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Dirty money ☆

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Abstract

An inter-governmental body is encouraging the replacement of currency with the objective of discouraging illegal economic activities. This policy is analyzed in a search-theoretic model where individuals choose legal or illegal production, settle trades via monetary or costly intermediated exchange, and where the government imperfectly monitors monetary transactions. Stationary monetary equilibria with both legal and illegal productions exist, in which case the over-provision of currency may increment the extent of illegal production. This result holds also in the presence of intermediated exchange of legal goods. Equilibria with differing transaction patterns and degrees of illicit activities coexist. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Recommendation 24, Financial Action Task Force on Money Laundering (FATF, 1998), states that "Countries should further encourage in general the development of modern and secure techniques of money management [...] as a means to encourage the replacement of cash transfers." The FATF is an OECD-based inter-governmental body, comprising 31 industrialized countries, whose purpose is the development and promotion of policies to combat money laundering. Recommendation 24 aims to prevent such proceeds from being utilized in future criminal activities and from affecting legitimate economic activity. Until now, however, little has been done to construct a model capable of rationalizing such a policy. While many have attempted to empirically characterize the link between the underground, official economy and currency supply, a convincing theoretical approach has not yet been developed. I fill this gap by developing a general equilibrium model capable of characterizing the link between currency and extent of illegitimate activities, in a framework where illegal activities arise endogenously in response to economic incentives, and agents choose among alternative methods of exchange.

FATF's Recommendation 24 appears to be a direct consequence of the commonly held belief that the underground economy almost totally uses currency for transactions.[1] While cash is believed to be the most used payment system in modern economies, there is consensus among observers that much of the demand for currency is not associated with domestic and legal transactions (see for instance Avery et al., 1987). Some ascribe it mostly to the presence of foreign balances (see Porter and Judson (1996), Feige (1994), or Sprenkle (1993)), while others point to the use of cash for transactions taking place in the underground economy and large internal hoards (see Laurent (1979), Kimball (1981), Sumner (1990), or Kruger (1997)). As an example, while recent surveys have estimated that 4 out of 5 transactions in the US are carried out with cash (Humphrey et al., 1996; Emmons, 1996), Sumner (1990) has estimated that in the post-war period less than one half of the demand for currency appears to be associated with legal transactions. Other observers have pointed out this special role of currency. Goodhart (1989), for instance, has noted that "much of such demand [for cash] probably relates to nefarious activities, the 'black economy', gambling, prostitution and drugs, where anonymity of currency is prized; indeed a large portion of outstanding notes is never caught in surveys." Emmons (1996)

[1] The underground economy may be broadly defined as all unreported economic activities that would be taxable if reported (see also the taxonomy used by Feige, 1994). This paper focuses on illicit or fraudulent economic activities, such as the ones stemming from enterprises breaking the law or criminal activities. A sociologist would refer to them as non-conformist or expropriative strategies that violate a specific set of normative rules, such as criminal law. Money laundering is the processing of criminal proceeds in order to disguise their illegal origin.

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