survey). It has even set up a multilingual hotline for whistleblowers.

The IMF made corruption an integral part of its country evaluation process. It suspended arrangements with endemically corrupt recipients of IMF financing. Since 1997, it has introduced policies regarding misreporting, abuse of IMF funds, monitoring the use of debt relief for poverty reduction, data dissemination, legal and judicial reform, fiscal and monetary transparency, and even internal governance (e.g., financial disclosure by staff members).

Yet, no one seems to agree on a universal definition of corruption. What amounts to venality in one culture (Sweden) is considered no more than hospitality, or an expression of gratitude, in another (France, or Italy). Corruption is discussed freely and forgivingly in one place - but concealed shamefully in another. Corruption, like other crimes, is probably seriously under-reported and under-penalized.

Moreover, bribing officials is often the unstated policy of multinationals, foreign investors, and expatriates. Many of them believe that it is inevitable if one is to expedite matters or secure a beneficial outcome. Rich world governments turn a blind eye, even where laws against such practices are extant and strict.

In his address to the Inter-American Development Bank on March 14, President Bush promised to "reward nations that root out corruption" within the framework of the Millennium Challenge Account initiative. The USA has pioneered global anti-corruption campaigns and is a signatory to the 1996 IAS Inter-American Convention against Corruption, the Council of Europe's Criminal Law Convention on Corruption, and the OECD's 1997 anti-bribery convention. The USA has had a comprehensive "Foreign Corrupt Practices Act" since 1977.

The Act applies to all American firms, to all firms - including foreign ones - traded in an American stock exchange, and to bribery on American territory by foreign and American firms alike. It outlaws the payment of bribes to foreign officials, political parties, party officials, and political candidates in foreign countries. A similar law has now been adopted by Britain.

Yet, "The Economist" reports that the American SEC has brought only three cases against listed companies until 1997. The US Department of Justice brought another 30 cases. Britain has persecuted successfully only one of its officials for overseas bribery since 1889. In the Netherlands bribery is tax deductible. Transparency International now publishes a name and shame Bribery Payers Index to complement its 91-country strong Corruption Perceptions Index.

Many rich world corporations and wealthy individuals make use of off-shore havens or "special purpose entities" to launder money, make illicit payments, avoid or evade taxes, and conceal assets or liabilities. According to Swiss authorities, more than \$40 billion are held by Russians in its banking system alone. The figure may be 5 to 10 times higher in the tax havens of the United Kingdom.

In a survey it conducted last month of 82 companies in which it invests, "Friends, Ivory, and Sime" found that only a quarter had clear anti-corruption management and accountability systems in place.

Tellingly only 35 countries signed the 1997 OECD "Convention on Combating Bribery of Foreign Public Officials in International Business Transactions" - including four non-OECD members: Chile, Argentina, Bulgaria, and Brazil. The convention has been in force since February 1999 and is only one of many OECD anti-corruption drives, among which are SIGMA (Support for Improvement in Governance and Management in Central and Eastern European countries), ACN (Anti-Corruption Network for Transition Economies in Europe), and FATF (the Financial Action Task Force on Money Laundering).

Moreover, The moral authority of those who preach against corruption in poor countries - the officials of the IMF, the World Bank, the EU, the OECD - is strained by their ostentatious lifestyle, conspicuous consumption, and "pragmatic" morality.

## ***II. What to do? What is Being Done?***

Two years ago, I proposed a taxonomy of corruption, venality, and graft. I suggested this cumulative definition:

- (a) The withholding of a service, information, or goods that, by law, and by right, should have been provided or divulged.
- (b) The provision of a service, information, or goods that, by law, and by right, should not have been provided or divulged.
- (c) That the withholding or the provision of said service, information, or goods are in the power of the withholder or the provider to withhold or to provide AND That the withholding or the provision of said service, information, or goods constitute an integral and substantial part of the authority or the function of the withholder or the provider.
- (d) That the service, information, or goods that are provided or divulged are provided or divulged against a benefit or the promise of a benefit from the recipient and as a result of the receipt of this specific benefit or the promise to receive such benefit.
- (e) That the service, information, or goods that are withheld are withheld because no benefit was provided or promised by the recipient.

There is also what the World Bank calls "State Capture" defined thus:

"The actions of individuals, groups, or firms, both in the public and private sectors, to influence the formation of laws, regulations, decrees, and other government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials."

We can classify corrupt and venal behaviours according to their outcomes:

(a) **Income Supplement** - Corrupt actions whose sole outcome is the supplementing of the income of the provider without affecting the "real world" in any manner.

(b) **Acceleration or Facilitation Fees** - Corrupt practices whose sole outcome is to accelerate or facilitate decision making, the provision of goods and services or the divulging of information.

(c) **Decision Altering Fees** - Bribes and promises of bribes which alter decisions or affect them, or which affect the formation of policies, laws, regulations, or decrees beneficial to the bribing entity or person.

(d) **Information Altering Fees** - Backhanders and bribes that subvert the flow of true and complete information within a society or an economic unit (for instance, by selling professional diplomas, certificates, or permits).

**(e) Reallocation Fees** - Benefits paid (mainly to politicians and political decision makers) in order to affect the allocation of economic resources and material wealth or the rights thereto. Concessions, licenses, permits, assets privatized, tenders awarded are all subject to reallocation fees.

To eradicate corruption, one must tackle both giver and taker.

History shows that all effective programs shared these common elements:

- (a) The persecution of corrupt, high-profile, public figures, multinationals, and institutions (domestic and foreign). This demonstrates that no one is above the law and that crime does not pay.
- (b) The conditioning of international aid, credits, and investments on a monitored reduction in corruption levels. The structural roots of corruption should be tackled rather than merely its symptoms.
- (c) The institution of incentives to avoid corruption, such as a higher pay, the fostering of civic pride, "good behaviour" bonuses, alternative income and pension plans, and so on.
- (d) In many new countries (in Asia, Africa, and Eastern Europe) the very concepts of "private" versus "public" property are fuzzy and impermissible behaviours are not clearly demarcated. Massive investments in education of the public and of state officials are required.

(e) Liberalization and deregulation of the economy. Abolition of red tape, licensing, protectionism, capital controls, monopolies, discretionary, non-public, procurement. Greater access to information and a public debate intended to foster a "stakeholder society".

(f) Strengthening of institutions: the police, the customs, the courts, the government, its agencies, the tax authorities - under time limited foreign management and supervision.

Awareness to corruption and graft is growing - though it mostly results in lip service. The Global Coalition for Africa adopted anti-corruption guidelines in 1999. The otherwise opaque Asia Pacific Economic Cooperation (APEC) forum is now championing transparency and good governance. The UN is promoting its pet convention against corruption.

The G-8 asked its Lyon Group of senior experts on transnational crime to recommend ways to fight corruption related to large money flows and money laundering. The USA and the Netherlands hosted global forums on corruption - as will South Korea next year. The OSCE is rumored to respond with its own initiative, in collaboration with the US Congressional Helsinki Commission.

The southeastern Europe Stability Pact sports its own Stability Pact Anti-corruption Initiative (SPAI). It held its first conference in September 2001 in Croatia. More than 1200 delegates participated in the 10th International Anti-Corruption Conference in Prague last year. The conference was attended by the Czech prime minister, the Mexican president, and the head of the Interpol.

The most potent remedy against corruption is sunshine - free, accessible, and available information disseminated and probed by an active opposition, uncompromised press, and assertive civic organizations and NGO's. In the absence of these, the fight against official avarice and criminality is doomed to failure. With them, it stands a chance.

Corruption can never be entirely eliminated - but it can be restrained and its effects confined. The cooperation of good people with trustworthy institutions is indispensable. Corruption can be defeated only from the inside, though with plenty of outside help. It is a process of self-redemption and self-transformation. It is the real transition.



## *Money Laundering in A Changed World*

Israel has always turned a blind eye to the origin of funds deposited by Jews from South Africa to Russia. In Britain it is perfectly legal to hide the true ownership of a company. Underpaid Asian bank clerks on immigrant work permits in the Gulf states rarely require identity documents from the mysterious and well-connected owners of multi-million dollar deposits. Hawaladars continue plying their paperless and trust-based trade - the transfer of billions of US dollars around the world. American and Swiss banks collaborate with dubious correspondent banks in off shore centres. Multinationals shift money through tax free territories in what is euphemistically known as "tax planning". Internet gambling outfits and casinos serve as fronts for narco-dollars. British Bureaux de Change launder up to 2.6 billion British pounds annually. The 500 Euro note will make it much easier to smuggle cash out of Europe. A French parliamentary committee accuses the City of London of being a money laundering haven in a 400 page report. Intelligence services cover the tracks of covert operations by opening accounts in obscure tax havens, from Cyprus to Nauru. Money laundering, its venues and techniques, are an integral part of the economic fabric of the world. Business as usual?

Not really. In retrospect, as far as money laundering goes, September 11 may be perceived as a watershed as important as the precipitous collapse of communism in 1989. Both events have forever altered the patterns of the global flows of illicit capital.

## **What is Money Laundering?**

Strictly speaking, money laundering is the age-old process of disguising the illegal origin and criminal nature of funds (obtained in sanctions-busting arms sales, smuggling, trafficking in humans, organized crime, drug trafficking, prostitution rings, embezzlement, insider trading, bribery, and computer fraud) by moving them untraceably and investing them in legitimate businesses, securities, or bank deposits. But this narrow definition masks the fact that the bulk of money laundered is the result of tax evasion, tax avoidance, and outright tax fraud, such as the "VAT carousel scheme" in the EU (moving goods among businesses in various jurisdictions to capitalize on differences in VAT rates). Tax-related laundering nets between 10-20 billion US dollars annually from France and Russia alone. The confluence of criminal and tax averse funds in money laundering networks serves to obscure the sources of both.

## **The Scale of the Problem**

According to a 1996 IMF estimate, money laundered annually amounts to 2-5% of world GDP (between 800 billion and 2 trillion US dollars in today's terms). The lower figure is considerably larger than an average European economy, such as Spain's.

## **The System**

It is important to realize that money laundering takes place within the banking system. Big amounts of cash are spread among numerous accounts (sometimes in free economic zones, financial off shore centers, and tax havens), converted to bearer financial instruments (money orders, bonds), or placed with trusts and charities. The money is then transferred to other locations, sometimes as bogus payments for "goods and services" against fake or inflated invoices issued by holding companies owned by lawyers or accountants on behalf of unnamed beneficiaries. The transferred funds are re-assembled in their destination and often "shipped" back to the point of origin under a new identity. The laundered funds are then invested in the legitimate economy. It is a simple procedure - yet an effective one. It results in either no paper trail - or too much of it. The accounts are invariably liquidated and all traces erased.

## **Why is it a Problem?**

Criminal and tax evading funds are idle and non-productive. Their injection, however surreptitiously, into the economy transforms them into a productive (and cheap) source of capital. Why is this negative?

Because it corrupts government officials, banks and their officers, contaminates legal sectors of the economy, crowds out legitimate and foreign capital, makes money supply unpredictable and uncontrollable, and increases cross-border capital movements, thereby enhancing the volatility of exchange rates.

A multilateral, co-ordinated, effort (exchange of information, uniform laws, extra-territorial legal powers) is required to counter the international dimensions of money laundering. Many countries opt in because money laundering has also become a domestic political and economic concern. The United Nations, the Bank for International Settlements, the OECD's FATF, the EU, the Council of Europe, the Organisation of American States, all published anti-money laundering standards. Regional groupings were formed (or are being established) in the Caribbean, Asia, Europe, southern Africa, western Africa, and Latin America.

## **Money Laundering in the Wake of the September 11 Attacks**

### **Regulation**

The least important trend is the tightening of financial regulations and the establishment or enhancement of compulsory (as opposed to industry or voluntary) regulatory and enforcement agencies.

New legislation in the US which amounts to extending the powers of the CIA domestically and of the DOJ extra-territorially, was rather xenophobically described by a DOJ official, Michael Chertoff, as intended to "make sure the American banking system does not become a haven for foreign corrupt leaders or other kinds of foreign organized criminals." Privacy and bank secrecy laws have been watered down.

Collaboration with off shore "shell" banks has been banned. Business with clients of correspondent banks was curtailed. Banks were effectively transformed into law enforcement agencies, responsible to verify both the identities of their (foreign) clients and the source and origin of their funds. Cash transactions were partly criminalized. And the securities and currency trading industry, insurance companies, and money transfer services are subjected to growing scrutiny as a conduit for "dirty cash".

Still, such legislation is highly ineffective. The American Bankers' Association puts the cost of compliance with the laxer anti-money-laundering laws in force in 1998 at 10 billion US dollars - or more than 10 million US dollars per obtained conviction. Even when the system does work, critical alerts drown in the torrent of reports mandated by the regulations. One bank actually reported a suspicious transaction in the account of one of the September 11 hijackers - only to be ignored.

The Treasury Department established Operation Green Quest, an investigative team charged with monitoring charities, NGO's, credit card fraud, cash smuggling, counterfeiting, and the Hawala networks. This is not without precedent. Previous teams tackled drug money, the biggest money laundering venue ever, BCCI (Bank of Credit and Commerce International), and ... Al Capone. The more veteran, New-York based, El-Dorado anti money laundering Task Force (established in 1992) will lend a hand and share information.

More than 150 countries promised to co-operate with the US in its fight against the financing of terrorism - 81 of which (including the Bahamas, Argentina, Kuwait, Indonesia, Pakistan, Switzerland, and the EU) actually froze assets of suspicious individuals, suspected charities, and dubious firms, or passed new anti money laundering laws and stricter regulations (the Philippines, the UK, Germany). A tabled EU directive would force lawyers to disclose incriminating information about their clients' money laundering activities. Pakistan initiated a "loyalty scheme", awarding expatriates who prefer official bank channels to the much maligned (but cheaper and more efficient) Hawala, with extra baggage allowance and special treatment in airports.

The magnitude of this international collaboration is unprecedented. But this burst of solidarity may yet fade. China, for instance, refuses to chime in. As a result, the statement issued by APEC last week on measures to stem the finances of terrorism was lukewarm at best. And, protestations of close collaboration to the contrary, Saudi Arabia has done nothing to combat money laundering "Islamic charities" (of which it is proud) on its territory.

Still, a universal code is emerging, based on the work of the OECD's FATF (Financial Action Task Force) since 1989 (its famous "40 recommendations") and on the relevant UN conventions. All countries are expected by the West, on pain of possible sanctions, to adopt a uniform legal platform (including reporting on suspicious transactions and freezing assets) and to apply it to all types of financial intermediaries, not only to banks. This is likely to result in ...

## **The decline of off shore financial centres and tax havens**

By far the most important outcome of this new-fangled juridical homogeneity is the acceleration of the decline of off shore financial and banking centres and tax havens. The distinction between off-shore and on-shore will vanish. Of the FATF's "name and shame" blacklist of 19 "black holes" (poorly regulated territories, including Israel, Indonesia, and Russia) - 11 have substantially revamped their banking laws and financial regulators. Coupled with the tightening of US, UK, and EU laws and the wider interpretation of money laundering to include political corruption, bribery, and embezzlement - this would make life a lot more difficult for venal politicians and major tax evaders. The likes of Sani Abacha (late President of Nigeria), Ferdinand Marcos (late President of the Philippines), Vladimiro Montesinos (former, now standing trial, chief of the intelligence services of Peru), or Raul Salinas (the brother of Mexico's President) - would have found it impossible to loot their countries to the same disgraceful extent in today's financial environment. And Osama bin Laden would not have been able to wire funds to US accounts from the Sudanese Al Shamal Bank, the "correspondent" of 33 American banks.

### **Quo Vadis, Money Laundering?**

Crime is resilient and fast adapting to new realities. Organized crime is in the process of establishing an alternative banking system, only tangentially connected to the West's, in the fringes, and by proxy.

This is done by purchasing defunct banks or banking licences in territories with lax regulation, cash economies, corrupt politicians, no tax collection, but reasonable infrastructure. The countries of Eastern Europe - Yugoslavia (Montenegro and Serbia), Macedonia, Ukraine, Moldova, Belarus, Albania, to mention a few - are natural targets. In some cases, organized crime is so all-pervasive and local politicians so corrupt that the distinction between criminal and politician is spurious.

Gradually, money laundering rings move their operations to these new, accommodating territories. The laundered funds are used to purchase assets in intentionally botched privatizations, real estate, existing businesses, and to finance trading operations. The wasteland that is Eastern Europe craves private capital and no questions are asked by investor and recipient alike.

The next frontier is cyberspace. Internet banking, Internet gambling, day trading, foreign exchange cyber transactions, e-cash, e-commerce, fictitious invoicing of the launderer's genuine credit cards - hold the promise of the future. Impossible to track and monitor, ex-territorial, totally digital, amenable to identity theft and fake identities - this is the ideal vehicle for money launderers.

This nascent platform is way too small to accommodate the enormous amounts of cash laundered daily - but in ten years time, it may. The problems is likely to be exacerbated by the introduction of smart cards, electronic purses, and payment-enabled mobile phones.



In its "Report on Money Laundering Typologies" (February 2001) the FATF was able to document concrete and suspected abuses of online banking, Internet casinos, and web-based financial services. It is difficult to identify a customer and to get to know it in cyberspace, was the alarming conclusion. It is equally complicated to establish jurisdiction.

Many capable professionals - stockbrokers, lawyers, accountants, traders, insurance brokers, real estate agents, sellers of high value items such as gold, diamonds, and art - are employed or co-opted by money laundering operations. Money launderers are likely to make increased use of global, around the clock, trading in foreign currencies and derivatives. These provide instantaneous transfer of funds and no audit trail. The underlying securities involved are susceptible to market manipulation and fraud. Complex insurance policies (with the "wrong" beneficiaries), and the securitization of receivables, leasing contracts, mortgages, and low grade bonds are already used in money laundering schemes. In general, money laundering goes well with risk arbitraging financial instruments.

Trust-based, globe-spanning, money transfer systems based on authentication codes and generations of commercial relationships cemented in honour and blood - are another wave of the future. The Hawala and Chinese networks in Asia, the Black Market Peso Exchange (BMPE) in Latin America, other evolving courier systems in Eastern Europe (mainly in Russia, Ukraine, and Albania) and in Western Europe (mainly in France and Spain).

In conjunction with encrypted e-mail and web anonymizers, these networks are virtually impenetrable. As emigration increases, diasporas established, and transport and telecommunications become ubiquitous, "ethnic banking" along the tradition of the Lombards and the Jews in medieval Europe may become the preferred venue of money laundering. September 11 may have retarded world civilization in more than one way.

# Hawala, or the Bank that Never Was

## I. OVERVIEW

In the wake of the September 11 terrorist attacks on the USA, attention was drawn to the age-old, secretive, and globe-spanning banking system developed in Asia and known as "Hawala" (to change, in Arabic). It is based on a short term, discountable, negotiable, promissory note (or bill of exchange) called "Hundi". While not limited to Moslems, it has come to be identified with "Islamic Banking".

Islamic Law (Sharia'a) regulates commerce and finance in the Fiqh Al Mua'malat, (transactions amongst people). Modern Islamic banks are overseen by the Shari'a Supervisory Board of Islamic Banks and Institutions ("The Shari'a Committee").

The Shi'a "Islamic Laws according to the Fatawa of Ayatullah al Uzama Syed Ali al-Husaini Seestani" has this to say about Hawala banking:

***"2298. If a debtor directs his creditor to collect his debt from the third person, and the creditor accepts the arrangement, the third person will, on completion of all the conditions to be explained later, become the debtor. Thereafter, the creditor cannot demand his debt from the first debtor."***

The prophet Muhammad (a cross border trader of goods and commodities by profession) encouraged the free movement of goods and the development of markets. Numerous Moslem scholars railed against hoarding and harmful speculation (market cornering and manipulation known as "Gharar"). Moslems were the first to use promissory notes and assignment, or transfer of debts via bills of exchange ("Hawala"). Among modern banking instruments, only floating and, therefore, uncertain, interest payments ("Riba" and "Jahala"), futures contracts, and forfeiting are frowned upon. But agile Moslem traders easily and often circumvent these religious restrictions by creating "synthetic Murabaha (contracts)" identical to Western forward and futures contracts. Actually, the only allowed transfer or trading of debts (as distinct from the underlying commodities or goods) is under the Hawala.

"Hawala" consists of transferring money (usually across borders and in order to avoid taxes or the need to bribe officials) without physical or electronic transfer of funds. Money changers ("Hawaladar") receive cash in one country, no questions asked. Correspondent hawaladars in another country dispense an identical amount (minus minimal fees and commissions) to a recipient or, less often, to a bank account. E-mail, or letter ("Hundi") carrying couriers are used to convey the necessary information (the amount of money, the date it has to be paid on) between Hawaladars. The sender provides the recipient with code words (or numbers, for instance the serial numbers of currency notes), a digital encrypted message, or agreed signals (like handshakes), to be used to retrieve the money. Big Hawaladars use a chain of middlemen in cities around the globe.

But most Hawaladars are small businesses. Their Hawala activity is a sideline or moonlighting operation. "Chits" (verbal agreements) substitute for certain written records. In bigger operations there are human "memorizers" who serve as arbiters in case of dispute. The Hawala system requires unbounded trust. Hawaladars are often members of the same family, village, clan, or ethnic group. It is a system older than the West. The ancient Chinese had their own "Hawala" - "fei qian" (or "flying money"). Arab traders used it to avoid being robbed on the Silk Road. Cheating is punished by effective ex-communication and "loss of honour" - the equivalent of an economic death sentence. Physical violence is rarer but not unheard of. Violence sometimes also erupts between money recipients and robbers who are after the huge quantities of physical cash sloshing about the system. But these, too, are rare events, as rare as bank robberies. One result of this effective social regulation is that commodity traders in Asia shift hundreds of millions of US dollars per trade based solely on trust and the verbal commitment of their counterparts.

Hawala arrangements are used to avoid customs duties, consumption taxes, and other trade-related levies. Suppliers provide importers with lower prices on their invoices, and get paid the difference via Hawala. Legitimate transactions and tax evasion constitute the bulk of Hawala operations. Modern Hawala networks emerged in the 1960's and 1970's to circumvent official bans on gold imports in Southeast Asia and to facilitate the transfer of hard earned wages of expatriates to their families ("home remittances") and their conversion at rates more favourable (often double) than the government's.

Hawala provides a cheap (it costs c. 1% of the amount transferred), efficient, and frictionless alternative to morbid and corrupt domestic financial institutions. It is Western Union without the hi-tech gear and the exorbitant transfer fees.

Unfortunately, these networks have been hijacked and compromised by drug traffickers (mainly in Afghanistan and Pakistan), corrupt officials, secret services, money launderers, organized crime, and terrorists. Pakistani Hawala networks alone move up to 5 billion US dollars annually according to estimates by Pakistan's Minister of Finance, Shaukat Aziz. In 1999, Institutional Investor Magazine identified 1100 money brokers in Pakistan and transactions that ran as high as 10 million US dollars apiece. As opposed to stereotypes, most Hawala networks are not controlled by Arabs, but by Indian and Pakistani expatriates and immigrants in the Gulf. The Hawala network in India has been brutally and ruthlessly demolished by Indira Gandhi (during the emergency regime imposed in 1975), but Indian nationals still play a big part in international Hawala networks. Similar networks in Sri Lanka, the Philippines, and Bangladesh have also been eradicated.

The OECD's Financial Action Task Force (FATF) says that:

***"Hawala remains a significant method for large numbers of businesses of all sizes and individuals to repatriate funds and purchase gold.... It is favoured because it usually costs less than moving funds through the banking system, it operates 24 hours per day and every day of the year, it is virtually completely reliable, and there is minimal paperwork required."***

(Organisation for Economic Co-Operation and Development (OECD), "Report on Money Laundering Typologies 1999-2000," Financial Action Task Force, FATF-XI, February 3, 2000, at [http://www.oecd.org/fatf/pdf/TY2000\\_en.pdf](http://www.oecd.org/fatf/pdf/TY2000_en.pdf) )

Hawala networks closely feed into Islamic banks throughout the world and to commodity trading in South Asia. There are more than 200 Islamic banks in the USA alone and many thousands in Europe, North and South Africa, Saudi Arabia, the Gulf states (especially in the free zone of Dubai and in Bahrain), Pakistan, Malaysia, Indonesia, and other South East Asian countries. By the end of 1998, the overt (read: tip of the iceberg) liabilities of these financial institutions amounted to 148 billion US dollars. They dabbled in equipment leasing, real estate leasing and development, corporate equity, and trade/structured trade and commodities financing (usually in consortia called "Mudaraba").

While previously confined to the Arab peninsula and to south and east Asia, this mode of traditional banking became truly international in the 1970's, following the unprecedented flow of wealth to many Moslem nations due to the oil shocks and the emergence of the Asian tigers. Islamic banks joined forces with corporations, multinationals, and banks in the West to finance oil exploration and drilling, mining, and agribusiness. Many leading law firms in the West (such as Norton Rose, Freshfields, Clyde and Co. and Clifford Chance) have "Islamic Finance" teams which are familiar with Islam-compatible commercial contracts.

## ***II. HAWALA AND TERRORISM***

Recent anti-terrorist legislation in the US and the UK allows government agencies to regularly supervise and inspect businesses that are suspected of being a front for the "Hawala" banking system, makes it a crime to smuggle more than \$10,000 in cash across USA borders, and empowers the Treasury secretary (and its Financial Crimes Enforcement Network - FinCEN) to tighten record-keeping and reporting rules for banks and financial institutions based in the USA. A new inter-agency Foreign Terrorist Asset Tracking Center (FTAT) was set up. A 1993 moribund proposed law requiring US-based Halawadar to register and to report suspicious transactions may be revived. These relatively radical measures reflect the belief that the al-Qaida network of Osama bin Laden uses the Hawala system to raise and move funds across national borders. A Hawaladar in Pakistan (Dihab Shill) was identified as the financier in the attacks on the American embassies in Kenya and Tanzania in 1998.

But the USA is not the only country to face terrorism financed by Hawala networks.

A few months ago, the Delhi police, the Indian government's Enforcement Directorate (ED), and the Military Intelligence (MI) arrested six Jammu Kashmir Islamic Front (JKIF) terrorists. The arrests led to the exposure of an enormous web of Hawala institutions in Delhi, aided and abetted, some say, by the ISI (Inter Services Intelligence, Pakistan's security services). The Hawala network was used to funnel money to terrorist groups in the disputed Kashmir Valley.



Luckily, the common perception that Hawala financing is paperless is wrong. The transfer of information regarding the funds often leaves digital (though heavily encrypted) trails. Couriers and "contract memorizers", gold dealers, commodity merchants, transporters, and moneylenders can be apprehended and interrogated. Written, physical, letters are still the favourite mode of communication among small and medium Hawaladars, who also invariably resort to extremely detailed single entry bookkeeping. And the sudden appearance and disappearance of funds in bank accounts still have to be explained. Moreover, the sheer scale of the amounts involved entails the collaboration of off shore banks and more established financial institutions in the West. Such flows of funds affect the local money markets in Asia and are instantaneously reflected in interest rates charged to frequent borrowers, such as wholesalers. Spending and consumption patterns change discernibly after such influxes. Most of the money ends up in prime world banks behind flimsy business facades. Hackers in Germany claimed (without providing proof) to have infiltrated Hawala-related bank accounts.

The problem is that banks and financial institutions - and not only in dodgy offshore havens ("black holes" in the lingo) - clam up and refuse to divulge information about their clients. Banking is largely a matter of fragile trust between bank and customer and tight secrecy. Bankers are reluctant to undermine either. Banks use mainframe computers which can rarely be hacked through cyberspace and can be compromised only physically in close co-operation with insiders. The shadier the bank - the more formidable its digital defenses.

The use of numbered accounts (outlawed in Austria, for instance, only recently) and pseudonyms (still possible in Lichtenstein) complicates matters. Bin Laden's accounts are unlikely to bear his name. He has collaborators.

Hawala networks are often used to launder money, or to evade taxes. Even when employed for legitimate purposes, to diversify the risk involved in the transfer of large sums, Hawaladars apply techniques borrowed from money laundering. Deposits are fragmented and wired to hundreds of banks the world over ("starburst"). Sometimes, the money ends up in the account of origin ("boomerang").

Hence the focus on payment clearing and settlement systems. Most countries have only one such system, the repository of data regarding all banking (and most non-banking) transactions in the country. Yet, even this is a partial solution. Most national systems maintain records for 6-12 months, private settlement and clearing systems for even less.

Yet, the crux of the problem is not the Hawala or the Hawaladars. The corrupt and inept governments of Asia are to blame for not regulating their banking systems, for over-regulating everything else, for not fostering competition, for throwing public money at bad debts and at worse borrowers, for over-taxing, for robbing people of their life savings through capital controls, for tearing at the delicate fabric of trust between customer and bank (Pakistan, for instance, froze all foreign exchange accounts two years ago). Perhaps if Asia had reasonably expedient, reasonably priced, reasonably regulated, user-friendly banks - Osama bin Laden would have found it impossible to finance his mischief so invisibly.

## *Straf - Corruption in Central and Eastern Europe*

The three policemen barked "straf", "straf" in unison. It was a Russianized version of the German word for "fine" and a euphemism for bribe. I and my fiancée were stranded in an empty ally at the heart of Moscow, physically encircled by these young bullies, an ominous propinquity. They held my passport ransom and began to drag me to a police station nearby. We paid.

To do the fashionable thing and to hold the moral high ground is rare. Yet, denouncing corruption and fighting it satisfies both conditions. Such hectoring is usually the preserve of well-heeled bureaucrats, driving utility vehicles and banging away at wireless laptops. The General Manager of the IMF makes 400,000 US dollars a year, tax-free, and perks. This is the equivalent of 2,300 (!) monthly salaries of a civil servant in Macedonia - or 7,000 monthly salaries of a teacher or a doctor in Yugoslavia, Moldova, Belarus, or Albania. He flies only first class and each one of his air tickets is worth the bi-annual income of a Macedonian factory worker. His shareholders - among them poor and developing countries - are forced to cough up these exorbitant fees and to finance the luxurious lifestyle of the likes of Kohler and Wolfensohn. And then they are made to listen to the IMF lecture them on belt tightening and how uncompetitive their economies are due to their expensive labour force. To me, such a double standard is the epitome of corruption. Organizations such as the IMF and World Bank will never be possessed of a shred of moral authority in these parts of the world unless and until they forgo their conspicuous consumption.

Yet, corruption is not a monolithic practice. Nor are its outcomes universally deplorable or damaging. One would do best to adopt a utilitarian and discerning approach to it. The advent of moral relativism has taught us that "right" and "wrong" are flexible, context dependent and culture-sensitive yardsticks.

What amounts to venality in one culture (Slovenia) is considered no more than gregariousness or hospitality in another (Macedonia).

Moreover, corruption is often "imported" by multinationals, foreign investors, and expats. It is introduced by them to all levels of governments, often in order to expedite matters or secure a beneficial outcome. To eradicate corruption, one must tackle both giver and taker.

Thus, we are better off asking "cui bono" than "is it the right thing to do". Phenomenologically, "corruption" is a common - and misleading - label for a group of behaviours. One of the following criteria must apply:

(a) The withholding of a service, information, or goods that, by law, and by right, should have been provided or divulged.

To have a phone installed in Russia one must openly bribe the installer (according to a rather rigid tariff). In many of the former republics of Yugoslavia, it is impossible to obtain statistics or other data (the salaries of senior public officeholders, for instance) without resorting to kickbacks.

(b) The provision of a service, information, or goods that, by law, and by right, should not have been provided or divulged.

Tenders in the Czech Republic are often won through bribery. The botched privatizations all over the former Eastern Bloc constitute a massive transfer of wealth to select members of a nomenklatura. Licences and concessions are often granted in Bulgaria and the rest of the Balkan as means of securing political allegiance or paying off old political "debts".

(c) That the withholding or the provision of said service, information, or goods are in the power of the withholder or the provider to withhold or to provide AND That the withholding or the provision of said service, information, or goods constitute an integral and substantial part of the authority or the function of the withholder or the provider.

The post-communist countries in transition are a dichotomous lot. On the one hand, they are intensely and stiflingly bureaucratic. On the other hand, none of the institutions functions properly or lawfully. While these countries are LEGALISTIC - they are never LAWFUL. This fuzziness allows officials in all ranks to usurp authority, to trade favours, to forge illegal consensus and to dodge criticism and accountability. There is a direct line between lack of transparency and venality. Eran Fraenkel of Search for Common Ground in Macedonia has coined the phrase "ambient corruption" to capture this complex of features.

(d) That the service, information, or goods that are provided or divulged are provided or divulged against a benefit or the promise of a benefit from the recipient and as a result of the receipt of this specific benefit or the promise to receive such benefit.

It is wrong to assume that corruption is necessarily, or even mostly, monetary or pecuniary. Corruption is built on mutual expectations. The reasonable expectation of a future benefit is, in itself, a benefit. Access, influence peddling, property rights, exclusivity, licences, permits, a job, a recommendation - all constitute benefits.

(e) That the service, information, or goods that are withheld are withheld because no benefit was provided or promised by the recipient.

Even then, in CEE, we can distinguish between a few types of corrupt and venal behaviours in accordance with their OUTCOMES (utilities):

**(a) Income Supplement**

Corrupt actions whose sole outcome is the supplementing of the income of the provider without affecting the "real world" in any manner.

Though the perception of corruption itself is a negative outcome - it is so only when corruption does not constitute an acceptable and normative part of the playing field. When corruption becomes institutionalised - it also becomes predictable and is easily and seamlessly incorporated into decision making processes of all economic players and moral agents. They develop "by-passes" and "techniques" which allow them to restore an efficient market equilibrium. In a way, all-pervasive corruption is transparent and, thus, a form of taxation.

This is the most common form of corruption exercised by low and mid-ranking civil servants, party hacks and municipal politicians throughout the CEE.

More than avarice, the motivating force here is sheer survival. The acts of corruption are repetitive, structured and in strict accordance with an un-written tariff and code of conduct.

#### **(b) Acceleration Fees**

Corrupt practices whose sole outcome is to ACCELERATE decision making, the provision of goods and services or the divulging of information. None of the outcomes or the utility functions are altered. Only the speed of the economic dynamics is altered. This kind of corruption is actually economically BENEFICIAL. It is a limited transfer of wealth (or tax) which increases efficiency. This is not to say that bureaucracies and venal officialdoms, over-regulation and intrusive political involvement in the workings of the marketplace are good (efficient) things.

They are not. But if the choice is between a slow, obstructive and passive-aggressive civil service and a more forthcoming and accommodating one (the result of bribery) - the latter is preferable.

Acceleration fees are collected mostly by mid-ranking bureaucrats and middle rung decision makers in both the political echelons and the civil service.

### **(c) Decision Altering Fees**

This is where the line is crossed from the point of view of aggregate utility. When bribes and promises of bribes actually alter outcomes in the real world - a less than optimal allocation of resources and distribution of means of production is obtained. The result is a fall in the general level of production. The many is hurt by the few. The economy is skewed and economic outcomes are distorted. This kind of corruption should be uprooted on utilitarian grounds as well as on moral ones.

### **(d) Subversive Outcomes**

Some corrupt collusions lead to the subversion of the flow of information within a society or an economic unit. Wrong information often leads to disastrous outcomes. Consider a medical doctor or an civil engineer who bribed their way into obtaining a professional diploma.

Human lives are at stake. The wrong information, in this case is the professional validity of the diplomas granted and the scholarship (knowledge) that such certificates stand for. But the outcomes are lost lives. This kind of corruption, of course, is by far the most damaging.



Unfortunately, it is widespread in CEE. It is proof of the collapse of the social treaty, of social solidarity and of the fraying of the social fabric.

No Western country accepts CEE diplomas without further accreditation, studies and examinations. Many "medical doctors" and "engineers" who emigrated to Israel from Russia and the former republics of the USSR - were suspiciously deficient professionally. Israel was forced to re-educate them prior to granting them a licence to practice locally.

#### **(e) Reallocation Fees**

Benefits paid (mainly to politicians and political decision makers) in order to affect the allocation of economic resources and material wealth or the rights thereto. Concessions, licences, permits, assets privatised, tenders awarded are all subject to reallocation fees. Here the damage is materially enormous (and visible) but, because it is widespread, it is "diluted" in individual terms. Still, it is often irreversible (like when a sold asset is purposefully under-valued) and pernicious. a factory sold to avaricious and criminally minded managers is likely to collapse and leave its workers unemployed.

Corruption pervades daily life even in the prim and often hectoring countries of the West. It is a win-win game (as far as Game Theory goes) - hence its attraction. We are all corrupt to varying degrees. But it is wrong and wasteful - really, counterproductive - to fight corruption in CEE in a wide front and indiscriminately.

It is the kind of corruption whose evil outcomes outweigh its benefits that should be fought. This fine (and blurred) distinction is too often lost on decision makers and law enforcement agencies in both East and West.

## **ERADICATING CORRUPTION**

An effective program to eradicate corruption must include the following elements:

- (a) Egregiously corrupt, high-profile, public figures, multinationals, and institutions (domestic and foreign) must be singled out for harsh (legal) treatment and thus demonstrate that no one is above the law and that crime does not pay.
- (b) All international aid, credits, and investments must be conditioned upon a clear, performance-based, plan to reduce corruption levels and intensity. Such a plan should be monitored and revised as needed. Corruption retards development and produces instability by undermining the credentials of democracy, state institutions, and the political class. Reduced corruption is, therefore, a major target of economic and institutional development.
- (c) Corruption cannot be reduced only by punitive measures. A system of incentives to avoid corruption must be established. Such incentives should include a higher pay, the fostering of civic pride, educational campaigns, "good behaviour" bonuses, alternative income and pension plans, and so on.

(d) Opportunities to be corrupt should be minimized by liberalizing and deregulating the economy. Red tape should be minimized, licensing abolished, international trade freed, capital controls eliminated, competition introduced, monopolies broken, transparent public tendering be made mandatory, freedom of information enshrined, the media should be directly supported by the international community, and so on. Deregulation should be a developmental target integral to every program of international aid, investment, or credit provision.

(e) Corruption is a symptom of systemic institutional failure. Corruption guarantees efficiency and favourable outcomes. The strengthening of institutions is of critical importance. The police, the customs, the courts, the government, its agencies, the tax authorities, the state owned media - all must be subjected to a massive overhaul. Such a process may require foreign management and supervision for a limited period of time. It most probably would entail the replacement of most of the current - irredeemably corrupt - personnel. It would need to be open to public scrutiny.

(f) Corruption is a symptom of an all-pervasive sense of helplessness. The citizen (or investor, or firm) feels dwarfed by the overwhelming and capricious powers of the state. It is through corruption and venality that the balance is restored. To minimize this imbalance, potential participants in corrupt dealings must be made to feel that they are real and effective stakeholders in their societies. A process of public debate coupled with transparency and the establishment of just distributive mechanisms will go a long way towards rendering corruption obsolete.

# *The Kleptocracies of the East*

By: [Dr. Sam Vaknin](#)

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*December 20, 2002*

The process of transition from communism to capitalism was largely hijacked either by outright criminals in budding outfits of organized crime - or by pernicious and all-pervasive kleptocracies: politicians and political parties bent on looting the state and suppressing the opposition, sometimes fatally.

In the past 13 years, industrial production in the economies in transition tumbled in real terms by more than 60 percent. The monthly salary in the poorer bits equals the daily wage of a skilled German industrial worker, or one seventh the European Union's average. Gross domestic product per capita is less than one third the EU's. Infrastructure, internal and export markets, state institutions - all crumbled with dizzying speed.

In some countries - not the least Russia - privatization amounted to a mass transfer of assets to cronies and insiders, often well-connected members of the communist nomenclature: managers, members of the security services and other penumbral figures. Laws were passed and institutions tweaked to reflect the special interests of these groupings.

"Classical" forms of crime flourished throughout the benighted region. Prostitution, gambling, drugs, smuggling, kidnapping, organ trafficking and other varieties of delinquency yielded to their perpetrators billions of dollars annually. In the impoverished economies of the east, these fantastic revenues - laundered through off shore accounts - were leveraged by criminals to garner political favors, to buy into legitimate businesses and to infiltrate civil society.

None of this is new to Western publics. Rogues and "robber barons" have always doubled as entrepreneurs. The oil, gaming and railways industries in America, for instance, owe their existence to dubious personas and questionable practices. Well into the 17th century, the British sovereign maintained a monopoly on chartering businesses and awarded the coveted licenses to loyal servants and obsequious sycophants.

Still, the ubiquity of crime in east Europe and its reach are unprecedented in European annals. In the void-like interregnum between centrally planned and free market economies only criminals, politicians, managers, and employees of the security services were positioned to benefit from the upheaval.

At the outset of transition, the underworld constituted an embryonic private sector, replete with international networks of contacts, cross-border experience, capital agglomeration and wealth formation, sources of venture (risk) capital, an entrepreneurial spirit, and a diversified portfolio of investments and revenue generating assets. Criminals were used to private sector practices: price signals, competition, joint venturing, and third party dispute settlement.

Crime - alone among all economic activities in communist societies - obeyed the laws of the free market. Criminals had to be entrepreneurial and profitable to survive. Their instincts sharpened by - often lethal - competition, they were never corrupted by central planning.

Deprived of access to state largesse, criminals invested their own capital in efficiently-run small to medium size enterprises. Attuned to the needs and wishes of their customers, criminals engaged in primitive forms of market research, through neighborhood and grassroots "pollsters" and "activists". They responded with agility and in real time to changes in the patterns of supply and demand by altering their product mix and their pricing. They have always been pioneers of bleeding-edge technologies.

Criminals are effective organizers and managers. They excel at enforcing workplace discipline with irresistible incentives and irreversible disincentives, at setting targets and at networking. The superior felonious echelons are upwardly mobile and have a clear career path. Every management fad - from territorially exclusive franchises to "stock" options - has been invented by criminals long before they triumphed in the boardroom.

In east Europe, criminals on all levels, from the organized to the petty, often substituted for the dysfunctional, or ideologically hidebound organs of the state. Consider the dispensation of justice. The criminal code of conduct and court system replaced the compromised and lethargic official judiciary. Debt collectors and enforcers stood in for venal and incompetent police forces.

Crime is a growth industry and sustains hordes of professionals: accountants and lawyers, forgers and cross border guides, weapons experts and bankers, mechanics and hit-men. Expertise, know-how and acumen, amassed over centuries of practice, are taught in the criminal universities known as penitentiaries: roads less traveled, countries more lenient, passports to be bought, sold, or forged, how-to manuals, goods and services on offer and demand.

Profit margins in crime are outlandish and lead to feverish wealth accumulation. The banking system is used both to stash the proceeds and to launder them. Tax havens, offshore financial institutions and money couriers - all form part of a global web.

Thus cleansed and rendered untraceable, the money is invested in legitimate activities. In some countries - especially on the drug path, or on the trail of white slavery - crime is a major engine of economic growth.

As opposed to the visible sectors of the east's demonetized economies, criminal enterprises never run out of liquidity and thus are always keen to invest. Moreover, crime is international and cosmopolitan. It is accustomed to sophisticated export-import transactions.

Many criminals - as opposed to the vast majority of their countrymen - are polyglottal, well-traveled, aware of world prices, the international financial system and demand and supply in various markets. They are experienced negotiators. In short: criminals are well-heeled international businessmen, well-connected both abroad and with the various indigenous elites.

The Wild East in Europe is often compared to the Wild West in America a century or so ago. The Russian oligarchs, goes the soothing analogy, are local versions of Morgan, Rockefeller, Pullman and Vanderbilt. But this affinity is spurious. The United States always had a civic culture with civic values and an aspiration to, ultimately, create a harmonious and benevolent civic society. Criminality was regarded as a shameful stepping stone on the way to an orderly community of learned, civilized, law-abiding citizens.



This cannot be said about Russia, for instance. The criminal there is, if anything, admired and emulated. Even the language of legal business in countries in transition is suffused with underworld parlance. There is no - and never was - a civic tradition in the countries of eastern Europe, a Bill of Rights, a veritable Constitution, a modicum of self rule, a true abolition of classes and nomenclatures. These territories are accustomed to being governed by paranoiac and murderous tyrants akin to the current crop of delinquents. That some criminals are members of the new political, financial and industrial elites (and vice versa) - tends to support this long-rooted association.

In all the countries of the region, politicians and managers abuse the state and its simulacrum institutions in close symbiosis with felons. Patronage and sinecures extend to collaborating lawbreakers. Veritable villains gain access to state owned assets and resources in a cycle of money laundering. Law enforcement agencies and the courts are "encouraged" to turn a blind eye, or even to help criminals eliminate internal and external competition in their turf.

Criminals, in return, serve as the "long and anonymous arm" of politicians, obtaining for them illicit goods, or providing "black" services. Corruption often flows through criminal channels or via the mediation and conduit of delinquents. Within the shared sphere of the informal economy, assets are shifted among these economic players. Both players oppose attempts at reform and transparency and encourage - even engender - nationalism and racism, paranoias and grievances to recruit foot soldiers.

Fortunately, there is the irrepressible urge to become legitimate. Politicians, who grope for a new ideological cover for their opportunism, partner with legitimacy-seeking, established crime lords. Both groups benefit from a swelling economic pie. They fight against other, less successful, criminals, who wish to persist in their old ways and, thus, hamper economic growth. The battle is never won but at least it succeeds to firmly drive crime where it belongs: underground.

## *Russia's Missing Billions*

Russia's Audit Chamber - with the help of the Swiss authorities and their host of dedicated investigators - may be about to solve a long standing mystery. An announcement by the Prosecutor's General Office is said to be imminent. The highest echelons of the Yeltsin entourage - perhaps even Yeltsin himself - may be implicated - or exonerated. A Russian team has been spending the better part of the last two months poring over documents and interviewing witnesses in Switzerland, France, Italy, and other European countries.

About \$4.8 billion of IMF funds are alleged to have gone amiss during the implosion of the Russian financial markets in August 1998. They were supposed to prop up the banking system (especially SBS-Agro) and the ailing and sharply devalued ruble. Instead, they ended up in the bank accounts of obscure corporations - and, then, incredibly, vanished into thin air.

The person in charge of the funds in 1998 was none other than Mikhail Kasyanov, Russia's current Prime Minister - at the time, Deputy Minister of Finance for External Debt. His signature on all foreign exchange transactions - even those handled by the central bank - was mandatory. In July 2000, he was flatly accused by the Italian daily, *La Repubblica*, of authorizing the diversion of the disputed funds.

Following public charges made by US Treasury Secretary Robert Rubin as early as March 1999, both Russian and American media delved deeply over the years into the affair. Communist Duma Deputy Viktor Ilyukhin jumped on the bandwagon citing an obscure "trustworthy foreign source" to substantiate his indictment of Kremlin cronies and oligarchs contained in an open letter to the Prosecutor General, Yuri Skuratov.

The money trail from the Federal Reserve Bank of New York to Swiss and German subsidiaries of the Russian central Bank was comprehensively reconstructed. Still, the former Chairman of the central bank, Sergei Dubinin, called Ilyukhin's allegations and the ensuing Swiss investigations - "a black PR campaign ... a lie."

Others pointed to an outlandish coincidence: the ruble collapsed twice in Russia's post-Communist annals. Once, in 1994, when Dubinin was Minister of Finance and was forced to resign. The second time was in 1998, when Dubinin was governor of the central bank and was, again, ousted.

Dubinin himself seems to be unable to make up his mind. In one interview he says that IMF funds were used to prop up the ruble - in others, that they went into "the national pot" (i.e., the Ministry of Finance, to cover a budgetary shortfall).

The Chairman of the Federation Council at the time, Yegor Stroev, appointed an investigative committee in 1999. Its report remains classified but Stroev confirmed that IMF funds were embezzled in the wake of the 1998 forced devaluation of the ruble.

This conclusion was weakly disowned by Eleonora Mitrofanova, an auditor within the Duma's Audit Chamber who said that they discovered nothing "strictly illegal" - though, incongruously, she accused the central bank of suppressing the Chamber's damning report. The Chairman of the Chamber of Accounts, Khachim Karmokov, quoted by PwC, said that "the audits performed by the Chamber revealed no serious procedural breaches in the bank's performance."

But Nikolai Gonchar, a Duma Deputy and member of its Budget Committee, came close to branding both as liars when he said that he read a copy of the Audit Chamber report and that it found that central bank funds were siphoned off to commercial accounts in foreign banks.

The Moscow Times cited a second Audit Chamber report which revealed that the central bank was simultaneously selling dollars for rubles and extending ruble loans to a few well-connected commercial banks, thus subsidizing their dollar purchases. The central bank went as far as printing rubles to fuel this lucrative arbitrage. The dollars came from IMF disbursements.

Radio Free Europe/Radio Liberty, based on its own sources and an article in the Russian weekly "Novaya Gazeta", claims that half the money was almost instantly diverted to shell companies in Sydney and London. The other half was mostly transferred to the Bank of New York and to Credit Suisse.

Why were additional IMF funds transferred to a chaotic Russia, despite warnings by many and a testimony by a Russian official that previous tranches were squandered? Moreover, why was the money sent to the Central Bank, then embroiled in a growing scandal over the manipulation of treasury bills, known as GKO's and other debt instruments, the OFZ's - and not to the Ministry of Finance, the beneficiary of all prior transfers? The central bank did act as MinFin's agent - but circumstances were unusual, to say the least.

There isn't enough to connect the IMF funds with the money laundering affair that engulfed the Bank of New York a year later to the day, in August 1999 - though several of the personalities straddled the divide between the bank and its clients. Swiss efforts to establish a firm linkage failed as did their attempt to implicate several banks in the Italian canton of Ticino. The Swiss - in collaboration with half a dozen national investigation bureaus, including the FBI - were more successful in Italy proper, where they were able to apprehend a few dozen suspects in an elaborate undercover operation.

FIMACO's name emerged rather early in the swirl of rumors and denials. At the IMF's behest, PricewaterhouseCoopers (PwC) was commissioned by Russia's central bank to investigate the relationship between the Russian central bank and its Channel Islands offshoot, Financial Management Company Limited, immediately when the accusations surfaced.

Skuratov unearthed \$50 billion in transfers of the nation's hard currency reserves from the central bank to FIMACO, which was majority-owned by Eurobank, the central bank's Paris-based daughter company. According to PwC, Eurobank was 23 percent owned by "Russian companies and private individuals".

Dubinina and his successor, Gerashchenko, admit that FIMACO was used to conceal Russia's assets from its unrelenting creditors, notably the Geneva-based Mr. Nessim Gaon, whose companies sued Russia for \$600 million. Gaon succeeded to freeze Russian accounts in Switzerland and Luxemburg in 1993. PwC alerted the IMF to this pernicious practice, but to no avail.

Moreover, FIMACO paid exorbitant management fees to self-liquidating entities, used funds to fuel the speculative GKO market, disbursed non-reported profits from its activities, through "trust companies", to Russian subjects, such as schools, hospitals, and charities - and, in general, transformed itself into a mammoth slush fund and source of patronage. Russia admitted to lying to the IMF in 1996. It misstated its reserves by \$1 billion.

Some of the money probably financed the fantastic salaries of Dubinin and his senior functionaries. He earned \$240,000 in 1997 - when the average annual salary in Russia was less than \$2000 and when Alan Greenspan, Chairman of the Federal Reserve of the USA, earned barely half as much.

Former Minister of Finance, Boris Fedorov, asked the governor of the central bank and the prime minister in 1993 to disclose how were the country's foreign exchange reserves being invested. He was told to mind his own business. To Radio Free Europe/Radio Liberty he said, six years later, that various central bank schemes were set up to "allow friends to earn handsome profits ... They allowed friends to make profits because when companies are created without any risk, and billions of dollars are transferred, somebody takes a (quite big) commission ... a minimum of tens of millions of dollars. The question is: Who received these commissions? Was this money repatriated to the country in the form of dividends?"

Dubinin's vehement denials of FIMACO's involvement in the GKO market are disingenuous. Close to half of all foreign investment in the money-spinning market for Russian domestic bonds were placed through FIMACO's nominal parent company, Eurobank and, possibly, through its subsidiary, co-owned with FIMACO, Eurofinance Bank.

Nor is Dubinin more credible when he denies that profits and commissions were accrued in FIMACO and then drained off. FIMACO's investment management agreement with Eurobank, signed in 1993, entitled it to 0.06 percent of the managed funds per quarter.



Even accepting the central banker's ludicrous insistence that the balance never exceeded \$1.4 billion - FIMACO would have earned \$3.5 million per annum from management fees alone - investment profits and brokerage fees notwithstanding. Even Eurobank's president at the time, Andrei Movchan, conceded that FIMACO earned \$1.7 million in management fees.

The IMF insisted that the PwC reports exonerated all the participants. It is, therefore, surprising and alarming to find that the online copies of these documents, previously made available on the IMF's Web site, were "Removed September 30, 1999 at the request of PricewaterhouseCoopers".

The cover of the main report carried a disclaimer that it was based on procedures dictated by the central bank and "... consequently, we (PwC) make no representation regarding the sufficiency of the procedures described below ... The report is based solely on financial and other information provided by, and discussions with, the persons set out in the report. The accuracy and completeness of the information on which the report is based is the sole responsibility of those persons. ... PricewaterhouseCoopers have not carried out any verification work which may be construed to represent audit procedures ... We have not been provided access to Ost West Handelsbank (the recipient of a large part of the \$4.8 IMF tranche)"

The scandal may have hastened the untimely departure of the IMF's Managing Director at the time, Michel Camdessus, though this was never officially acknowledged. The US Congress was reluctant to augment the Fund's resources in view of its controversial handling of the Asian and Russian crises and contagion.

This reluctance persisted well into the new millennium. A congressional delegation, headed by James Leach (R, Iowa), Chairman of the Banking and Financial Services Committee, visited Russia in April 2000, accompanied by the FBI, to investigate the persistent contentions about the misappropriation of IMF funds.

Camdessus himself went out of his way to defend his record and reacted in an unprecedented manner to the allegations. In a letter to *Le Monde*, dated August 18, 1999 - and still posted on the IMF's Web site, three years later - he wrote, inadvertently admitting to serious mismanagement:

"I wish to express my indignation at the false statements, allegations, and insinuations contained in the articles and editorial commentary appearing in *Le Monde* on August 6, 8, and 9 on the content of the PricewaterhouseCoopers (PWC) audit report relating to the operations of the Central Bank of Russia and its subsidiary, FIMACO.

Your readers will be shocked to learn that the report in question, requested and made public at the initiative of the IMF ... (concludes that) no misuse of funds has been proven, and the report does not criticize the IMF's behavior ... I would also point out that your representation of the IMF's knowledge and actions is misleading. We did know that part of the reserves of the Central Bank of Russia was held in foreign subsidiaries, which is not an illegal practice; however, we did not learn of FIMACO's activities until this year--because the audit reports for 1993 and 1994 were not provided to us by the Central Bank of Russia.

The IMF, when apprised of the possible range of FIMACO activities, informed the Russian authorities that it would not resume lending to Russia until a report on these activities was available for review by the IMF and corrective actions had been agreed as needed ... I would add that what the IMF objected to in FIMACO's operations extends well beyond the misrepresentation of Russia's international reserves in mid-1996 and includes several other instances where transactions through it had resulted in a misleading representation of the reserves and of monetary and exchange policies. These include loans to Russian commercial banks and investments in the GKO market."

No one accepted - or accepts - the IMF's convoluted post-facto "clarifications" at face value. Nor was Dubinin's tortured sophistry - IMF funds cease to be IMF funds when they are transferred from the Ministry of Finance to the central bank - countenanced.

Even the compromised office of the Russian Prosecutor-General urged Russian officials, as late as July 2000, to re-open the investigation regarding the diversion of the funds. The IMF dismissed this sudden burst of rectitude as the rehashing of old stories. But Western officials - interviews by Radio Free Europe/Radio Liberty - begged to differ.

Yuri Skuratov, the former Prosecutor-General, ousted for undue diligence, wrote in a book he published two years ago, that only c. \$500 million of the \$4.8 were ever used to stabilize the ruble. Even George Bush Jr., when still a presidential candidate accused Russia's former Prime Minister Viktor Chernomyrdin of complicity in embezzling IMF funds. Chernomyrdin threatened to sue.

The rot may run even deeper. The Geneva daily "Le Temps", which has been following the affair relentlessly, accused, two years ago, Roman Abramovich, a Yeltsin-era oligarch and a member of the board of directors of Sibneft, of colluding with Runicom, Sibneft's trading arm, to misappropriate IMF funds. Swiss prosecutors raided Runicom's offices just one day after Russian Tax Police raided Sibneft's Moscow headquarters.

Absconding with IMF funds seemed to have been a pattern of behavior during Yeltsin's venal regime. The columnist Bradley Cook recounts how Aldrich Ames, the mole within the CIA, "was told by his Russian control officer during their last meeting, in November 1993, that the \$130,000 in fresh \$100 bills that he was being bribed with had come directly from IMF loans." Venyamin Sokolov, who headed the Audit Chamber prior to Sergei Stepashin, informed the US Senate of \$2 billion that evaporated from the coffers of the central bank in 1995.

Even the IMF reluctantly admits:

"Capital transferred abroad from Russia may represent such legal activities as exports, or illegal sources. But it is impossible to determine whether specific capital flows from Russia-legal or illegal-come from a particular inflow, such as IMF loans or export earnings. To put the scale of IMF lending to Russia into perspective, Russia's exports of goods and services averaged about \$80 billion a year in recent years, which is over 25 times the average annual disbursement from the IMF since 1992."

## *The Enrons of the East*

Hermitage Capital Management, an international investment firm owned by HSBC London, is suing PwC (PricewaterhouseCoopers), the biggest among the big four accounting firms (Andersen, the fifth, is being cannibalized by its competitors).

Hermitage also demands to have PwC's license suspended in Russia. All this fuss over allegedly shoddy audits of Gazprom, the Russian energy behemoth with over \$20 billion in annual sales and the world's largest reserves of natural gas. Hermitage runs a \$600 million Russia fund which is invested in the shares of the allegedly misaudited giant.

The accusations are serious. According to infuriated Hermitage, PwC falsified and distorted the 2000-1 audits by misrepresenting the sale of Gazprom's subsidiary, Purgaz, to Itera, a conveniently obscure entity. Other loss spinning transactions were also creatively tackled. Stoitransgaz - partly owned by former Gazprom managers and their relatives - landed more than \$1 billion in lucrative Gazprom contracts.

These shenanigans resulted in billions of dollars of losses and a depressed share price. AFP quotes William Browder, Hermitage's disgruntled CEO, as saying: "This is Russia's Enron". PwC threatened to counter-sue Hermitage over its "completely unfounded" allegations.

But Browder's charges are supported by Boris Fyodorov, a former Russian minister of finance and a current Gazprom independent director. Fyodorov manages his own investment boutique, United Financial Group. Browder is a former Solomon Brothers investment banker. Other investment banks and brokerage firms - foreign and Russian - are supportive of his allegations. They won't and can't be fobbed.

Fyodorov speculates that PwC turned a blind eye to many of Gazprom's shadier deals in order to keep the account. Gazprom shareholders will decide in June whether to retain it as an auditor or not. Browder is initiating a class action lawsuit in New York of Gazprom ADR holders against PwC.

Even Russia's president concurs. A year ago, he muttered ominously about "enormous amounts of misspent money (in Gazprom)". He replaced Rem Vyakhirev, the oligarch that ran Gazprom, with his own protégé. Russia owns 38 percent of the company.

Gazprom is just the latest in an inordinately long stream of companies with dubious methods. Avto VAZ bled itself white - under PwC's nose - shipping cars to dealers, without guarantees or advance payments. The penumbral dealers then vanished without a trace. Avto VAZ wrote off more than \$1 billion in "uncollected bills" by late 1995. PwC did make a mild comment in the 1997 audit. But the first real warning appeared only three years later in the audit for the year 2000.

Andrei Sharonov, deputy minister in the federal Ministry of Economics said, in an interview he granted "Business Week" last February: "Auditors have been working on behalf of management rather than shareholders." In a series of outlandish ads, published in Russian business dailies in late February, senior partners in the PwC Moscow office made this incredible statement: "(Audit) does not represent a review of each transaction, or a qualitative assessment of a company's performance."

The New York Times quotes a former employee of Ernst&Young in Moscow as saying: "A big client is god. You do what they want and tell you to do. You can play straight-laced and try to be upright and protect your reputation with minor clients, but you can't do it with the big guys. If you lose that account, no matter how justified you are, that's the end of a career."

PwC should know. When it mentioned suspicious heavily discounted sales of oil to Rosneft in a 1998 audit report, its client, Purneftegaz, replaced it with Arthur Andersen. The dubious deals dutifully vanished from the audit reports, though they continue apace. Andersen claims such transactions do not require disclosure under Russian law.

How times change! Throughout the 1990's, Russia and its nascent private sector were subjected to self-righteous harangues from visiting Big Five accountants. The hectoring targeted the lack of good governance among Russia's corporations and public administration alike. Hordes of pampered speakers and consultants espoused transparent accounting, minority shareholders' rights, management accessibility and accountability and other noble goals.



That was before Enron. The tables have turned. The Big Five - from disintegrating Andersen to KPMG - are being chastised and fined for negligent practices, flagrant conflicts of interests, misrepresentation, questionable ethics and worse. Their worldwide clout, moral authority, and professional standing have been considerably dented.

America's GAAP (Generally Accepted Accounting Practices) - once considered the undisputable benchmark of rectitude and disclosure - are now thought in need of urgent revision. The American issuer of accounting standards - FASB (Financial Accounting Standards Board) - is widely perceived to be an incestuous arrangement between the clubby members of a rapacious and unscrupulous profession. Many American scholars even suggest to adopt the hitherto much-derided alternative - the International Accounting Standards (IAS) recently implemented through much of central and eastern Europe.

Russia's Federal Commission for the Securities Market (FCSM) convened a conclave of Western and domestic auditing firms. The theme was how to spot and neutralize bad auditors. With barely concealed and gleeful schadenfreude, the Russians said that the Enron scandal undermined their confidence in Western accountants and the GAAP.

The Institute of Corporate Law and Corporate Governance (ICLG), having studied the statements of a few major Russian firms, concluded that there are indications of financial problems, "not mentioned by (mostly Western) auditors". They may have a point. Most of the banks that collapsed ignominiously in 1998 received glowing audits signed by Western auditors, often one of the Big Five.

The Russian Investor Protection Association (IPA) and Institute of Professional Auditors (IPAR) embarked on a survey of Russian investors, enterprises, auditors, and state officials - and what they think about the quality of the audit services they are getting.

Many Russian managers - as avaricious and venal as ever - now can justify hiring malleable and puny local auditors instead of big international or domestic ones. Surgutneftegaz - with \$2 billion net profit last year and on-going dispute with its shareholders about dividends - wants to sack "Rosexperitza", a respectable Russian accountancy, and hire "Aval", a little known accounting outfit. Aval does not even make it to the list of 200 largest accounting firms in Russia, according to Renaissance Capital, an investment bank.

Other Russian managers are genuinely alarmed by the vertiginous decline in the reputation of the global accounting firms and by the inherent conflict of interest between consulting and audit jobs performed by the same entity. Sviazinvest, a holding and telecom company, hired Accenture on top of - some say instead of - Andersen Consulting.

A decade of achievements in fostering transparency, better corporate governance, and more realistic accounting in central and eastern Europe - may well evaporate in the wake of Enron and other scandals. The forces of reaction and corruption in these nether lands - greedy managers, venal bureaucrats, and anti-reformists - all seized the opportunity to reverse what was hitherto considered an irreversible trend towards Western standards. This, in turn, is likely to deter investors and retard the progress towards a more efficient market economy.

The Big Six accounting firms were among the first to establish a presence in Russia. Together with major league consultancies, such as Baker-McKinsey, they coached Russian entrepreneurs and managers in the ways of the West. They introduced investors to Russia when it was still considered a frontier land. They promoted Russian enterprises abroad and nursed the first, precarious, joint ventures between paranoid Russians and disdainful Westerners.

Companies like Ernst&Young are at the forefront of the fight to include independent directors in the boards of Russian firms, invariably stuffed with relatives and cronies. Together with IPA, Ernst&Young recently established the National Association of Independent Directors (NAID). It is intended to "assist Russian companies to increase their efficiency through introduction of best independent directors' practices."

But even these - often missionary - pioneers were blinded by the spoils of a "free for all", "winner takes all", and "might is right" environment. They geared the accounts of their clients - by minimizing their profits - towards tax avoidance and the abolition of dividends. Quoting unnamed former employees of the audit firms, "The New York Times" described how "... the auditors often chose to play by Russian rules, and in doing so sacrificed the transparency that investors were counting on them to ensure."

# *The Typology of Financial Scandals*

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## *I. Overview*

The recent implosion of the global equity markets - from Hong Kong to New York - engendered yet another round of the sempiternal debate: should central banks contemplate abrupt adjustments in the prices of assets - such as stocks or real estate - as they do changes in the consumer price indices? Are asset bubbles indeed inflationary and their bursting deflationary?

Central bankers counter that it is hard to tell a bubble until it bursts and that market intervention bring about that which it is intended to prevent. There is insufficient historical data, they reprimand errant scholars who insist otherwise. This is disingenuous. Ponzi and pyramid schemes have been a fixture of Western civilization at least since the middle Renaissance.

Assets tend to accumulate in "asset stocks". Residences built in the 19th century still serve their purpose today. The quantity of new assets created at any given period is, inevitably, negligible compared to the stock of the same class of assets accumulated over decades and, sometimes, centuries. This is why the prices of assets are not anchored - they are only loosely connected to their production costs or even to their replacement value.

Asset bubbles are not the exclusive domain of stock exchanges and shares. "Real" assets include land and the property built on it, machinery, and other tangibles.

"Financial" assets include anything that stores value and can serve as means of exchange - from cash to securities. Even tulip bulbs will do.

In 1634, in what later came to be known as "tulipmania", tulip bulbs were traded in a special marketplace in Amsterdam, the scene of a rabid speculative frenzy. Some rare black tulip bulbs changed hands for the price of a big mansion house. For four feverish years it seemed like the craze would last forever. But the bubble burst in 1637. In a matter of a few days, the price of tulip bulbs was slashed by 96%!

Uniquely, tulipmania was not an organized scam with an identifiable group of movers and shakers, which controlled and directed it. Nor has anyone made explicit promises to investors regarding guaranteed future profits. The hysteria was evenly distributed and fed on itself. Subsequent investment fiddles were different, though.

Modern dodges entangle a large number of victims. Their size and all-pervasiveness sometimes threaten the national economy and the very fabric of society and incur grave political and social costs.

There are two types of bubbles.

Asset bubbles of the first type are run or fanned by financial intermediaries such as banks or brokerage houses. They consist of "pumping" the price of an asset or an asset class.

The assets concerned can be shares, currencies, other securities and financial instruments - or even savings accounts. To promise unearthly yields on one's savings is to artificially inflate the "price", or the "value" of one's savings account.

More than one fifth of the population of 1983 Israel were involved in a banking scandal of Albanian proportions. It was a classic pyramid scheme. All the banks, bar one, promised to gullible investors ever increasing returns on the banks' own publicly-traded shares.

These explicit and incredible promises were included in prospectuses of the banks' public offerings and won the implicit acquiescence and collaboration of successive Israeli governments. The banks used deposits, their capital, retained earnings and funds illegally borrowed through shady offshore subsidiaries to try to keep their impossible and unhealthy promises. Everyone knew what was going on and everyone was involved. It lasted 7 years. The prices of some shares increased by 1-2 percent daily.

On October 6, 1983, the entire banking sector of Israel crumbled. Faced with ominously mounting civil unrest, the government was forced to compensate shareholders. It offered them an elaborate share buyback plan over 9 years. The cost of this plan was pegged at \$6 billion - almost 15 percent of Israel's annual GDP. The indirect damage remains unknown.

Avaricious and susceptible investors are lured into investment swindles by the promise of impossibly high profits or interest payments.

The organizers use the money entrusted to them by new investors to pay off the old ones and thus establish a credible reputation. Charles Ponzi perpetrated many such schemes in 1919-1925 in Boston and later the Florida real estate market in the USA. Hence a "Ponzi scheme".

In Macedonia, a savings bank named TAT collapsed in 1997, erasing the economy of an entire major city, Bitola. After much wrangling and recriminations - many politicians seem to have benefited from the scam - the government, faced with elections in September, has recently decided, in defiance of IMF diktats, to offer meager compensation to the afflicted savers. TAT was only one of a few similar cases. Similar scandals took place in Russia and Bulgaria in the 1990's .

One third of the impoverished population of Albania was cast into destitution by the collapse of a series of nationwide leveraged investment plans in 1997. Inept political and financial crisis management led Albania to the verge of disintegration and a civil war. Rioters invaded police stations and army barracks and expropriated hundreds of thousands of weapons.

Islam forbids its adherents to charge interest on money lent - as does Judaism. To circumvent this onerous decree, entrepreneurs and religious figures in Egypt and in Pakistan established "Islamic banks". These institutions pay no interest on deposits, nor do they demand interest from borrowers. Instead, depositors are made partners in the banks' - largely fictitious - profits. Clients are charged for - no less fictitious - losses. A few Islamic banks were in the habit of offering vertiginously high "profits". They went the way of other, less pious, pyramid schemes.



They melted down and dragged economies and political establishments with them.

By definition, pyramid schemes are doomed to failure. The number of new "investors" - and the new money they make available to the pyramid's organizers - is limited. When the funds run out and the old investors can no longer be paid, panic ensues. In a classic "run on the bank", everyone attempts to draw his money simultaneously. Even healthy banks - a distant relative of pyramid schemes - cannot cope with such stampedes. Some of the money is invested long-term, or lent. Few financial institutions keep more than 10 percent of their deposits in liquid on-call reserves.

Studies repeatedly demonstrated that investors in pyramid schemes realize their dubious nature and stand forewarned by the collapse of other contemporaneous scams. But they are swayed by recurrent promises that they could draw their money at will ("liquidity") and, in the meantime, receive alluring returns on it ("capital gains", "interest payments", "profits").

People know that they are likelier to lose all or part of their money as time passes. But they convince themselves that they can outwit the organizers of the pyramid, that their withdrawals of profits or interest payments prior to the inevitable collapse will more than amply compensate them for the loss of their money. Many believe that they will succeed to accurately time the extraction of their original investment based on - mostly useless and superstitious - "warning signs".

While the speculative rash lasts, a host of pundits, analysts, and scholars aim to justify it. The "new economy" is exempt from "old rules and archaic modes of thinking". Productivity has surged and established a steeper, but sustainable, trend line. Information technology is as revolutionary as electricity. No, more than electricity. Stock valuations are reasonable. The Dow is on its way to 33,000. People want to believe these "objective, disinterested analyses" from "experts".

Investments by households are only one of the engines of this first kind of asset bubbles. A lot of the money that pours into pyramid schemes and stock exchange booms is laundered, the fruits of illicit pursuits. The laundering of tax-evaded money or the proceeds of criminal activities, mainly drugs, is effected through regular banking channels. The money changes ownership a few times to obscure its trail and the identities of the true owners.

Many offshore banks manage shady investment ploys. They maintain two sets of books. The "public" or "cooked" set is made available to the authorities - the tax administration, bank supervision, deposit insurance, law enforcement agencies, and securities and exchange commission. The true record is kept in the second, inaccessible, set of files.

This second set of accounts reflects reality: who deposited how much, when and subject to which conditions - and who borrowed what, when and subject to what terms. These arrangements are so stealthy and convoluted that sometimes even the shareholders of the bank lose track of its activities and misapprehend its real situation.

Unscrupulous management and staff sometimes take advantage of the situation. Embezzlement, abuse of authority, mysterious trades, misuse of funds are more widespread than acknowledged.

The thunderous disintegration of the Bank for Credit and Commerce International (BCCI) in London in 1991 revealed that, for the better part of a decade, the executives and employees of this penumbral institution were busy stealing and misappropriating \$10 billion. The Bank of England's supervision department failed to spot the rot on time. Depositors were - partially - compensated by the main shareholder of the bank, an Arab sheikh. The story repeated itself with Nick Leeson and his unauthorized disastrous trades which brought down the venerable and veteran Barings Bank in 1995.

The combination of black money, shoddy financial controls, shady bank accounts and shredded documents renders a true account of the cash flows and damages in such cases all but impossible. There is no telling what were the contributions of drug barons, American off-shore corporations, or European and Japanese tax-evaders - channeled precisely through such institutions - to the stratospheric rise in Wall-Street in the last few years.

But there is another - potentially the most pernicious - type of asset bubble. When financial institutions lend to the unworthy but the politically well-connected, to cronies, and family members of influential politicians - they often end up fostering a bubble. South Korean chaebols, Japanese keiretsu, as well as American conglomerates frequently used these cheap funds to prop up their stock or to invest in real estate, driving prices up in both markets artificially.

Moreover, despite decades of bitter experiences - from Mexico in 1982 to Asia in 1997 and Russia in 1998 - financial institutions still bow to fads and fashions. They act herd-like in conformity with "lending trends". They shift assets to garner the highest yields in the shortest possible period of time. In this respect, they are not very different from investors in pyramid investment schemes.

## ***II. Case Study - The Savings and Loans Associations Bailout***

*Also published by [United Press International \(UPI\)](#)*

Asset bubbles - in the stock exchange, in the real estate or the commodity markets - invariably burst and often lead to banking crises. One such calamity struck the USA in 1986-1989. It is instructive to study the decisive reaction of the administration and Congress alike. They tackled both the ensuing liquidity crunch and the structural flaws exposed by the crisis with tenacity and skill. Compare this to the lackluster and hesitant tentativeness of the current lot. True, the crisis - the result of a speculative bubble - concerned the banking and real estate markets rather than the capital markets. But the similarities are there.

The savings and loans association, or the thrift, was a strange banking hybrid, very much akin to the building society in Britain. It was allowed to take in deposits but was really merely a mortgage bank. The Depository Institutions Deregulation and Monetary Control Act of 1980 forced S&L's to achieve interest parity with commercial banks, thus eliminating the interest ceiling on deposits which they enjoyed hitherto.

But it still allowed them only very limited entry into commercial and consumer lending and trust services. Thus, these institutions were heavily exposed to the vicissitudes of the residential real estate markets in their respective regions. Every normal cyclical slump in property values or regional economic shock - e.g., a plunge in commodity prices - affected them disproportionately.

Interest rate volatility created a mismatch between the assets of these associations and their liabilities. The negative spread between their cost of funds and the yield of their assets - eroded their operating margins. The 1982 Garn-St. Germain Depository Institutions Act encouraged thrifts to convert from mutual - i.e., depositor-owned - associations to stock companies, allowing them to tap the capital markets in order to enhance their faltering net worth.

But this was too little and too late. The S&L's were rendered unable to further support the price of real estate by rolling over old credits, refinancing residential equity, and underwriting development projects. Endemic corruption and mismanagement exacerbated the ruin. The bubble burst.

Hundreds of thousands of depositors scrambled to withdraw their funds and hundreds of savings and loans association (out of a total of more than 3,000) became insolvent instantly, unable to pay their depositors. They were besieged by angry - at times, violent - clients who lost their life savings.

The illiquidity spread like fire. As institutions closed their gates, one by one, they left in their wake major financial upheavals, wrecked businesses and homeowners, and devastated communities. At one point, the contagion threatened the stability of the entire banking system.

The Federal Savings and Loans Insurance Corporation (FSLIC) - which insured the deposits in the savings and loans associations - was no longer able to meet the claims and, effectively, went bankrupt. Though the obligations of the FSLIC were never guaranteed by the Treasury, it was widely perceived to be an arm of the federal government. The public was shocked. The crisis acquired a political dimension.

A hasty \$300 billion bailout package was arranged to inject liquidity into the shriveling system through a special agency, the FHFB. The supervision of the banks was subtracted from the Federal Reserve. The role of the the Federal Deposit Insurance Corporation (FDIC) was greatly expanded.

Prior to 1989, savings and loans were insured by the now-defunct FSLIC. The FDIC insured only banks. Congress had to eliminate FSLIC and place the insurance of thrifts under FDIC. The FDIC kept the Bank Insurance Fund (BIF) separate from the Savings Associations Insurance Fund (SAIF), to confine the ripple effect of the meltdown.

The FDIC is designed to be independent. Its money comes from premiums and earnings of the two insurance funds, not from Congressional appropriations. Its board of directors has full authority to run the agency.

The board obeys the law, not political masters. The FDIC has a preemptive role. It regulates banks and savings and loans with the aim of avoiding insurance claims by depositors.

When an institution becomes unsound, the FDIC can either shore it up with loans or take it over. If it does the latter, it can run it and then sell it as a going concern, or close it, pay off the depositors and try to collect the loans. At times, the FDIC ends up owning collateral and trying to sell it.

Another outcome of the scandal was the Resolution Trust Corporation (RTC). Many savings and loans were treated as "special risk" and placed under the jurisdiction of the RTC until August 1992. The RTC operated and sold these institutions - or paid off the depositors and closed them. A new government corporation (Resolution Fund Corporation, RefCorp) issued federally guaranteed bailout bonds whose proceeds were used to finance the RTC until 1996.

The Office of Thrift Supervision (OTS) was also established in 1989 to replace the dismantled Federal Home Loan Board (FHLB) in supervising savings and loans. OTS is a unit within the Treasury Department, but law and custom make it practically an independent agency.

The Federal Housing Finance Board (FHFB) regulates the savings establishments for liquidity. It provides lines of credit from twelve regional Federal Home Loan Banks (FHLB). Those banks and the thrifts make up the Federal Home Loan Bank System (FHLBS). FHFB gets its funds from the System and is independent of supervision by the executive branch.

Thus a clear, streamlined, and powerful regulatory mechanism was put in place. Banks and savings and loans abused the confusing overlaps in authority and regulation among numerous government agencies. Not one regulator possessed a full and truthful picture. Following the reforms, it all became clearer: insurance was the FDIC's job, the OTS provided supervision, and liquidity was monitored and imparted by the FHLB.

Healthy thrifts were coaxed and cajoled to purchase less sturdy ones. This weakened their balance sheets considerably and the government reneged on its promises to allow them to amortize the goodwill element of the purchase over 40 years. Still, there were 2,898 thrifts in 1989. Six years later, their number shrank to 1,612 and it stands now at less than 1,000. The consolidated institutions are bigger, stronger, and better capitalized.

Later on, Congress demanded that thrifts obtain a bank charter by 1998. This was not too onerous for most of them. At the height of the crisis the ratio of their combined equity to their combined assets was less than 1%. But in 1994 it reached almost 10% and remained there ever since.



This remarkable turnaround was the result of serendipity as much as careful planning. Interest rate spreads became highly positive. In a classic arbitrage, savings and loans paid low interest on deposits and invested the money in high yielding government and corporate bonds. The prolonged equity bull market allowed thrifts to float new stock at exorbitant prices.

As the juridical relics of the Great Depression - chiefly amongst them, the Glass-Steagall Act - were repealed, banks were liberated to enter new markets, offer new financial instruments, and spread throughout the USA. Product and geographical diversification led to enhanced financial health.

But the very fact that S&L's were poised to exploit these opportunities is a tribute to politicians and regulators alike - though except for setting the general tone of urgency and resolution, the relative absence of political intervention in the handling of the crisis is notable. It was managed by the autonomous, able, utterly professional, largely a-political Federal Reserve. The political class provided the professionals with the tools they needed to do the job. This mode of collaboration may well be the most important lesson of this crisis.

### ***III. Case Study - Wall Street, October 1929***

*Also published by [United Press International \(UPI\)](#)*

Claud Cockburn, writing for the "Times of London" from New-York, described the irrational exuberance that gripped the nation just prior to the Great Depression.

As Europe wallowed in post-war malaise, America seemed to have discovered a new economy, the secret of uninterrupted growth and prosperity, the fount of transforming technology:

"The atmosphere of the great boom was savagely exciting, but there were times when a person with my European background felt alarmingly lonely. He would have liked to believe, as these people believed, in the eternal upswing of the big bull market or else to meet just one person with whom he might discuss some general doubts without being regarded as an imbecile or a person of deliberately evil intent—some kind of anarchist, perhaps."

The greatest analysts with the most impeccable credentials and track records failed to predict the forthcoming crash and the unprecedented economic depression that followed it. Irving Fisher, a preeminent economist, who, according to his biographer-son, Irving Norton Fisher, lost the equivalent of \$140 million in today's money in the crash, made a series of soothing predictions. On October 22 he uttered these avuncular statements: "Quotations have not caught up with real values as yet ... (There is) no cause for a slump ... The market has not been inflated but merely readjusted..."

Even as the market convulsed on Black Thursday, October 24, 1929 and on Black Tuesday, October 29 - the New York Times wrote: "Rally at close cheers brokers, bankers optimistic".

In an editorial on October 26, it blasted rabid speculators and compliant analysts: ``We shall hear considerably less in the future of those newly invented conceptions of finance which revised the principles of political economy with a view solely to fitting the stock market's vagaries." But it ended thus: "(The Federal Reserve has) insured the soundness of the business situation when the speculative markets went on the rocks."

Compare this to Alan Greenspan Congressional testimony this summer: "While bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy ... (The Depression was brought on by) ensuing failures of policy".

Investors, their equity leveraged with bank and broker loans, crowded into stocks of exciting "new technologies", such as the radio and mass electrification. The bull market - especially in issues of public utilities - was fueled by "mergers, new groupings, combinations and good earnings" and by corporate purchasing for "employee stock funds".

Cautionary voices - such as Paul Warburg, the influential banker, Roger Babson, the "Prophet of Loss" and Alexander Noyes, the eternal Cassandra from the New York Times - were derided. The number of brokerage accounts doubled between March 1927 and March 1929.

When the market corrected by 8 percent between March 18-27 - following a Fed induced credit crunch and a series of mysterious closed-door sessions of the Fed's board - bankers rushed in. The New York Times reported:

“Responsible bankers agree that stocks should now be supported, having reached a level that makes them attractive.” By August, the market was up 35 percent on its March lows. But it reached a peak on September 3 and it was downhill since then.

On October 19, five days before "Black Thursday", Business Week published this sanguine prognosis:

"Now, of course, the crucial weaknesses of such periods -- price inflation, heavy inventories, over-extension of commercial credit -- are totally absent. The security market seems to be suffering only an attack of stock indigestion... There is additional reassurance in the fact that, should business show any further signs of fatigue, the banking system is in a good position now to administer any needed credit tonic from its excellent Reserve supply."

The crash unfolded gradually. Black Thursday actually ended with an inspiring rally. Friday and Saturday - trading ceased only on Sundays - witnessed an upswing followed by mild profit taking. The market dropped 12.8 percent on Monday, with Winston Churchill watching from the visitors' gallery - incurring a loss of \$10-14 billion.

The Wall Street Journal warned naive investors:

"Many are looking for technical corrective reactions from time to time, but do not expect these to disturb the upward trend for any prolonged period."

The market plummeted another 11.7 percent the next day - though trading ended with an impressive rally from the lows. October 31 was a good day with a "vigorous, buoyant rally from bell to bell". Even Rockefeller joined the myriad buyers. Shares soared. It seemed that the worst was over.

The New York Times was optimistic:

"It is thought that stocks will become stabilized at their actual worth levels, some higher and some lower than the present ones, and that the selling prices will be guided in the immediate future by the worth of each particular security, based on its dividend record, earnings ability and prospects. Little is heard in Wall Street these days about 'putting stocks up.'"

But it was not long before irate customers began blaming their stupendous losses on advice they received from their brokers. Alec Wilder, a songwriter in New York in 1929, interviewed by Stud Terkel in "Hard Times" four decades later, described this typical exchange with his money manager:

"I knew something was terribly wrong because I heard bellboys, everybody, talking about the stock market. About six weeks before the Wall Street Crash, I persuaded my mother in Rochester to let me talk to our family adviser. I wanted to sell stock which had been left me by my father. He got very sentimental: 'Oh your father wouldn't have liked you to do that.' He was so persuasive, I said O.K. I could have sold it for \$160,000. Four years later, I sold it for \$4,000."

Exhausted and numb from days of hectic trading and back office operations, the brokerage houses pressured the stock exchange to declare a two day trading holiday. Exchanges around North America followed suit.

At first, the Fed refused to reduce the discount rate. "(There) was no change in financial conditions which the board thought called for its action." - though it did inject liquidity into the money market by purchasing government bonds. Then, it partially succumbed and reduced the New York discount rate, which, curiously, was 1 percent above the other Fed districts - by 1 percent. This was too little and too late. The market never recovered after November 1. Despite further reductions in the discount rate to 4 percent, it shed a whopping 89 percent in nominal terms when it hit bottom three years later.

Everyone was duped. The rich were impoverished overnight. Small time margin traders - the forerunners of today's day traders - lost their shirts and much else besides. The New York Times:

"Yesterday's market crash was one which largely affected rich men, institutions, investment trusts and others who participate in the market on a broad and intelligent scale. It was not the margin traders who were caught in the rush to sell, but the rich men of the country who are able to swing blocks of 5,000, 10,000, up to 100,000 shares of high-priced stocks. They went overboard with no more consideration than the little trader who was swept out on the first day of the market's upheaval, whose prices, even at their lowest of last Thursday, now look high by comparison ...

To most of those who have been in the market it is all the more awe-inspiring because their financial history is limited to bull markets."

Overseas - mainly European - selling was an important factor. Some conspiracy theorists, such as Webster Tarpley in his "British Financial Warfare", supported by contemporary reporting by the likes of "The Economist", went as far as writing:

"When this Wall Street Bubble had reached gargantuan proportions in the autumn of 1929, (Lord) Montagu Norman (governor of the Bank of England 1920-1944) sharply (upped) the British bank rate, repatriating British hot money, and pulling the rug out from under the Wall Street speculators, thus deliberately and consciously imploding the US markets. This caused a violent depression in the United States and some other countries, with the collapse of financial markets and the contraction of production and employment. In 1929, Norman engineered a collapse by puncturing the bubble."

The crash was, in large part, a reaction to a sharp reversal, starting in 1928, of the reflationary, "cheap money", policies of the Fed intended, as Adolph Miller of the Fed's Board of Governors told a Senate committee, "to bring down money rates, the call rate among them, because of the international importance the call rate had come to acquire. The purpose was to start an outflow of gold - to reverse the previous inflow of gold into this country (back to Britain)." But the Fed had already lost control of the speculative rush.

The crash of 1929 was not without its Enrons and World.com's. Clarence Hatry and his associates admitted to forging the accounts of their investment group to show a fake net worth of \$24 million British pounds - rather than the true picture of 19 billion in liabilities. This led to forced liquidation of Wall Street positions by harried British financiers.

The collapse of Middle West Utilities, run by the energy tycoon, Samuel Insull, exposed a web of offshore holding companies whose only purpose was to hide losses and disguise leverage. The former president of NYSE, Richard Whitney was arrested for larceny.

Analysts and commentators thought of the stock exchange as decoupled from the real economy. Only one tenth of the population was invested - compared to 40 percent today. "The World" wrote, with more than a bit of Schadenfreude: "The country has not suffered a catastrophe ... The American people ... has been gambling largely with the surplus of its astonishing prosperity."

"The Daily News" concurred: "The sagging of the stocks has not destroyed a single factory, wiped out a single farm or city lot or real estate development, decreased the productive powers of a single workman or machine in the United States." In Louisville, the "Herald Post" commented sagely: "While Wall Street was getting rid of its weak holder to their own most drastic punishment, grain was stronger. That will go to the credit side of the national prosperity and help replace that buying power which some fear has been gravely impaired."



During the Coolidge presidency, according to the Encyclopedia Britannica, "stock dividends rose by 108 percent, corporate profits by 76 percent, and wages by 33 percent. In 1929, 4,455,100 passenger cars were sold by American factories, one for every 27 members of the population, a record that was not broken until 1950. Productivity was the key to America's economic growth. Because of improvements in technology, overall labour costs declined by nearly 10 percent, even though the wages of individual workers rose."

Jude Wanniski adds in his tome "The Way the World Works" that "between 1921 and 1929, GNP grew to \$103.1 billion from \$69.6 billion. And because prices were falling, real output increased even faster." Tax rates were sharply reduced.

John Kenneth Galbraith noted these data in his seminal "The Great Crash":

"Between 1925 and 1929, the number of manufacturing establishments increased from 183,900 to 206,700; the value of their output rose from \$60.8 billions to \$68 billions. The Federal Reserve index of industrial production which had averaged only 67 in 1921 ... had risen to 110 by July 1928, and it reached 126 in June 1929 ... (but the American people) were also displaying an inordinate desire to get rich quickly with a minimum of physical effort."

Personal borrowing for consumption peaked in 1928 - though the administration, unlike today, maintained twin fiscal and current account surpluses and the USA was a large net creditor.

Charles Kettering, head of the research division of General Motors described consumeritis thus, just days before the crash: “The key to economic prosperity is the organized creation of dissatisfaction.”

Inequality skyrocketed. While output per man-hour shot up by 32 percent between 1923 and 1929, wages crept up only 8 percent. In 1929, the top 0.1 percent of the population earned as much as the bottom 42 percent. Business-friendly administrations reduced by 70 percent the exorbitant taxes paid by those with an income of more than \$1 million. But in the summer of 1929, businesses reported sharp increases in inventories. It was the beginning of the end.

Were stocks overvalued prior to the crash? Did all stocks collapse indiscriminately? Not so. Even at the height of the panic, investors remained conscious of real values. On November 3, 1929 the shares of American Can, General Electric, Westinghouse and Anaconda Copper were still substantially higher than on March 3, 1928.

John Campbell and Robert Shiller, author of "Irrational Exuberance", calculated, in a joint paper titled "Valuation Ratios and the Lon-Run Market Outlook: An Update" posted on Yale University's Web Site, that share prices divided by a moving average of 10 years worth of earnings reached 28 just prior to the crash. Contrast this with 45 on March 2000.

In an NBER working paper published December 2001 and tellingly titled "The Stock Market Crash of 1929 - Irving Fisher was Right", Ellen McGrattan and Edward Prescott boldly claim:

"We find that the stock market in 1929 did not crash because the market was overvalued. In fact, the evidence strongly suggests that stocks were undervalued, even at their 1929 peak."

According to their detailed paper, stocks were trading at 19 times after-tax corporate earning at the peak in 1929, a fraction of today's valuations even after the recent correction. A March 1999 "Economic Letter" published by the Federal Reserve Bank of San-Francisco wholeheartedly concurs. It notes that at the peak, prices stood at 30.5 times the dividend yield, only slightly above the long term average.

Contrast this with an article published in June 1990 issue of the "Journal of Economic History" by Robert Barsky and Bradford De Long and titled "Bull and Bear Markets in the Twentieth Century":

"Major bull and bear markets were driven by shifts in assessments of fundamentals: investors had little knowledge of crucial factors, in particular the long run dividend growth rate, and their changing expectations of average dividend growth plausibly lie behind the major swings of this century."

Jude Waninski attributes the crash to the disintegration of the pro-free-trade coalition in the Senate which later led to the notorious Smoot-Hawley Tariff Act of 1930. He traces all the important moves in the market between March 1929 and June 1930 to the intricate protectionist danse macabre in Congress.

This argument may never be decided. Is a similar crash on the cards? This cannot be ruled out.

The 1990's resembled the 1920's in more than one way. Are we ready for a recurrence of 1929? About as we were prepared in 1928. Human nature - the prime mover behind market meltdowns - seemed not to have changed that much in these intervening seven decades.

Will a stock market crash, should it happen, be followed by another "Great Depression"? It depends which kind of crash. The short term puncturing of a temporary bubble - e.g., in 1962 and 1987 - is usually divorced from other economic fundamentals. But a major correction to a lasting bull market invariably leads to recession or worse.

As the economist Hernan Cortes Douglas reminds us in "The Collapse of Wall Street and the Lessons of History" published by the Friedberg Mercantile Group, this was the sequence in London in 1720 (the infamous "South Sea Bubble"), and in the USA in 1835-40 and 1929-32.

# *The Shadowy World of International Finance*

Strange, penumbral, characters roam the boardrooms of banks in the countries in transition. Some of them pop apparently from nowhere, others are very well connected and equipped with the most excellent introductions. They all peddle financial transactions which are too good to be true and often are. In the unctuously perfumed propinquity of their Mercedeses, Rolex waving entourage - the polydipsic natives dissolve in their irresistible charm and the temptations of the cash: mountainous returns on capital, effulgent profits, no collaterals, track record, or business plan required. Total security is cloyingly assured.

These Fausts roughly belong to four tribes:

## **The Shoppers**

These are the shabby operators of the marginal shadows of the world of finance. They broker financial deals with meretricious sweat only to be rewarded their meagre, humiliated fees. Most of their deals do not materialize. The principle is very simple:

They approach a bank, a financial institution, or a borrower and say: "We are connected to banks or financial institutions in the West. We can bring you money in the form of credits. But to do that - you must first express interest in getting this money. You must furnish us with a bank guarantee / promissory note / letter of intent that indicates that you desire the credit and that you are willing to provide a liquid financial instrument to back it up."

Having obtained such instruments, the shoppers begin to "shop around". They approach banks and financial institutions (usually, in the West). This time, they reverse their text: "We have an excellent client, a good borrower. Are you willing to lend to it?" An informal process of tendering ensues. Sometimes it ends in a transaction and the shopper collects a small commission (between one quarter of a percentage point and two percentage points - depending on the amount). Mostly it doesn't -and the Flying Dutchman resumes his wanderings looking for more venal gulosity and less legal probity.

### **The Con-Men**

These are crooks who set up elaborate schemes ("sting operations") to extract money from unsuspecting people and financial institutions. They establish "front" or "phantom" firms and offices throughout the world. They tempt the gullible by offering them enormous, immediate, tax-free, effort-free, profits. They let the victims profit in the first round or two of the scam. Then, they sting: the victims invest money and it evaporates together with the dishonest operators.

The "offices" are deserted, the fake identities, the forged bank references, the falsified guarantees are all exposed (often with the help of an inside informant).

Probably the most famous and enduring scam is the "Nigerian-type Connection". Letters - allegedly composed by very influential and highly placed officials - are sent out to unsuspecting businessmen. The latter are asked to make their bank accounts available to the former, who profess to need the third party bank accounts through which to funnel the sweet fruits of corruption.

The account owners are promised huge financial rewards if they collaborate and if they bear some minor-by-comparison upfront costs. The con-men pocket these "expenses" and vanish. Sometimes, they even empty the accounts of their entire balance as they evaporate.

### **The Launderers**

A lot of cash goes undeclared to tax authorities in countries in transition. The informal economy (the daughter of both criminal and legitimate parents) comprises between 15% (Slovenia) and 50% (Russia, Macedonia) of the official one. Some say these figures are a deliberate and ferocious understatement. These are mind boggling amounts, which circulate between financial centres and off shore havens in the world: Cyprus, the Cayman Islands, Liechtenstein (Vaduz), Panama and dozens of aspiring laundrettes.

The money thus smuggled is kept in low-yielding cash deposits. To escape the cruel fate of inflationary corrosion, it has to be reinvested. It is stealthily re-introduced to the very economy that it so sought to evade, in the form of investment capital or other financial assets (loans and credits). Its anxious owners are preoccupied with legitimising their stillborn cash through the conduit of tax-fearing enterprises, or with lending it to same. The emphasis is on the word: "legitimate". The money surges in through mysterious and anonymous foreign corporations, via off-shore banking centres, even through respectable financial institutions (the Bank of New York we mentioned?). It is easy to recognize a laundering operation. Its hallmark is a pronounced lack of selectivity.

The money is invested in anything and everything, as long as it appears legitimate. Diversification is not sought by these nouveau tycoons and they have no core investment strategy. They spread their illicit funds among dozens of disparate economic activities and show not the slightest interest in the putative yields on their investments, the maturity of their assets, the quality of their newly acquired businesses, their history, or real value. Never the sedulous, they pay exorbitantly for all manner of prestidigital endeavours. The future prospects and other normal investment criteria are beyond them. All they are after is a mirage of lapidarity.

### **The Investors**

This is the most intriguing group. Normative, law abiding, businessmen, who stumbled across methods to secure excessive yields on their capital and are looking to borrow their way into increasing it. By cleverly participating in bond tenders, by devising ingenious option strategies, or by arbitraging - yields of up to 300% can be collected in the immature markets of transition without the normally associated risks. This sub-species can be found mainly in Russia and in the Balkans.

Its members often buy sovereign bonds and notes at discounts of up to 80% of their face value. Russian obligations could be had for less in August 1998 and Macedonian ones during the Kosovo crisis. In cahoots with the issuing country's central bank, they then convert the obligations to local currency at par (=for 100% of their face value). The difference makes, needless to add, for an immediate and hefty profit, yet it is in (often worthless and vicissitudinal) local currency.



The latter is then hurriedly disposed of (at a discount) and sold to multinationals with operations in the country of issue, which are in need of local tender. This fast becomes an almost addictive avocation.

Intoxicated by this pecuniary nectar, the fortunate, those privy to the secret, try to raise more capital by hunting for financial instruments they can convert to cash in Western banks. A bank guarantee, a promissory note, a confirmed letter of credit, a note or a bond guaranteed by the Central Bank - all will do as deposited collateral against which a credit line is established and cash is drawn. The cash is then invested in a new cycle of inebriation to yield fantastic profits.

It is easy to identify these "investors". They eagerly seek financial instruments from almost any local bank, no matter how suspect. They offer to pay for these coveted documents (bank guarantees, bankers' acceptances, letters of credit) either in cash or by lending to the bank's clients and this within a month or more from the date of their issuance. They agree to "cancel" the locally issued financial instruments by offering a "counter-financial-instrument" (safe keeping receipt, contra-guarantee, counter promissory note, etc.). This "counter-instrument" is issued by the very Prime World or European Bank in which the locally issued financial instruments are deposited as collateral.

The Investors invariably confidently claim that the financial instrument issued by the local bank will never be presented or used (which is true) and that this is a risk free transaction (which is not entirely so).

If they are forced to lend to the bank's clients, they often ignore the quality of the credit takers, the yields, the maturities and other considerations which normally tend to interest lenders very much.

Whether a financial instrument cancelled by another is still valid, presentable and should be honoured by its issuer is still debated. In some cases it is clearly so. If something goes horribly (and rarely, admittedly) wrong with these transactions - the local bank stands to suffer, too.

It all boils down to a terrible hunger, the kind of thirst that can be quelled only by the denominated liquidity of lucre. In the post nuclear landscape of this part of the world, a fantasy is shared by both predators and prey. Circling each other in marble temples, they switch their roles in dizzying progression. Tycoons and politicians, industrialists and bureaucrats all vie for the attention of Mammon. The shifting coalitions of well groomed man in back stabbed suits, an hallucinatory carousel of avarice and guile. But every circus folds and every luna park is destined to shut down. The dying music, the frozen accounts of the deceived, the bankrupt banks, the Jurassic Park of skeletal industrial beasts - a muted testimony to a wild age of mutual assured destruction and self deceit. The future of Eastern and South Europe. The present of Russia, Albania and Yugoslavia.

# *Treasure Island Revisited*

## *On Maritime Piracy*

The rumors concerning the demise of maritime piracy back in the 19th century were a tad premature. The scourge has so resurged that the International Maritime Board (IMB), founded by the International Chamber of Commerce (ICC) in 1981, is forced to broadcast daily piracy reports to all shipping companies by satellite from its Kuala Lumpur Piracy Reporting Center, established in 1992 and partly funded by maritime insurers. The reports carry this alarming disclaimer:

"For statistical purposes, the IMB defines piracy and armed robbery as: An act of boarding or attempting to board any ship with the apparent intent to commit theft or any other crime and with the apparent intent or capability to use force in the furtherance of that act. This definition thus covers actual or attempted attacks whether the ship is berthed, at anchor or at sea. Petty thefts are excluded, unless the thieves are armed."

The 1994 United Nations Convention on the Law of the Sea defines piracy as "any illegal acts of violence or detention, or any act of depredation, committed by individuals (borne aboard a pirate vessel) for private ends against a private ship or aircraft (the victim vessel)." When no "pirate vessel" is involved - for instance, when criminals embark on a ship and capture it - the legal term is hijacking.

On July 8, seven pirates, armed with long knives attacked an officer of a cargo ship berthed in Chittagong port in Bangladesh, snatched his gold chain and watch and dislocated his arm. This was the third such attack since the ship dropped anchor in this minacious port.

Three days earlier, in Indonesia, similarly-armed pirates escaped with the crew's valuables, having tied the hands of the duty officer. Pirates in small boats stole anodes from the stern of a bulk carrier in Bangladesh. Others, in Indonesia, absconded with a life raft.

The pirates of Guyana are either unlucky or untrained. They were consistently scared off by flares hurled at them and alarms set by vigilant hands on deck. A Colombian band, riding a high speed boat, attempted to board a container ship. Warring parties in Somalia hijacked yet another ship last month.

A particularly egregious case - and signs of growing sophistication and coordinated action - is described in the July 1-8 report of the IMB:

"Six armed pirates boarded a chemical tanker from a small boat and stole ship's stores. Another group of pirates broke in to engine room and stole spare parts. Thefts took place in spite of the ship engaging three shore security watchmen." Piracy incidents have been reported in India, Malaysia, Philippines, Thailand, Vietnam, the Red Sea, the Gulf of Aden, Nigeria, Brazil, Colombia, Dominican Republic, Ecuador, Peru, Venezuela.

According to the ICC Year 2001 Piracy Report, more than 330 attacks on seafaring vessels were reported last year - down by a quarter compared to 2000 but 10 percent higher than 1999 and four times the 1991 figure. Piracy rose 40 percent between 1998 and 1999 alone.

Sixteen ships - double the number in 2000 - were captured and taken over. Eighty seven attacks were reported during the first quarter of this year - up from 68 in the corresponding period last year. Seven of these were hijackings - compared to only 1 in the first quarter of 2001. Nine of every 10 hijacked ships are ultimately recovered, often with the help of the IMB.

Many masters and shipowners do not report piracy for fear of delays due to protracted investigations, increased insurance premiums, bad publicity, and stifling red tape. The number of unreported attacks in 1999 was estimated by the World Maritime Piracy Report to be 130.

According to "The Economist", the IMO believes that half of all incidents remain untold. Still, increased patrols and international collaboration among law enforcement agencies dented the clear upward trend in maritime crime - even in the piracy capital, Indonesia.

The number of incidents in the pirate-infested Malacca Straits dropped from 75 to 17 last year - though the number of crew "kidnap and ransom" operations, especially in Aceh, has increased. Owners usually pay the "reasonable" amounts demanded - c. \$100,000 per ship. Contrary to folklore, most ships are attacked while at anchor.

Twenty one people, including passengers, were killed last year - and 210 taken hostage. Assaults involving guns were up 50 percent to 73 - those involving mere knives down by a quarter to 105. Piracy seems to ebb and flow with the business cycles of the host economies. The Asian crisis, triggered by the freefall of the Thai baht, gave a boost to East Asian maritime robbers. So did the debt crises of Latin America a decade earlier. Drug transporters - armed with light aircraft and high speed motorboats - sometimes double as pirates during the dry season of crop growth.

Pirates endanger ship and crew. But they often cause collateral damage as well. Pirates have been known to dump noxious cargo into the sea, or tie up the crew and let an oil tanker steam ahead, its navigational aides smashed, or tamper with substances dangerous to themselves and to others, or cast crew and passengers adrift in tiny rafts with little food and water.

Many shipowners resorted to installing on-board satellite tracking systems, such as Shiploc, and aircraft-like "black boxes". A bulletproof life vest, replete with an integral jagged edged knife, was on display in the millennium exhibition at the Millennium Dome two years ago. The International Maritime Organization (IMO) is considering to compel shipowners to tag their vessels with visibly embossed numbers in compliance with the Safety of Life at Sea Convention.

The IMB also advises shipping companies to closely examine the papers of crew and masters, thousands of whom carry forged documents.

In 54 maritime administrations surveyed last year by the Seafarers' International Research Centre, Cardiff University in Wales, more than 12,000 cases of forged certificates of competency were unearthed.

Many issuing authorities are either careless or venal or both. The IMB recently accused the Coast Guard Office of Puerto Rico for issuing 500 such "suspicious" certificates. The Chinese customs and navy - especially along the southern coast - have often been accused of working hand in glove with pirates.

False documents are an integral - and crucial - part of maritime piracy. The IMB says:

"Many of the phantom ships that set off to sea with a cargo and then disappear are sailed by crewmen with false passports and competency certificates. They usually escape detection by the port authorities. In a recent case of a vessel located and arrested in South-East Asia further to IMB investigations, it has emerged that all the senior officers had false passports. The ship's registry documents were also false."

As documents go electronic and integrated in proprietary or common cargo tracking systems, such forgery will wane. Bolero - an international digital bill of lading ledger - is backed by the European Union, banks, shipping and insurance companies. The IMO is a proponent of a technology to apply encrypted "digital signatures" to electronic bills of lading. Still, the industry is highly fragmented and many ships and ports don't even possess rudimentary information technology.

The protection afforded by the likes of Bolero is at least a decade away.

Pirates sometimes work hand in hand with conspiring crew members (or, less often, stowaways). In many countries - in East Asia, Latin America, and Africa - Coast Guard operatives, corrupt drug agents, and other law enforcement officials, moonlight as pirates. Renegade members of British trained Indonesian anti-piracy squads are still roaming the Malacca Straits.

Pirates also enjoy the support of an insidious and vast network of suborned judges and bureaucrats. Local villagers along the coasts of Indonesia and Malaysia - and Africa - welcome pirate business and provide the perpetrators with food and shelter.

Moreover, large tankers, container ships, and cargo vessels are largely computerized and their crew members few. The value of an average vessel's freight has increased dramatically with improvements in container and oil storage technologies. "Flag of convenience" registration has assumed monstrous proportions, allowing ship owners and managers to conceal their identity effectively. Belize, Honduras, and Panama are the most notorious, no questions asked, havens.

Piracy has matured into a branch of organized crime. Hijacking requires money, equipment, weapons, planning, experience and contacts with corrupt officials. The loot per vessel ranges from \$8 million to \$200 million.



Pottengal Mukundan, Director of ICC's Commercial Crime Services states, in a recent IMB press release:

"(Piracy) typically involves a mother ship from which to launch the attacks, a supply of automatic weapons, false identity papers for the crew and vessel, fake cargo documents, and a broker network to sell the stolen goods illegally. Individual pirates don't have these resources. Hijackings are the work of organized crime rings."

The IMB describes the aftermath of a typical hijacking:

"The Global Mars has probably been given a new name and repainted. Armed with false registration papers and bills of lading, the pirates - or more likely the mafia bosses pulling the strings - will then try to dispose of their booty. The vessel has probably put in to a port where the false identity of vessel and cargo may escape detection. Even when identified, the gangs have been known to bribe local officials to allow them to sell the cargo and leave the port."

Such a ship is often "recycled" a few times. It earns its operators an average of \$40-50 million per "cycle", according to "The Economist". The pirates contract with sellers or shipping agents to load it with a legitimate consignment of goods or commodities. The sellers and agents are unaware of the true identity of the ship, or of its unsavory "owners/managers".

The pirates invariably produce an authentic vessel registration certificate that they acquired from crooked officials - and provide the sellers or agents with a bill of lading. The payload is then sold to networks of traders in stolen merchandise or to gullible buyers in a different port of destination - and the ship is ready for yet another round.

This January, the Indonesian Navy has permanently stationed six battleships in the Malacca Straits, three of them off the coast of the secessionist region of Aceh. A further 20-30 ships and 10 aircraft conduct daily patrols of the treacherous traffic lane. Some 200-600 ships cross the Straits daily. A mere 50 ships or so are boarded and searched every month.

The Greek government has gunboats patrolling the 2 miles wide Corfu Channel, where yachts frequently fall prey to Albanian pirates. Brazil has imposed an unpopular anti-piracy inspection fee on berthing vessels and used the proceeds to finance a SWAT team to protect ships and their crews while in port. Both India and Thailand have similar units.

International cooperation is also on the rise. About one third of the world's shipping traffic goes through the South China Sea. A conference convened by Japan in March 2000 - Japanese vessels have become favored targets of piracy in the last few years - pushed for the ratification of the International Maritime Organisation's (IMO) 1988 Rome Convention on the Suppression of Unlawful Acts against the Safety of Maritime Navigation by Asian and ASEAN countries.

The Convention makes piracy an extraterritorial crime and, thus, removes the thorny issue of jurisdiction in cases of piracy carried in another country's territorial waters or out on the high seas. The Comité Maritime International - the umbrella organization of national maritime law associations - promulgated a model anti-piracy law last year.

Though it rejected Japan's offer for collaboration, in a sharp reversal of its previous policy, China started handing down death sentences against murderous pirates. The 13 marauders who seized the Cheung Son and massacred its 23 Chinese sailors were executed two years ago in the southern city of Shanwei. Another 25 people received long prison sentences. The - declared - booty amounted to a mere \$300,000.

India and Iran - two emerging "pirates safe harbor" destinations - have also tightened up sentencing and port inspections. In the Alondra Rainbow hijacking, the Indian Navy captured the Indonesian culprits in a cinematic chase off Goa. They were later sentenced severely under both the Indian Penal Code and international law. Even the junta in Myanmar has taken tentative steps against compatriots with piratical predilections.

Law enforcement does not tolerate a vacuum. "The Economist" reports about two private military companies - Marine Risk Management and Satellite Protection Services (SPS) - which deploy airborne mercenaries to deal with piracy. SPS has even suggested to station 2500 former Dutch marines in Subic Bay in the Philippines - for a mere \$2500 per day per combatant.

Shipowners are desperate. Quoted by "The Economist", they "suggest that the region's governments negotiate the right for navies to chase pirates across national boundaries: the so-called "right of hot pursuit". So far, only Singapore and Indonesia have negotiated limited rights. Some suggest that the American navy should be invited into territorial waters to combat piracy, a "live" exercise it might relish. At the very least, countries such as Indonesia should advertise which bits of their territorial waters at any time are patrolled and safe from pirates. No countries currently do this."

# *Legalizing Crime*

*Also Read:*

[\*Narcissists, Ethnic or Religious Affiliation, and Terrorists\*](#)

The state has a monopoly on behavior usually deemed criminal. It murders, kidnaps, and locks up people. Sovereignty has come to be identified with the unbridled - and exclusive - exercise of violence. The emergence of modern international law has narrowed the field of permissible conduct. A sovereign can no longer commit genocide or ethnic cleansing with impunity, for instance.

Many acts - such as the waging of aggressive war, the mistreatment of minorities, the suppression of the freedom of association - hitherto sovereign privilege, have thankfully been criminalized. Many politicians, hitherto immune to international prosecution, are no longer so. Consider Yugoslavia's Milosevic and Chile's Pinochet.

But, the irony is that a similar trend of criminalization - within national legal systems - allows governments to oppress their citizenry to an extent previously unknown. Hitherto civil torts, permissible acts, and common behavior patterns are routinely criminalized by legislators and regulators. Precious few are decriminalized.

Consider, for instance, the criminalization in the Economic Espionage Act (1996) of the misappropriation of trade secrets and the criminalization of the violation of copyrights in the Digital Millennium Copyright Act (2000) – both in the USA. These used to be civil torts. They still are in many countries. Drug use, common behavior in England only 50 years ago – is now criminal. The list goes on.

Criminal laws pertaining to property have malignantly proliferated and pervaded every economic and private interaction. The result is a bewildering multitude of laws, regulations statutes, and acts.

The average Babylonian could have memorized and assimilated the Hammurabic code 37 centuries ago - it was short, simple, and intuitively just.

English criminal law - partly applicable in many of its former colonies, such as India, Pakistan, Canada, and Australia - is a mishmash of overlapping and contradictory statutes - some of these hundreds of years old - and court decisions, collectively known as "case law".

Despite the publishing of a Model Penal Code in 1962 by the American Law Institute, the criminal provisions of various states within the USA often conflict. The typical American can't hope to get acquainted with even a negligible fraction of his country's fiendishly complex and hopelessly brobdignagian criminal code. Such inevitable ignorance breeds criminal behavior - sometimes inadvertently - and transforms many upright citizens into delinquents.

In the land of the free - the USA - close to 2 million adults are behind bars and another 4.5 million are on probation, most of them on drug charges. The costs of criminalization - both financial and social - are mind boggling.

What constitutes a crime? A clear and consistent definition has yet to transpire.

There are five types of criminal behavior: crimes against oneself, or "victimless crimes" (such as suicide, abortion, and the consumption of drugs), crimes against others (such as murder or mugging), crimes among consenting adults (such as incest, and in certain countries, homosexuality and euthanasia), crimes against collectives (such as treason, genocide, or ethnic cleansing), and crimes against the international community and world order (such as executing prisoners of war). The last two categories often overlap.

The Encyclopedia Britannica provides this definition of a crime:

***"The intentional commission of an act usually deemed socially harmful or dangerous and specifically defined, prohibited, and punishable under the criminal law."***

But who decides what is socially harmful? What about acts committed unintentionally (known as "strict liability offenses" in the parlance)? How can we establish intention - "mens rea", or the "guilty mind" - beyond a reasonable doubt?

A much tighter definition would be: "***The commission of an act punishable under the criminal law.***" A crime is what the law - state law, kinship law, religious law, or any other widely accepted law - says is a crime. Legal systems and texts often conflict.

Murderous blood feuds are legitimate according to the 15th century "Qanoon", still applicable in large parts of Albania. Killing one's infant daughters and old relatives is socially condoned - though illegal - in India, China, Alaska, and parts of Africa. Genocide may have been legally sanctioned in Germany and Rwanda - but is strictly forbidden under international law.

Laws being the outcomes of compromises and power plays, there is only a tenuous connection between justice and morality. Some "crimes" are categorical imperatives. Helping the Jews in Nazi Germany was a criminal act - yet a highly moral one.

The ethical nature of some crimes depends on circumstances, timing, and cultural context. Murder is a vile deed - but assassinating Saddam Hussein may be morally commendable. Killing an embryo is a crime in some countries - but not so killing a fetus. A "status offense" is not a criminal act if committed by an adult. Mutilating the body of a live baby is heinous - but this is the essence of Jewish circumcision. In some societies, criminal guilt is collective. All Americans are held blameworthy by the Arab street for the choices and actions of their leaders. All Jews are accomplices in the "crimes" of the "Zionists".



In all societies, crime is a growth industry. Millions of professionals - judges, police officers, criminologists, psychologists, journalists, publishers, prosecutors, lawyers, social workers, probation officers, wardens, sociologists, non-governmental-organizations, weapons manufacturers, laboratory technicians, graphologists, and private detectives - derive their livelihood, parasitically, from crime. They often perpetuate models of punishment and retribution that lead to recidivism rather than to the reintegration of criminals in society and their rehabilitation.

Organized in vocal interest groups and lobbies, they harp on the insecurities and phobias of the alienated urbanites. They consume ever growing budgets and rejoice with every new behavior criminalized by exasperated lawmakers. In the majority of countries, the justice system is a dismal failure and law enforcement agencies are part of the problem, not its solution.

The sad truth is that many types of crime are considered by people to be normative and common behaviors and, thus, go unreported. Victim surveys and self-report studies conducted by criminologists reveal that most crimes go unreported. The protracted fad of criminalization has rendered criminal many perfectly acceptable and recurring behaviors and acts. Homosexuality, abortion, gambling, prostitution, pornography, and suicide have all been criminal offenses at one time or another.

But the quintessential example of over-criminalization is drug abuse.

There is scant medical evidence that soft drugs such as cannabis or MDMA ("Ecstasy") - and even cocaine - have an irreversible effect on brain chemistry or functioning. Last month an almighty row erupted in Britain when Jon Cole, an addiction researcher at Liverpool University, claimed, to quote "The Economist" quoting the "Psychologist", that:

"Experimental evidence suggesting a link between Ecstasy use and problems such as nerve damage and brain impairment is flawed ... using this ill-substantiated cause-and-effect to tell the 'chemical generation' that they are brain damaged when they are not creates public health problems of its own."

Moreover, it is commonly accepted that alcohol abuse and nicotine abuse can be at least as harmful as the abuse of marijuana, for instance. Yet, though somewhat curbed, alcohol consumption and cigarette smoking are legal. In contrast, users of cocaine - only a century ago recommended by doctors as tranquilizer - face life in jail in many countries, death in others. Almost everywhere pot smokers are confronted with prison terms.

The "war on drugs" - one of the most expensive and protracted in history - has failed abysmally. Drugs are more abundant and cheaper than ever. The social costs have been staggering: the emergence of violent crime where none existed before, the destabilization of drug-producing countries, the collusion of drug traffickers with terrorists, and the death of millions - law enforcement agents, criminals, and users.

Few doubt that legalizing most drugs would have a beneficial effect. Crime empires would crumble overnight, users would be assured of the quality of the products they consume, and the addicted few would not be incarcerated or stigmatized - but rather treated and rehabilitated.

That soft, largely harmless, drugs continue to be illicit is the outcome of compounded political and economic pressures by lobby and interest groups of manufacturers of legal drugs, law enforcement agencies, the judicial system, and the aforementioned long list of those who benefit from the status quo.

Only a popular movement can lead to the decriminalization of the more innocuous drugs. But such a crusade should be part of a larger campaign to reverse the overall tide of criminalization. Many "crimes" should revert to their erstwhile status as civil torts. Others should be wiped off the statute books altogether. Hundreds of thousands should be pardoned and allowed to reintegrate in society, unencumbered by a past of transgressions against an inane and inflationary penal code.

This, admittedly, will reduce the leverage the state has today against its citizens and its ability to intrude on their lives, preferences, privacy, and leisure. Bureaucrats and politicians may find this abhorrent. Freedom loving people should rejoice.

# *Begging Your Trust in Africa*

By: [Dr. Sam Vaknin](#)

Also published by [United Press International \(UPI\)](#)

The syntax is tortured, the grammar mutilated, but the message - sent by snail mail, telex, fax, or e-mail - is coherent: an African bigwig or his heirs wish to transfer funds amassed in years of graft and venality to a safe bank account in the West. They seek the recipient's permission to make use of his or her inconspicuous services for a percentage of the loot - usually many millions of dollars. A fee is required to expedite the proceedings, or to pay taxes, or to bribe officials - they plausibly explain.

It is a scam two decades old - and it still works. Only last month, a bookkeeper for a Berkley, Michigan law firm embezzled \$2.1 million and wired it to various bank accounts in South Africa and Taiwan. Other victims were kidnapped for ransom as they traveled abroad to collect their "share". Some never made it back. Every year, there are 5 such murders as well as 8-10 snatchings of American citizens alone. The usual ransom demanded is half a million to a million dollars.

The scam is so widespread that the Nigerians saw fit to explicitly ban it in article 419 of their penal code. The Nigerian President, Olusegun Obasanjo castigated the fraudsters for inflicting "incalculable damage to Nigerian businesses" and for "placing the entire country under suspicion."

"Wired" quotes statistics presented at the International Conference on Advance Fee (419) Frauds in New York on Sept. 17:

"Roughly 1 percent of the millions of people who receive 419 e-mails and faxes are successfully scammed. Annual losses to the scam in the United States total more than \$100 million, and law enforcement officials believe global losses may total over \$1.5 billion."

According to the "IFCC 2001 Internet Fraud Report", published by the FBI and the National White Collar Crime Center, Nigerian letter fraud cases amount to 15.5 percent of all grievances. The Internet Fraud Complaint Center refers such rip-offs to the US Secret Service. While the median loss in all manner of Internet fraud was \$435 - in the Nigerian scam it was a staggering \$5575. But only one in ten successful crimes is reported, says the FBI's report.

The IFCC provides this advisory to potential targets:

- Be skeptical of individuals representing themselves as Nigerian or other foreign government officials asking for your help in placing large sums of money in overseas bank accounts.
- Do not believe the promise of large sums of money for your cooperation.
- Do not give out any personal information regarding your savings, checking, credit, or other financial accounts.
- If you are solicited, do not respond and quickly notify the appropriate authorities.

The "419 Coalition" is more succinct and a lot more pessimistic:

1. NEVER pay anything up front for ANY reason.
2. NEVER extend credit for ANY reason.
3. NEVER do ANYTHING until their check clears.
4. NEVER expect ANY help from the Nigerian Government.
5. NEVER rely on YOUR Government to bail you out."

The State Department's Bureau of International Narcotics and Law Enforcement Affairs published a brochure titled "Nigerian Advance Fee Fraud". It describes the history of this particular type of swindle:

"AFF criminals include university-educated professionals who are the best in the world for nonviolent spectacular crimes. AFF letters first surfaced in the mid-1980s around the time of the collapse of world oil prices, which is Nigeria's main foreign exchange earner. Some Nigerians turned to crime in order to survive. Fraudulent schemes such as AFF succeeded in Nigeria, because Nigerian criminals took advantage of the fact that Nigerians speak English, the international language of business, and the country's vast oil wealth and natural gas reserves—ranked 13th in the world—offer lucrative business opportunities that attract many foreign companies and individuals."

According to London's Metropolitan Police Company Fraud Department, potential targets in the UK and the USA alone receive c. 1500 solicitations a week. The US Secret Service Financial Crime Division takes in 100 calls a day from Americans approach by the con-men.

It now acknowledges that "Nigerian organized crime rings running fraud schemes through the mail and phone lines are now so large, they represent a serious financial threat to the country."

Sometimes even the stamps affixed to such letters are forged. Nigerian postal workers are known to be in cahoots with the fraudsters. Names and addresses are obtained from "trade journals, business directories, magazine and newspaper advertisements, chambers of commerce, and the Internet."

Victims are either too intimidated to complain or else reluctant to admit their collusion in money laundering and fraud. Others try in vain to recoup their losses by ploughing more money into the scheme.

Contrary to popular image, the scammers are often violent and involved in other criminal pursuits, such as drug trafficking, According to Nigeria's Drug Law Enforcement Agency. The blight has spread to other countries. Letters from Sierra Leone, Ghana, Congo, Liberia, Togo, Ivory Coast, Benin, Burkina Faso, South Africa, Taiwan, or even Canada, the United Kingdom, Oman, and Vietnam are not uncommon.

The dodges fall into a few categories.

Over-invoiced contract scams involve the ostensible transfer of amounts obtained through inflated invoices to the bank account of an unrelated foreign firm. Contract fraud or "trade default" is simply a bogus order accompanied by a fraudulent bank draft for the products of an export company accompanied by demand for "samples" and various transaction "fees and charges".

Some of the rackets are plain outlandish. In the "wash-wash" confidence trick people have been known to pay up to \$200,000 for a special solution to remove stains from millions in defaced dollar notes. Others "bought" heavily "discounted" crude oil stored in "secret" locations - or real estate in rezoned locales. "Clearing houses" or "venture capital organizations" claiming to act on behalf of the Central Bank of Nigeria launder the proceeds of the scams.

In another twist, charities, academic institutions, nonprofit organizations, and religious groups are asked to pay the inheritances tax on a "donation". Some "dignitaries" and their relatives may seek to flee the country and ask the victims to advance the bribe money in return for a generous cut of the wealth they have stashed abroad.

"Bankers" may find inactive accounts with millions of dollars - often in lottery winnings - waiting to be transferred to a safe off-shore haven. Bogus jobs with inflated wages are another ostensible way to defraud state-owned companies - as is the sale of the target's used vehicle to them for an extravagant price. There seems to be no end to criminal ingenuity.

Lately, the correspondence purports to be coming from - often white - disinterested professional third parties. Accountants, lawyers, directors, trustees, security personnel, or bankers pretend to be acting as fiduciaries for the real dignitary in need of help. Less gullible victims are subjected to plain old extortion with verbal intimidation and stalking.



The more heightened public awareness grows with over-exposure and the tighter the net of international cooperation against the scam, the wilder the stories it spawns. Letters have surfaced recently signed by dying refugees, survivors of the September 11 attacks, and serendipitous US commandos on mission in Afghanistan.

Governments throughout the world have geared up to protect their businessmen. The US Department of Commerce, for instance, publishes the "World Traders data Report", compiled by US embassy in Nigeria. It "provides the following types of information: types of organizations, year established, principal owners, size, product line, and financial and trade references."

Unilateral US activity, inefficacious collaboration with the Nigerian government some of whose officials are rumored to be in on the deals, multilateral efforts in the framework of the OECD and the Interpol, education and information campaigns - nothing seems to be working.

The treatment of 419 fraudsters in Nigeria is so lenient that, according to the "Nigeria Tribune", the United States threatened the country with sanctions if it does not considerably improve its record on financial crime by November 2002. Both the US Treasury's Financial Crime Enforcement Network (FINCEN) and the OECD's Financial Action Task Force (FATF) had characterized the country as "one of the worst perpetrators of financial crimes in the world". The Nigerian central bank promises to get to grips with this debilitating problem.

Nigerians themselves - though often victims of the scams - take the phenomenon in stride. The Nigerian "Daily Champion", proffered this insightful apologia on behalf of the ruthless and merciless 419 gangs. It is worth quoting at length:

"To eradicate the 419 scourge, leaders at all levels should work assiduously to create employment opportunities and people perception of the leaders as role models. The country's very high unemployment figure has made nonsense of the so-called democracy dividends. Great majority of Nigerian youthful school leaver's including University graduates, are without visible means of livelihood ... The fact remains that most of these teeming youths cannot just watch our so-called leaders siphon their God-given wealthy. So, they resorted to alternative fraudulent means of livelihood called 419, at least to be seen as have arrived ... Some of these 419ers are in the National Assembly and the State Houses of Assembly while some surround the President and governors across the country."

Some swindlers seek to glorify their criminal activities with a political and historical context. The Web site of the "419 Coalition" contains letters casting the scam as a form of forced reparation for slavery, akin to the compensation paid by Germany to survivors of the holocaust. The confidence tricksters boast of defrauding the "white civilization" and unmasking the falsity of its claims for superiority. But a few delusional individuals aside, this is nothing but a smokescreen.

Greed outweighs fear and avarice enmeshes people in clearly criminal enterprises. The "victims" of advance fee scams are rarely incognizant of their alleged role. They knowingly and intentionally collude with self-professed criminals to fleece governments and institutions. This is one of the rare crimes where prey and perpetrator may well deserve each other.

## ***Organ Trafficking in Eastern Europe***

By: [Dr. Sam Vaknin](#)

Also published by [United Press International \(UPI\)](#)

A kidney fetches \$2700 in Turkey. According to last month's issue of the Journal of the American Medical Association, this is a high price. An Indian or Iraqi kidney enriches its former owner by a mere \$1000. Wealthy clients later pay for the rare organ up to \$150,000.

CBS News aired, two years ago, a documentary, filmed by Antenna 3 of Spain, in which undercover reporters in Mexico were asked, by a priest acting as a middleman for a doctor, to pay close to 1 million dollars for a single kidney. An auction of a human kidney on eBay in February 2000 drew a bid of \$100,000 before the company put a stop to it. Another auction in September 1999 drew \$5.7 million - though, probably, merely as a prank.

Organ harvesting operations flourish in Turkey, in central Europe, mainly in the Czech Republic, and in the Caucasus, mainly in Georgia. They operate on Turkish, Moldovan, Russian, Ukrainian, Belarusian, Romanian, Bosnian, Kosovar, Macedonian, Albanian and assorted east European donors.

They remove kidneys, lungs, pieces of liver, even corneas, bones, tendons, heart valves, skin and other sellable human bits. The organs are kept in cold storage and air lifted to illegal distribution centers in the United States, Germany, Scandinavia, the United Kingdom, Israel, South Africa, and other rich, industrialized locales. It gives "brain drain" a new, spine chilling, meaning.

Organ trafficking has become an international trade. It involves Indian, Thai, Philippine, Brazilian, Turkish and Israeli doctors who scour the Balkan and other destitute regions for tissues. The Washington Post reported last week that in a single village in Moldova, 14 out of 40 men were reduced by penury to selling body parts.

Last year, Moldova cut off the thriving baby adoption trade due to an - an unfounded - fear the toddlers were being dissected for spare organs. According to the Israeli daily, Ha'aretz, the Romanians are investigating similar allegations in Israel and have withheld permission to adopt Romanian babies from dozens of eager and out of pocket couples. American authorities are scrutinizing a two year old Moldovan harvesting operation based in the United States.

Organ theft and trading in Ukraine is a smooth operation. According to news agencies, last August three Ukrainian doctors were charged in Lvov with trafficking in the organs of victims of road accidents. The doctors used helicopters to ferry kidneys and livers to colluding hospitals. They charged up to \$19,000 per organ.

The West Australian daily surveyed in January the thriving organs business in Bosnia-Herzegovina. Sellers are offering their wares openly, through newspaper ads. Prices reach up to \$68,000. Compared to an average monthly wage of less than \$200, this is an unimaginable fortune.

National health insurance schemes turn a blind eye. Israel's participates in the costs of purchasing organs abroad, though only subject to rigorous vetting of the sources of the donation. Still, a May 2001 article in the New York Times Magazine, quotes "the coordinator of kidney transplantation at Hadassah University Hospital in Jerusalem (as saying that) 60 of the 244 patients currently receiving post-transplant care purchased their new kidney from a stranger - just short of 25 percent of the patients at one of Israel's largest medical centers participating in the organ business."

Many Israelis - attempting to avoid scrutiny - travel to east Europe, accompanied by Israeli doctors, to perform the transplantation surgery. These junkets are euphemistically known as "transplant tourism". Clinics have sprouted all over the benighted region. Israeli doctors have recently visited impoverished Macedonia, Bulgaria, Kosovo and Yugoslavia to discuss with local businessmen and doctors the setting up of kidney transplant clinics.

Such open involvement in what can be charitably described as a latter day slave trade gives rise to a new wave of thinly disguised anti-Semitism. The Ukrainian Echo, quoting the Ukrinform news agency, reported, on January 7, that, implausibly, a Ukrainian guest worker died in Tel-Aviv in mysterious circumstances and his heart was removed. The Interpol, according to the paper, is investigating this lurid affair.

According to scholars, reports of organ thefts and related abductions, mainly of children, have been rife in Poland and Russia at least since 1991. The buyers are supposed to be rich Arabs.

Nancy Scheper-Hughes, an anthropologist at the University of California at Berkeley and co-founder of Organs Watch, a research and documentation center, is also a member and co-author of the Bellagio Task Force Report on Transplantation, Bodily Integrity and the International Traffic in Organs. In a report presented in June 2001 to the House Subcommittee on International Operations and Human Rights, she substantiated at least the nationality of the alleged buyers, though not the urban legends regarding organ theft:

"In the Middle East residents of the Gulf States (Kuwait, Saudi Arabia, and Oman) have for many years traveled to India, the Philippines, and to Eastern Europe to purchase kidneys made scarce locally due to local fundamentalist Islamic teachings that allow organ transplantation (to save a life), but prohibit organ harvesting from brain-dead bodies.

Meanwhile, hundreds of kidney patients from Israel, which has its own well -developed, but under-used transplantation centers (due to ultra-orthodox Jewish reservations about brain death) travel in 'transplant tourist' junkets to Turkey, Moldova, Romania where desperate kidney sellers can be found, and to Russia where an excess of lucrative cadaveric organs are produced due to lax standards for designating brain death, and to South Africa where the amenities in transplantation clinics in private hospitals can resemble four star hotels.

We found in many countries - from Brazil and Argentina to India, Russia, Romania, Turkey to South Africa and parts of the United States - a kind of "apartheid medicine" that divides the world into two distinctly different populations of 'organs supplies' and 'organs receivers'."

Russia, together with Estonia, China and Iraq, is, indeed, a major harvesting and trading centre. International news agencies described, two years ago, how a grandmother in Ryazan tried to sell her grandchild to a mediator. The boy was to be smuggled to the West and there dismembered for his organs. The uncle, who assisted in the matter, was supposed to collect \$70,000 - a fortune in Russian terms.

When confronted by the European Union on this issue, Russia responded that it lacks the resources required to monitor organ donations. The Italian magazine, Happy Web, reports that organ trading has taken to the Internet. A simple query on the Google search engine yields thousands of Web sites purporting to sell various body parts - mostly kidneys - for up to \$125,000. The sellers are Russian, Moldovan, Ukrainian and Romanian.



Scheper-Hughes, an avid opponent of legalizing any form of trade in organs, says that "in general, the movement and flow of living donor organs - mostly kidneys - is from South to North, from poor to rich, from black and brown to white, and from female to male bodies."

Yet, this summer, bowing to reality, the American Medical Association commissioned a study to examine the effects of paying for cadaveric organs would have on the current shortage. The 1984 National Organ Transplant Act that forbids such payments is also under attack. Bills to amend it were submitted recently by several Congressmen. These are steps in the right direction.

Organ trafficking is the outcome of the international ban on organ sales and live donor organs. But wherever there is demand there is a market. Excruciating poverty of potential donors, lengthening patient waiting lists and the better quality of organs harvested from live people make organ sales an irresistible proposition. The medical professions and authorities everywhere would do better to legalize and regulate the trade rather than transform it into a form of organized crime. The denizens of Moldova would surely appreciate it.

## *Selling Arms to Rogue States*

By: [Dr. Sam Vaknin](#)

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In a desperate bid to fend off sanctions, the Bosnian government banned yesterday all trade in arms and munitions. A local, Serb-owned company was documented by the State Department selling spare parts and maintenance for military aircraft to Iraq via Yugoslav shell companies.

Heads rolled. In the Republika Srpska, the Serb component of the ramshackle Bosnian state, both the Defense Minister Slobodan Bilic and army Chief of Staff Novica Simic resigned. Another casualty was the general director of the Orao Aircraft Institute of Bijeljina - Milan Prica. On the Yugoslav side, Jugoimport chief Gen Jovan Cekovic and federal Deputy Defense Minister Ivan Djokic stood down.

Bosnia's is only the latest in a series of embarrassing disclosures in practically every country of the former eastern bloc, including all the EU accession candidates.

With the crumbling of the Warsaw pact and the economies of the region, millions of former military and secret service operators resorted to peddling weapons and martial expertise to rogue states, terrorist outfits, and organized crime. The confluence - and, lately, convergence - of these interests is threatening Europe's very stability.

Last week, the Polish "Rzeczpospolita" accused the Military Information services (WSI) of illicit arms sales between 1992-6 through both private and state-run entities. The weapons were plundered from the Polish army and sold at half price to Croatia and Somalia, both under UN arms embargo.

Deals were struck with the emerging international operations of the Russian mafia. Terrorist middlemen and Latvian state officials were involved. Breaching Poland's democratic veneer, the Polish Ministry of Defense threatened to sue the paper for disclosing state secrets.

Police in Lodz is still investigating the alarming disappearance of 4 Arrow anti-aircraft missiles from a train transporting arms from a factory to the port of Gdansk, to be exported. The private security escort claim innocence.

The Czech Military Intelligence Services (VZS) have long been embroiled in serial scandals. The Czech defense attaché to India, Miroslav Kvasnak, was recently fired for disobeying explicit orders from the minister of defense.

According to Jane's, Kvasnak headed URNA - the elite anti-terrorist unit of the Czech National Police. He was sacked in 1995 for selling Semtex, the notorious Czech plastic explosive, as well as weapons and munitions to organized crime gangs.

In late August, the Czechs arrested arms traffickers, members of an international ring, for selling Russian weapons - including, incredibly, tanks, fighter planes, naval vessels, long range rockets, and missile platforms - to Iraq. The operation has lasted 3 years and was conducted from Prague.

According to the "Wall Street Journal", the Czech intelligence services halted the sale of \$300 million worth of the Tamara radar systems to Iraq in 1997. Czech firms, such as Agroplast, a leading waste processing company, have often been openly accused of weapons smuggling. "The Guardian" tracked in February a delivery of missiles and guidance systems from the Czech Republic through Syria to Iraq.

German go-betweens operate in the Baltic countries. In May a sale of more than two pounds of the radioactive element cesium-137 was thwarted in Vilnius, the capital of Lithuania. The substance was sold to terrorist groups bent on producing a "dirty bomb", believe US officials quoted by "The Guardian". The Director of the CIA, John Deutsch, testified in Congress in 1996 about previous cases in Lithuania involving two tons of radioactive wolfram and 220 pounds of uranium-238.

Still, the epicenters of the illicit trade in weapons are in the Balkan, in Russia, and in the republics of the former Soviet Union. Here, domestic firms intermesh with Western intermediaries, criminals, terrorists, and state officials to engender a pernicious, ubiquitous and malignant web of smuggling and corruption.

According to the Center for Public Integrity and the Western media, over the last decade, renegade Russian army officers have sold weapons to every criminal and terrorist organization in the world - from the IRA to al-Qaida and to every failed state, from Liberia to Libya.

They are protected by well-connected, bribe-paying, arms dealers and high-level functionaries in every branch of government. They launder the proceeds through Russian oil multinationals, Cypriot, Balkan, and Lebanese banks, and Asian, Swiss, Austrian, and British trading conglomerates - all obscurely owned and managed.

The most serious breach of the united international front against Iraq may be the sale of the \$100 million anti-stealth Ukrainian Kolchuga radar to the pariah state two years ago. Taped evidence suggests that president Leonid Kuchma himself instructed the General Director of the Ukrainian arms sales company, UkrSpetzExport, Valery Malev to conclude the deal. Malev died in a mysterious car accident on March 6, three days after his taped conversation with Kuchma surfaced.

The Ukrainians insist that they were preempted by Russian dealers who sold a similar radar system to Iraq - but this is highly unlikely as the Russian system was still in development at the time. The American and British are currently conducting a high-profile investigation in Kyiv.

In Russia, illegal arms are traded mainly by the Western Group of Forces in cahoots with private companies, both domestic and foreign. The Air Defense Army specializes in selling light arms. The army is the main source of weapons - plastic explosives, grenade launchers, munitions - of both Chechen rebels and Chechen criminals. Contrary to received opinion, volunteer-soldiers, not conscripts, control the arms trade. The state itself is involved in arms proliferation. Sales to China and Iran were long classified. From June, all sales of materiel enjoy "state secret" status.

There is little the US can do. The Bush administration has imposed in May sanctions on Armenian and Moldovan companies, among others, for aiding and abetting Iran's efforts to obtain weapons of mass destruction. Armenian president, Robert Kocharian, indignantly denied knowledge of such transactions and vowed to get to the bottom of the American allegations.

The Foreign Policy Research Institute, quoted by Radio Free Europe/Radio Liberty, described a "Department of Energy (DOE) initiative, underway since 1993, to improve 'material protection, control and accountability' at former Soviet nuclear enterprises. The program enjoys substantial bipartisan support in the United States and is considered the first line of defense against unwanted proliferation episodes."

"As of February 2000, more than 8 years after the collapse of the USSR, new security systems had been installed at 113 buildings, most of them in Russia; however, these sites contained only 7 percent of the estimated 650 tons of weapons-usable material considered at risk for theft or diversion. DOE plans call for safeguarding 60 percent of the material by 2006 and the rest in 10 to 15 years or longer."

Russian traders learned to circumvent official channels and work through Belarus. Major General Stsyapan Sukharenka, the first deputy chief of the Belarusian KGB, denied, in March, any criminal arms trading in his country. This vehement protest is gainsaid by the preponderance of Belarusian arms traders replete with fake end-user certificates in Croatia during the Yugoslav wars of secession (1992-5).

Deputy Assistant Secretary of State Steven Pifer said that UN inspectors unearthed Belarusian artillery in Iraq in 1996. Iraqis are also being trained in Belarus to operate various advanced weapons systems. The secret services and armies of Ukraine, Russia, and even Romania use Belarus to mask the true origin of weapons sold in contravention of UN sanctions.

Western arms manufacturers lobby their governments to enhance their sales. Legitimate Russian and Ukrainian sales are often thwarted by Western political arm-twisting. When Macedonia, in the throes of a civil war it was about to lose, purchased helicopter gunships from Ukraine, the American Embassy leaned on the government to annul the contracts and threatened to withhold aid and credits if it does not succumb.

The duopoly, enjoyed by the USA and Russia, forces competitors to go underground and to seek rogue or felonious customers. Yugoslav scientists, employed by Jugoimport and other firms run by former army officers, are developing cruise missiles for Iraq, alleges the American administration. The accusation, though, is dubious as Iraq has no access to satellites to guide such missiles.

Another Yugoslav firm, Brunner, constructed a Libyan rocket propellant manufacturing facility. In an interview to the "Washington Post", Yugoslavia's president Vojislav Kostunica brushed off the American complaints about, as he put it disdainfully, "overhauling older-generation aircraft engines".

Such exploits are not unique to Yugoslavia or Bosnia. The Croat security services are notorious for their collusion in drug and arms trafficking, mainly via Hungary. Macedonian construction companies collaborate with manufacturers of heavy machinery and purveyors of missile technology in an effort to recoup hundreds of millions of dollars in Iraqi debts. Albanian crime gangs collude with weapon smugglers based in Montenegro and Kosovo. The Balkan - from Greece to Hungary - is teeming with these penumbral figures.

Arms smuggling is a by-product of criminalized societies, destitution, and dysfunctional institutions. The prolonged period of failed transition in countries such as Yugoslavia, Macedonia, Bosnia, Moldova, Belarus, and Ukraine has entrenched organized crime. It now permeates every legitimate economic sphere and every organ of the state.



Whether this situation is reversible is the subject of heated debate. But it is the West which pays the price in increased crime rates and, probably in Iraq, in added fatalities once it launches war against that murderous regime.

## *The Industrious Spies*

By: [Dr. Sam Vaknin](#)

Also published by [United Press International \(UPI\)](#)

The Web site of GURPS (Generic Universal Role Playing System) lists 18 "state of the art equipments (sic) used for advanced spying". These include binoculars to read lips, voice activated bugs, electronic imaging devices, computer taps, electromagnetic induction detectors, acoustic stethoscopes, fiber optic scopes, detectors of acoustic emissions (e.g., of printers), laser mikes that can decipher and amplify voice-activated vibrations of windows, and other James Bond gear.

Such contraptions are an integral part of industrial espionage. The American Society for Industrial Security (ASIC) estimated a few years ago that the damage caused by economic or commercial espionage to American industry between 1993-5 alone was c. \$63 billion.

The average net loss per incident reported was \$19 million in high technology, \$29 million in services, and \$36 million in manufacturing. ASIC than upped its estimate to \$300 billion in 1997 alone - compared to \$100 billion assessed by the 1995 report of the White House Office of Science and Technology.

These figures are mere extrapolations based on anecdotal tales of failed espionage. Many incidents go unreported. In his address to the 1998 World Economic Forum, Frank Ciluffo, Deputy Director of the CSIS Global Organized Crime Project, made clear why:

The perpetrators keep quiet for obvious reasons. The victims do so out of fear. It may jeopardize shareholder and consumer confidence. Employees may lose their jobs. It may invite copycats by inadvertently revealing vulnerabilities. And competitors may take advantage of the negative publicity. In fact, they keep quiet for all the same reasons corporations do not report computer intrusions."

Interactive Television Technologies complained - in a press release dated August 16, 1996 - that someone broke into its Amherst, NY, offices and stole "three computers containing the plans, schematics, diagrams and specifications for the BUTLER, plus a number of computer disks with access codes." BUTLER is a proprietary technology which helps connect television to computer networks, such as the Internet. It took four years to develop.

In a single case, described in the Jan/Feb 1996 issue of "Foreign Affairs", Ronald Hoffman, a software scientist, sold secret applications developed for the Strategic Defense Initiative to Japanese corporations, such as Nissan Motor Company, Mitsubishi Electric, Mitsubishi Heavy Industries, and Ishikawajima-Harima Heavy Industries. He was caught in 1992, having received \$750,000 from his "clients", who used the software in their civilian aerospace projects.

Canal Plus Technologies, a subsidiary of French media giant Vivendi, filed a lawsuit last March against NDS, a division of News Corp. Canal accused NDS of hacking into its pay TV smart cards and distributing the cracked codes freely on a piracy Web site. It sued NDS for \$1.1 billion in lost revenues. This provided a rare glimpse into information age, hacker-based, corporate espionage tactics.

Executives of publicly traded design software developer Avant! went to jail for purchasing batches of computer code from former employees of Cadence in 1997.

Reuters Analytics, an American subsidiary of Reuters Holdings, was accused in 1998 of theft of proprietary information from Bloomberg by stealing source codes from its computers.

In December 2001, Say Lye Ow, a Malaysian subject and a former employee of Intel, was sentenced to 24 months in prison for illicitly copying computer files containing advanced designs of Intel's Merced (Itanium) microprocessor. It was the crowning achievement of a collaboration between the FBI's High-Tech squad and the US Attorney's Office CHIP - Computer Hacking and Intellectual Property - unit.

U.S. Attorney David W. Shapiro said: "People and companies who steal intellectual property are thieves just as bank robbers are thieves. In this case, the Itanium microprocessor is an extremely valuable product that took Intel and HP years to develop.

These cases should send the message throughout Silicon Valley and the Northern District that the U.S. Attorney's Office takes seriously the theft of intellectual property and will prosecute these cases to the full extent of the law."

Yet, such cases are vastly more common than publicly acknowledged.

"People have struck up online friendships with employers and then lured them into conspiracy to commit espionage. People have put bounties on laptops of executives. People have disguised themselves as janitors to gain physical access," Richard Power, editorial director of the Computer Security Institute told MSNBC.

Marshall Phelps, IBM Vice President for Commercial and Industry Relations admitted to the Senate Judiciary Committee as early as April 1992:

"Among the most blatant actions are outright theft of corporate proprietary assets. Such theft has occurred from many quarters: competitors, governments seeking to bolster national industrial champions, even employees. Unfortunately, IBM has been the victim of such acts."

Raytheon, a once thriving defense contractor, released "SilentRunner", a \$25,000-65,000 software package designed to counter the "insider threat". Its brochure, quoted by "Wired", says:

"We know that 84 percent of your network threats can be expected to come from inside your organization.... This least intrusive of all detection systems will guard the integrity of your network against abuses from unauthorized employees, former employees, hackers or terrorists and competitors."

This reminds many of the FBI's Carnivore massive network sniffer software. It also revives the old dilemma between privacy and security. An Omni Consulting survey of 3200 companies worldwide pegged damage caused by insecure networks at \$12 billion.

There is no end to the twists and turns of espionage cases and to the creativity shown by the perpetrators.

On June 2001 an indictment was handed down against Nicholas Daddona. He stands accused of a unique variation on the old theme of industrial espionage: he was employed by two firms - transferring trade secrets from one (Fabricated Metal Products) to the other (Eyelet).

Jungsheng Wang was indicted last year for copying the architecture of the Sequoia ultrasound machine developed by Acuson Corporation. He sold it to Bell Imaging, a Californian company which, together with a Chinese firm, owns a mainland China corporation, also charged in the case. The web of collaboration between foreign - or foreign born - scientists with access to trade and technology secrets, domestic corporations and foreign firms, often a cover for government interests - is clearly exposed here.

Kenneth Cullen and Bruce Zak were indicted on April 2001 for trying to purchase a printed or text version of the source code of a computer application for the processing of health care benefit claim forms developed by ZirMed. The legal status of printed source code is unclear. It is undoubtedly intellectual property - but of which kind? Is it software or printed matter?

Peter Morch, a senior R&D team leader for CISCO was accused on March 2001 for simply burning onto compact discs all the intellectual property he could lay his hands on with the intent of using it in his new workplace, Calix Networks, a competitor of CISCO.

Perhaps the most bizarre case involves Fausto Estrada. He was employed by a catering company that served the private lunches to Mastercard's board of directors. He offered to sell Visa proprietary information that he claimed to have stolen from Mastercard. In a letter signed "Cagliostro", Fausto demanded \$1 million. He was caught red-handed in an FBI sting operation on February 2001.

Multinationals are rarely persecuted even when known to have colluded with offenders. Steven Louis Davis pleaded guilty on January 1998 to stealing trade secrets and designs from Gillette and selling them to its competitors, such as Bic Corporation, American Safety Razor, and Warner Lambert. Yet, it seems that only he paid the price for his misdeeds - 27 months in prison. Bic claims to have immediately informed Gillette of the theft and to have collaborated with Gillette's Legal Department and the FBI.

Nor are industrial espionage or the theft of intellectual property limited to industry. Mayra Justine Trujillo-Cohen was sentenced on October 1998 to 48 months in prison for stealing proprietary software from Deloitte-Touche, where she worked as a consultant, and passing it for its own. Carroll Lee Campbell, the circulation manager of Gwinette Daily Post (GDP), offered to sell proprietary business and financial information of his employer to lawyers representing a rival paper locked in bitter dispute with GDP.

Nor does industrial espionage necessarily involve clandestine, cloak and dagger, operations. The Internet and information technology are playing an increasing role.

In a bizarre case, Caryn Camp developed in 1999 an Internet-relationship with a self-proclaimed entrepreneur, Stephen Martin. She stole he employer's trade secrets for Martin in the hope of attaining a senior position in Martin's outfit - or, at least, of being richly rewarded. Camp was exposed when she mis-addressed an e-mail expressing her fears - to a co-worker.

Steven Hallstead and Brian Pringle simply advertised their wares - designs of five advanced Intel chips - on the Web. They were, of course, caught and sentenced to more than 5 years in prison. David Kern copied the contents of a laptop inadvertently left behind by a serviceman of a competing firm. Kern trapped himself. He was forced to plead the Fifth Amendment during his deposition in a civil lawsuit he filed against his former employer. This, of course, provoked the curiosity of the FBI.



Stolen trade secrets can spell the difference between extinction and profitability. Jack Shearer admitted to building an \$8 million business on trade secrets pilfered from Caterpillar and Solar Turbines.

United States Attorney Paul E. Coggins stated: "This is the first EEA case in which the defendants pled guilty to taking trade secret information and actually converting the stolen information into manufactured products that were placed in the stream of commerce. The sentences handed down today (June 15, 2000) are among the longest sentences ever imposed in an Economic Espionage case."

Economic intelligence gathering - usually based on open sources - is both legitimate and indispensable. Even reverse engineering - disassembling a competitor's products to learn its secrets - is a grey legal area. Spying is different. It involves the purchase or theft of proprietary information illicitly. It is mostly committed by firms. But governments also share with domestic corporations and multinationals the fruits of their intelligence networks.

Former - and current - intelligence operators (i.e., spooks), political and military information brokers, and assorted shady intermediaries - all switched from dwindling Cold War business to the lucrative market of "competitive intelligence."

US News and World Report described on May 6, 1996, how a certain Mr. Kota - an alleged purveyor of secret military technology to the KGB in the 1980's - conspired with a scientist, a decade later, to smuggle biotechnologically modified hamster ovaries to India.

This transition fosters international tensions even among allies. "Countries don't have friends - they have interests!" - screamed a DOE poster in the mid-nineties. France has vigorously protested US spying on French economic and technological developments - until it was revealed to be doing the same. French relentless and unscrupulous pursuit of purloined intellectual property in the USA is described in Peter Schweizer's "Friendly Spies: How America's Allies Are Using Economic Espionage to Steal Our Secrets."

"Le Mond" reported back in 1996 about intensified American efforts to purchase from French bureaucrats and legislators information regarding France's WTO, telecommunications, and audio-visual policies. Several CIA operators were expelled.

Similarly, according to Robert Dreyfuss in the January 1995 issue of "Mother Jones", Non Official Cover (NOC) CIA operators - usually posing as businessmen - are stationed in Japan. These agents conduct economic and technological espionage throughout Asia, including in South Korea and China.

Even the New York Times chimed in, accusing American intelligence agents of assisting US trade negotiators by eavesdropping on Japanese officials during the car imports row in 1995. And President Clinton admitted openly that intelligence gathered by the CIA regarding the illegal practices of French competitors allowed American aerospace firms to win multi-billion dollar contracts in Brazil and Saudi Arabia.

The respected German weekly, Der Spiegel, castigated the USA, in 1990, for arm-twisting the Indonesian government into splitting a \$200 million satellite contract between the Japanese NEC and US manufacturers. The American, alleged the magazines, intercepted messages pertaining to the deal, using the infrastructure of the National Security Agency (NSA). Brian Gladwell, a former NATO computer expert, calls it "state-sponsored information piracy".

Robert Dreyfuss, writing in "Mother Jones", accused the CIA of actively gathering industrial intelligence (i.e., stealing trade secrets) and passing them on to America's Big Three carmakers. He quoted Clinton administration officials as saying: "(the CIA) is a good source of information about the current state of technology in a foreign country ... We've always managed to get intelligence to the business community. There is contact between business people and the intelligence community, and information flows both ways, informally."

A February 1995 National Security Strategy statement cited by MSNBC declared:

"Collection and analysis can help level the economic playing field by identifying threats to U.S. companies from foreign intelligence services and unfair trading practices."

The Commerce Department's Advocacy Center solicits commercial information thus:

"Contracts pursued by foreign firms that receive assistance from their home governments to pressure a customer into a buying decision; unfair treatment by government decision-makers, preventing you from a chance to compete; tenders tied up in bureaucratic red tape, resulting in lost opportunities and unfair advantage to a competitor. If these or any similar export issues are affecting your company, it's time to call the Advocacy Center."

And then, of course, there is Echelon.

Exposed two years ago by the European Parliament in great fanfare, this telecommunications interception network, run by the US, UK, New Zealand, Australia, and Canada has become the focus of bitter mutual recriminations and far flung conspiracy theories.

These have abated following the brutal terrorist attacks of September 11 when the need for Echelon-like system with even laxer legal control was made abundantly clear. France, Russia, and 28 other nations operate indigenous mini-Echelons, their hypocritical protestations to the contrary notwithstanding.

But, with well over \$600 billion a year invested in easily pilfered R&D, the US is by far the prime target and main victim of such activities rather than their chief perpetrator. The harsh - and much industry lobbied - "Economic Espionage (and Protection of Proprietary Economic Information) Act of 1996" defines the criminal offender thus:

"Whoever, intending or knowing that the offense will benefit any foreign government, foreign instrumentality, or foreign agent, knowingly" and "whoever, with intent to convert a trade secret, that is related to or included in a product that is produced for or placed in interstate or foreign commerce, to the economic benefit of anyone other than the owner thereof, and intending or knowing that the offense will , injure any owner of that trade secret":

(1) steals, or without authorization appropriates, takes, carries away, or conceals, or by fraud, artifice, or deception obtains a trade secret (2) without authorization copies, duplicates, sketches, draws, photographs, downloads, uploads, alters, destroys, photocopies, replicates, transmits, delivers, sends, mails, communicates, or conveys a trade secret (3) receives, buys, or possesses a trade secret, knowing the same to have been stolen or appropriated, obtained, or converted without authorization (4) attempts to commit any offense described in any of paragraphs (1) through (3); or (5) conspires with one or more other persons to commit any offense described in any of paragraphs (1) through (4), and one or more of such persons do any act to effect the object of conspiracy."

Other countries either have similar statutes (e.g., France) - or are considering to introduce them. Taiwan's National Security Council has been debating a local version of an economic espionage law lat month. There have been dozens of prosecutions under the law hitherto. Companies - such as "Four Pillars" which stole trade secrets from Avery Dennison - paid fines of millions of US dollars.

Employees - such as PPG's Patrick Worthing - and their accomplices were jailed.

Foreign citizens - like the Taiwanese Kai-Lo Hsu and Prof. Charles Ho from National Chiao Tung university - were detained. Mark Halligan of Welsh and Katz in Chicago lists on his Web site more than 30 important economic espionage cases tried under the law by July last year.

The Economic Espionage law authorizes the FBI to act against foreign intelligence gathering agencies toiling on US soil with the aim of garnering proprietary economic information. During the Congressional hearings that preceded the law, the FBI estimated that no less than 23 governments, including the Israeli, French, Japanese, German, British, Swiss, Swedish, and Russian, were busy doing exactly that. Louis Freeh, the former director of the FBI, put it succinctly: "Economic Espionage is the greatest threat to our national security since the Cold War."

The French Ministry of Foreign Affairs runs a program which commutes military service to work at high tech US firms. Program-enrolled French computer engineers were arrested attempting to steal proprietary source codes from their American employers.

In an interview he granted to the German ZDF Television quoted by "Daily Yomiuri" and Netsafe, the former Director of the French foreign counterintelligence service, the DGSE, freely confessed:

"....All secret services of the big democracies undertake economic espionage ... Their role is to peer into hidden corners and in that context business plays an important part ... In France the state is not just responsible for the laws, it is also an entrepreneur. There are state-owned and semi-public companies. And that is why it is correct that for decades the French state regulated the market with its right hand in some ways and used its intelligence service with its left hand to furnish its commercial companies ... It is among the tasks of the secret services to shed light on and analyze the white, grey and black aspects of the granting of such major contracts, particularly in far-off countries."

The FBI investigated 400 economic espionage cases in 1995 - and 800 in 1996. It interfaces with American corporations and obtains investigative leads from them through its 26 years old Development of Espionage, Counterintelligence, and Counter terrorism Awareness (DECA) Program renamed ANSIR (Awareness of National Security Issues and Response). Every local FBI office has a White Collar Crime squad in charge of thwarting industrial espionage. The State Department runs a similar outfit called the Overseas Security Advisory Council (OSAC).

These are massive operations. In 1993-4 alone, the FBI briefed well over a quarter of a million corporate officers in more than 20,000 firms. By 1995, OSAC collaborated on overseas security problems with over 1400 private enterprises. "Country Councils", comprised of embassy official and private American business, operate in dozens of foreign cities. They facilitate the exchange of timely "unclassified" and threat-related security information.

More than 1600 US companies and organization are currently permanently affiliated wit OSAC. Its Advisory Council is made up of twenty-one private sector and four public sector member organizations that, according to OSAC, "represent specific industries or agencies that operate abroad. Private sector members serve for two to three years. More than fifty U.S. companies and organizations have already served on the Council. Member organizations designate representatives to work on the Council.

These representatives provide the direction and guidance to develop programs that most benefit the U.S. private sector overseas. Representatives meet quarterly and staff committees tasked with specific projects. Current committees include Transnational Crime, Country Council Support, Protection of Information and Technology, and Security Awareness and Education."

But the FBI is only one of many agencies that deal with the problem in the USA. The President's Annual Report to Congress on "Foreign Economic Collection and Industrial Espionage" dated July 1995, describes the multiple competitive intelligence (CI) roles of the Customs Service, the Department of Defense, the Department of Energy, and the CIA.

The federal government alerts its contractors to CI threats and subjects them to "awareness programs" under the DOD's Defense Information Counter Espionage (DICE) program. The Defense Investigative Service (DIS) maintains a host of useful databases such as the Foreign Ownership, Control, or Influence (FOCI) register.



It is active otherwise as well, conducting personal security interviews by industrial security representatives and keeping tabs on the foreign contacts of security cleared facilities. And the list goes on.

According to the aforementioned report to Congress:

"The industries that have been the targets in most cases of economic espionage and other collection activities include biotechnology; aerospace; telecommunications, including the technology to build the "information superhighway"; computer software/ hardware; advanced transportation and engine technology; advanced materials and coatings, including ' stealth" technologies; energy research; defense and armaments technology; manufacturing processes; and semiconductors. Proprietary business information-that is, bid, contract, customer, and strategy in these sectors is aggressively targeted. Foreign collectors have also shown great interest in government and corporate financial and trade data."

The collection methods range from the traditional - agent recruitment and break ins - to the technologically fantastic. Mergers, acquisitions, joint ventures, research and development partnerships, licensing and franchise agreements, friendship societies, international exchange programs, import-export companies - often cover up for old fashioned reconnaissance. Foreign governments disseminate disinformation to scare off competitors - or lure them into well-set traps.

Foreign students, foreign employees, foreign tourist guides, tourists, immigrants, translators, affable employees of NGO's, eager consultants, lobbyists, spin doctors, and mock journalists are all part of national concerted efforts to prevail in the global commercial jungle. Recruitment of traitors and patriots is at its peak in international trade fairs, air shows, sabbaticals, scientific congresses, and conferences.

On May 2001, Takashi Okamoto and Hiroaki Serizwa were indicted of stealing DNA and cell line reagents from Lerner Research Institute and the Cleveland Clinic Foundation. This was done on behalf of the Institute of Physical and Chemical Research (RIKEN) in Japan - an outfit 94 funded by the Japanese government. The indictment called RIKEN "an instrumentality of the government of Japan".

The Chinese Ministry of Posts and Telecommunications was involved on May 2001 in an egregious case of theft of intellectual property. Two development scientists of Chinese origin transferred the PathStar Access Server technology to a Chinese corporation owned by the ministry. The joint venture it formed with the thieves promptly came out with its own product probably based on the stolen secrets.

The following ad appeared in the Asian Wall Street Journal in 1991 - followed by a contact phone number in western Europe:

"Do you have advanced/privileged information of any type of project/contract that is going to be carried out in your country? We hold commission/agency agreements with many large European companies and could introduce them to your project/contract. Any commission received would be shared with yourselves."

Ben Venzke, publisher of Intelligence Watch Report, describes how Mitsubishi filed c. 1500 FOIA (Freedom of Information Act) requests in 1987 alone, in an effort to enter the space industry. The US Patent office is another great source of freely available proprietary information.

Industrial espionage is not new. In his book, "War by Other Means : Economic Espionage in America", The Wall Street Journal's John Fialka, vividly describes how Frances Cabot Lowell absconded from Britain with the plans for the cutting edge Cartwright loom in 1813.

Still, the phenomenon has lately become more egregious and more controversial. As Cold War structures - from NATO to the KGB and the CIA - seek to redefine themselves and to assume new roles and new functions, economic espionage offers a tempting solution.

Moreover, decades of increasing state involvement in modern economies have blurred the traditional demarcation between the private and the public sectors. Many firms are either state-owned (in Europe) or state-financed (in Asia) or sustained by state largesse and patronage (the USA). Many businessmen double as politicians and numerous politicians serve on corporate boards.

Eisenhower's "military-industrial complex" though not as sinister as once imagined is, all the same, a reality. The deployment of state intelligence assets and resources to help the private sector gain a competitive edge is merely its manifestation.

As foreign corporate ownership becomes widespread, as multinationals expand, as nation-states dissolve into regions and coalesce into supranational states - the classic, exclusionary, and dichotomous view of the world ("we" versus "they") will fade. But the notion of "proprietary information" is here to stay. And theft will never cease as long as there is profit to be had.

## *Russia's Idled Spies*

By: [Dr. Sam Vaknin](#)

Also published by [United Press International \(UPI\)](#)

*Also Read*

[The Industrious Spies](#)

[Russian Roulette - The Security Apparatus](#)

Sweden expelled yesterday two Russian diplomats for spying on radar and missile guidance technologies for the JAS 39 British-Swedish Gripen fighter jet developed by Telefon AB LM Ericsson, the telecommunications multinational. The Russians threatened to reciprocate. Five current and former employees of the corporate giant are being investigated. Ironically, the first foreign buyer of the aircraft may well be Poland, a former Soviet satellite state and a current European Union candidate.

Sweden arrested in February last year a worker of the Swiss-Swedish engineering group, ABB, on suspicion of spying for Russia. The man was released after two days for lack of evidence and reinstated. But the weighty Swedish daily, Dagens Nyheter, speculated that the recent Russian indiscretion was in deliberate retaliation for Swedish espionage in Russia. Sweden is rumored to have been in the market for Russian air radar designs and the JAS radar system is said by some observers to uncannily resemble its eastern counterparts.

The same day, a Russian military intelligence (GRU) colonel, Aleksander Sipachev, was sentenced in Moscow to eight years in prison and stripped of his rank. According to Russian news agencies, he was convicted of attempting to sell secret documents to the CIA. Russian secret service personnel, idled by the withering of Russia's global presence, resort to private business or are re-deployed by the state to spy on industrial and economic secrets in order to aid budding Russian multinationals.

According to the FBI and the National White-collar Crime Center, Russian former secret agents have teamed with computer hackers to break into corporate networks to steal vital information about product development and marketing strategies. Microsoft has recently admitted to such a compromising intrusion.

In a December 1999 interview to Segodnya, a Russia paper, Eyer Winkler, a former high-ranking staffer with the National Security Agency (NSA) confirmed that "corruption in the Russian Government, the Foreign Intelligence Service, and the Main Intelligence Department allows Russian organized criminal groups to use these departments in their own interests. Criminals receive the major part of information collected by the Russian special services by means of breaking into American computer networks."

When the KGB was dismantled and replaced by a host of new acronyms, Russian industrial espionage was still in diapers. as a result, it is a bureaucratic no-man's land roamed by agents of the GRU, the Foreign Intelligence Service (SVR), and smaller outfits, such as the Federal Agency on Government Communications and Information (FAPSI).

According to Stratfor, the strategic forecasting consultancy, "the SVR and GRU both handle manned intelligence on U.S. territory, with the Russian Federal Security Service (FSB) doing counterintelligence in America. Also, both the SVR and GRU have internal counterintelligence units created for finding foreign intelligence moles." This, to some extent, is the division of labor in Europe as well.

Germany's Federal Prosecutor has consistently warned against \$5 billion worth of secrets pilfered annually from German industrial firms by foreign intelligence services, especially from east Europe and Russia. The Counterintelligence News and Developments newsletter pegs the damage at \$13 billion in 1996 alone:

"Modus operandi included placing agents in international organizations, setting up joint-ventures with German companies, and setting up bogus companies. The (Federal Prosecutor's) report also warned business leaders to be particularly wary of former diplomats or people who used to work for foreign secret services because they often had the language skills and knowledge of Germany that made them excellent agents."

Russian spy rings now operate from Canada to Japan. Many of the spies have been dormant for decades and recalled to service following the implosion of the USSR. According to Asian media, Russians have become increasingly active in the Far East, mainly in Japan, South Korea, Taiwan, and mainland China.

Russia is worried about losing its edge in avionics, electronics, information technology and some emerging defense industries such as laser shields, positronics, unmanned vehicles, wearable computing, and real time triple C (communication, command and control) computerized battlefield management. The main targets are, surprisingly, Israel and France. According to media reports, the substantive clients of Russia's defense industry - such as India - insist on hollowing out Russian craft and installing Israeli and west European systems instead.

Russia's paranoid state of mind extends to its interior. Uralinformbureau reported earlier this year that the Yamal-Nenets autonomous okrug (district) restricted access to foreigners citing concerns about industrial espionage and potential sabotage of oil and gas companies. The Kremlin maintains an ever-expanding list of regions and territories with limited - or outright - forbidden - access to foreigners.

The FSB, the KGB's main successor, is busy arresting spies all over the vast country. To select a random events of the dozens reported every year - and many are not - the Russian daily Kommersant recounted in February how when the Trunov works at the Novolipetsk metallurgical combine concluded an agreement with a Chinese company to supply it with slabs, its chief negotiator was nabbed as a spy working for "circles in China". His crime? He was in possession of certain documents which contained "intellectual property" of the crumbling and antiquated mill pertaining to a slab quality enhancement process.



Foreigners are also being arrested, though rarely. An American businessman, Edmund Pope, was detained in April 2000 for attempting to purchase the blueprints of an advanced torpedo from a Russian scientist. There have been a few other isolated apprehensions, mainly for "proper", military, espionage. But Russians bear the brunt of the campaign against foreign economic intelligence gathering.

Strana.ru reported last December that, speaking on the occasion of Security Services Day, Putin - himself a KGB alumnus - warned veterans that the most crucial task facing the services today is "protecting the country's economy against industrial espionage."

This is nothing new. According to History of Espionage Web site, long before they established diplomatic relations with the USA in 1933, the Soviets had Amtorg Trading Company. Ostensibly its purpose was to encourage joint ventures between Russian and American firms. Really it was a hub of industrial undercover activities. Dozens of Soviet intelligence officers supervised, at its peak during the Depression, 800 American communists. The Soviet Union's European operations in Berlin (Handelsvertretung) and in London (Arcos, Ltd.) were even more successful.

## *The Business of Torture*

By: [Dr. Sam Vaknin](#)

Also published by [United Press International \(UPI\)](#)

*Also Read*

[\*The Argument for Torture\*](#)

The European Court of Human Rights agreed yesterday - more than two years after the applications have been filed - to hear six cases filed by Chechens against Russia. The claimants accuse the Russian military of torture and indiscriminate killings. The Court has ruled in the past against the Russian Federation and awarded assorted plaintiffs thousands of euros per case in compensation.

As awareness of human rights increased, as their definition expanded and as new, often authoritarian polities, resorted to torture and repression - human rights advocates and non-governmental organizations proliferated. It has become a business in its own right: lawyers, consultants, psychologists, therapists, law enforcement agencies, scholars and pundits tirelessly peddle books, seminars, conferences, therapy sessions for victims, court appearances and other services.

Human rights activists target mainly countries and multinationals.

In June 2001, the International Labor Rights Fund filed a lawsuit on behalf of 11 villagers against the American oil behemoth, ExxonMobile, for "abetting" abuses in Aceh, Indonesia. They alleged that the company provided the army with equipment for digging mass graves and helped in the construction of interrogation and torture centers.

This past November, the law firm of Cohen, Milstein, Hausfeld & Toll joined other American and South African law firms in filing a complaint that "seeks to hold businesses responsible for aiding and abetting the apartheid regime in South Africa ... forced labor, genocide, extrajudicial killing, torture, sexual assault, and unlawful detention."

Among the accused: "IBM and ICL which provided the computers that enabled South Africa to ... control the black South African population. Car manufacturers provided the armored vehicles that were used to patrol the townships. Arms manufacturers violated the embargoes on sales to South Africa, as did the oil companies. The banks provided the funding that enabled South Africa to expand its police and security apparatus."

Charges were leveled against Unocal in Myanmar and dozens of other multinationals. Berger & Montague filed, last September, a class action complaint against Royal Dutch Petroleum and Shell Transport. The oil giants are charged with "purchasing ammunition and using ... helicopters and boats and providing logistical support for 'Operation Restore Order in Ogoniland'" which was designed, according to the law firm, to "terrorize the civilian population into ending peaceful protests against Shell's environmentally unsound oil exploration and extraction activities".

The defendants in all these court cases strongly deny any wrongdoing.

But this is merely one facet of the torture business.

Torture implements are produced - mostly in the West - and sold openly, frequently to nasty regimes in developing countries and even through the Internet. Hi-tech devices abound: sophisticated electroconvulsive stun guns, painful restraints, truth serums, chemicals such as pepper gas. Export licensing is universally minimal and non-intrusive and completely ignores the technical specifications of the goods (for instance, whether they could be lethal, or merely inflict pain).

Amnesty International and the UK-based Omega Foundation, found more than 150 manufacturers of stun guns in the USA alone. They face tough competition from Germany (30 companies), Taiwan (19), France (14), South Korea (13), China (12), South Africa (nine), Israel (eight), Mexico (six), Poland (four), Russia (four), Brazil (three), Spain (three) and the Czech Republic (two).

Many torture implements pass through "off-shore" supply networks in Austria, Canada, Indonesia, Kuwait, Lebanon, Lithuania, Macedonia, Albania, Russia, Israel, the Philippines, Romania and Turkey. This helps European Union based companies circumvent legal bans at home. The US government has traditionally turned a blind eye to the international trading of such gadgets.

American high-voltage electro-shock stun shields turned up in Turkey, stun guns in Indonesia, and electro-shock batons and shields, and dart-firing taser guns in torture-prone Saudi Arabia. American firms are the dominant manufacturers of stun belts. Explains Dennis Kaufman, President of Stun Tech Inc, a US manufacturer of this innovation: "Electricity speaks every language known to man. No translation necessary. Everybody is afraid of electricity, and rightfully so." (Quoted by Amnesty International).

The Omega Foundation and Amnesty claim that 49 US companies are also major suppliers of mechanical restraints, including leg-irons and thumbcuffs. But they are not alone. Other suppliers are found in Germany (8), France (5), China (3), Taiwan (3), South Africa (2), Spain (2), the UK (2) and South Korea (1).

Not surprisingly, the Commerce Department doesn't keep tab on this category of exports.

Nor is the money sloshing around negligible. Records kept under the export control commodity number A985 show that Saudi Arabia alone spent in the United States more than \$1 million a year between 1997-2000 merely on stun guns. Venezuela's bill for shock batons and such reached \$3.7 million in the same period. Other clients included Hong Kong, Taiwan, Mexico and - surprisingly - Bulgaria. Egypt's notoriously brutal services - already well-equipped - spent a mere \$40,000.

The United States is not the only culprit. The European Commission, according to an Amnesty International report titled "Stopping the Torture Trade" and published in 2001:

"Gave a quality award to a Taiwanese electro-shock baton, but when challenged could not cite evidence as to independent safety tests for such a baton or whether member states of the European Union (EU) had been consulted. Most EU states have banned the use of such weapons at home, but French and German companies are still allowed to supply them to other countries."

Torture expertise is widely proffered by former soldiers, agents of the security services made redundant, retired policemen and even rogue medical doctors. China, Israel, South Africa, France, Russia, the United Kingdom and the United States are founts of such useful knowledge and its propagators.

How rooted torture is was revealed in September 1996 when the US Department of Defense admitted that "intelligence training manuals" were used in the Federally sponsored School of the Americas - one of 150 such facilities - between 1982 and 1991. The manuals, written in Spanish and used to train thousands of Latin American security agents, "advocated execution, torture, beatings and blackmail", says Amnesty International.

Where there is demand there is supply. Rather than ignore the discomfiting subject, governments would do well to legalize and supervise it. Alan Dershowitz, a prominent American criminal defense attorney, proposed, in an op-ed article in the Los Angeles Times, published November 8, 2001, to legalize torture in extreme cases and to have judges issue "torture warrants". This may be a radical departure from the human rights tradition of the civilized world. But dispensing export carefully reviewed licenses for dual-use implements is a different matter altogether - and long overdue.

# ***T H E   A U T H O R***

**SHMUEL (SAM) VAKNIN**

## **Curriculum Vitae**

*Click on [blue text](#) to access relevant web sites – thank you.*

Born in 1961 in Qiryat-Yam, Israel.

Served in the Israeli Defence Force (1979-1982) in training and education units.

## **Education**

Graduated a few semesters in the Technion - Israel Institute of Technology, Haifa.

Ph.D. in Philosophy (major : Philosophy of Physics) - Pacific Western University, California.

Graduate of numerous courses in Finance Theory and International Trading.

Certified [E-Commerce Concepts Analyst](#).

Certified in [Psychological Counselling Techniques](#).

Full proficiency in Hebrew and in English.

## **Business Experience**

### ***1980 to 1983***

Founder and co-owner of a chain of computerized information kiosks in Tel-Aviv, Israel.

### ***1982 to 1985***

Senior positions with the Nessim D. Gaon Group of Companies in Geneva, Paris and New-York (NOGA and APROFIM SA):

- Chief Analyst of Edible Commodities in the Group's Headquarters in Switzerland.
- Manager of the Research and Analysis Division
- Manager of the Data Processing Division
- Project Manager of The Nigerian Computerized Census
- Vice President in charge of RND and Advanced Technologies
- Vice President in charge of Sovereign Debt Financing

### ***1985 to 1986***

Represented Canadian Venture Capital Funds in Israel.

### ***1986 to 1987***

General Manager of IPE Ltd. in London. The firm financed international multi-lateral countertrade and leasing transactions.



### ***1988 to 1990***

Co-founder and Director of "Mikbats - Tesuah", a portfolio management firm based in Tel-Aviv. Activities included large-scale portfolio management, underwriting, forex trading and general financial advisory services.

### ***1990 to Present***

Free-lance consultant to many of Israel's Blue-Chip firms, mainly on issues related to the capital markets in Israel, Canada, the UK and the USA.

Consultant to foreign RND ventures and to Governments on macro-economic matters.

President of the Israel chapter of the Professors World Peace Academy (PWPA) and (briefly) Israel representative of the "Washington Times".

### ***1993 to 1994***

Co-owner and Director of many business enterprises:

- The Omega and Energy Air-Conditioning Concern
  - AVP Financial Consultants
  - Handiman Legal Services
- Total annual turnover of the group: 10 million USD.

Co-owner, Director and Finance Manager of COSTI Ltd. - Israel's largest computerized information vendor and developer. Raised funds through a series of private placements locally, in the USA, Canada and London.

***1993 to 1996***

Publisher and Editor of a Capital Markets Newsletter distributed by subscription only to dozens of subscribers countrywide.

In a legal precedent in 1995 - studied in business schools and law faculties across Israel - was tried for his role in an attempted takeover of Israel's Agriculture Bank.

Was interned in the State School of Prison Wardens.

Managed the Central School Library, wrote, published and lectured on various occasions.

Managed the Internet and International News Department of an Israeli mass media group, "Ha-Tikshoret and Namer".

Assistant in the Law Faculty in Tel-Aviv University (to Prof. S.G. Shoham).

***1996 to 1999***

Financial consultant to leading businesses in Macedonia, Russia and the Czech Republic.

Collaborated with the Agency of Transformation of Business with Social Capital.

Economic commentator in "[Nova Makedonija](#)", "[Dnevnik](#)", "Izvestia", "Argumenti i Fakti", "The Middle East Times", "Makedonija Denes", "[The New Presence](#)", "[Central Europe Review](#)", and other periodicals and in the economic programs on various channels of Macedonian Television.

Chief Lecturer in courses organized by the Agency of Transformation, by the Macedonian Stock Exchange and by the Ministry of Trade.

### ***1999 to 2002***

Economic Advisor to the Government of the Republic of Macedonia and to the Ministry of Finance.

### ***2001 to present***

Senior Business Correspondent for [United Press International \(UPI\)](#)

## **Web and Journalistic Activities**

Author of extensive Websites in Psychology ("[Malignant Self Love](#)") - An [Open Directory Cool Site](#)

Philosophy ("[Philosophical Musings](#)")

Economics and Geopolitics ("[World in Conflict and Transition](#)")

Owner of the [Narcissistic Abuse Announcement and Study List](#) and the Narcissism Revisited mailing list (more than 3900 members)

Owner of the [Economies in Conflict and Transition Study list](#).

Editor of mental health disorders and Central and Eastern Europe categories in web directories ([Open Directory Suite 101](#), [Search Europe](#)).

Columnist and commentator in "[The New Presence](#)", [United Press International \(UPI\)](#), [InternetContent](#), [eBookWeb](#) and "[Central Europe Review](#)".

## **Publications and Awards**

"Managing Investment Portfolios in states of Uncertainty", Limon Publishers, Tel-Aviv, 1988

"The Gambling Industry", Limon Publishers., Tel-Aviv, 1990

["Requesting my Loved One - Short Stories"](#), Yedioth Aharonot, Tel-Aviv, 1997

"The Macedonian Economy at a Crossroads - On the way to a Healthier Economy" (with [Nikola Gruevski](#)), Skopje, 1998

["Malignant Self Love - Narcissism Revisited"](#), Narcissus Publications, Prague and Skopje, 1999, 2001, 2002

[The Narcissism Series](#) - e-books regarding relationships with abusive narcissists (Skopje, 1999-2002)

["The Exporters' Pocketbook"](#), Ministry of Trade, Republic of Macedonia, Skopje, 1999

["The Suffering of Being Kafka"](#) (electronic book of Hebrew Short Fiction, Prague, 1998)

["After the Rain - How the West Lost the East"](#), Narcissus Publications in association with [Central Europe Review/CEENMI](#), Prague and Skopje, 2000

Winner of numerous awards, among them the Israeli Education Ministry Prize (Literature) 1997, The Rotary Club Award for Social Studies (1976) and the Bilateral Relations Studies Award of the American Embassy in Israel (1978).

Hundreds of professional articles in all fields of finances and the economy and numerous articles dealing with geopolitical and political economic issues published in both print and web periodicals in many countries.

Many appearances in the electronic media on subjects in philosophy and the Sciences and concerning economic matters.

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**My Web Sites:**

*Economy / Politics:*

<http://ceeandbalkan.tripod.com/>

*Psychology:*

<http://samvak.tripod.com/index.html>

*Philosophy:*

<http://philosophos.tripod.com/>

*Poetry:*

<http://samvak.tripod.com/contents.html>

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# *After the Rain*

*How the West  
Lost the East*

## **The Book**

This is a series of articles written and published in 1996-2000 in Macedonia, in Russia, in Egypt and in the Czech Republic.

How the West lost the East. The economics, the politics, the geopolitics, the conspiracies, the corruption, the old and the new, the plough and the internet – it is all here, in colourful and provocative prose.

From "The Mind of Darkness":

"The Balkans' – I say – 'is the unconscious of the world'. People stop to digest this metaphor and then they nod enthusiastically. It is here that the repressed memories of history, its traumas and fears and images reside. It is here that the psychodynamics of humanity – the tectonic clash between Rome and Byzantium, West and East, Judeo-Christianity and Islam – is still easily discernible. We are seated at a New Year's dining table, loaded with a roasted pig and exotic salads. I, the Jew, only half foreign to this cradle of Slavonics. Four Serbs, five Macedonians. It is in the Balkans that all ethnic distinctions fail and it is here that they prevail anachronistically and atavistically. Contradiction and change the only two fixtures of this tormented region. The women of the Balkan - buried under provocative mask-like make up, retro hairstyles and too narrow dresses. The men, clad in sepia colours, old fashioned suits and turn of the century moustaches. In the background there is the crying game that is Balkanian music: liturgy and folk and elegy combined. The smells are heavy with muskular perfumes. It is like time travel. It is like revisiting one's childhood."

## The Author

*Sam Vaknin is the author of [Malignant Self Love - Narcissism Revisited](#) and [After the Rain - How the West Lost the East](#). He is a columnist for [Central Europe Review](#), [PopMatters](#), and [eBookWeb](#), a [United Press International \(UPI\)](#) Senior Business Correspondent, and the editor of mental health and Central East Europe categories in The [Open Directory](#) and [Suite101](#).*

*Until recently, he served as the Economic Advisor to the Government of Macedonia.*

*Visit Sam's Web site at <http://samvak.tripod.com>*