

The Political Forum

*A review of social and political trends and events
impacting the world's financial markets*

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GLOBALIZATION LENDS CORRUPTION LIGHTER WINGS TO FLY

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For almost two years now, I have been writing regularly in these pages, and discussing in speeches and client presentations, my belief that the greatest danger to stable financial markets in the future will be international corruption on a scale never before witnessed in Western society.

There has, of course, always been corruption in the world. But for a variety of reasons, which include technological advances and the globalization of commerce following the fall of the Berlin Wall, I would argue that never have there been so many crooks out and around; never have the crooks been so well capitalized; and never have they been presented with such a panoply of opportunities for international expansion and diversification.

Modern corruption comes in various forms. But in each of its many manifestations it threatens honest trade, economic efficiency, social order, property rights, and of course, valuation models. And in doing so, it adds some serious new wrinkles to the risk curve.

- o There is the all-encompassing corruption that emerged from the anarchy of post-Communist Russia, like Athena out of the forehead of Zeus, full-grown and armored.
- o There is the totalitarian corruption that is endemic to Communism, and which festers throughout China and infects all of its international dealings.
- o There is the culturally institutionalized corruption of the Asian Democracies, which goes under various names, but is most often called "crony capitalism."
- o There is the corruption that seeps insidiously into conventional Western societies whenever respect for traditional moral values and the rule of law wanes, as it has been doing in the United States and Europe for several decades.

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o And finally, there is the corruption that is spreading across the globe like a metastasizing cancer, in the wake of the bustling and booming international narcotics trade.

It is rare that I find anyone who takes this problem as seriously as I, including, from all appearances, the economic gurus at such esteemed international organizations as the U.S. Treasury, the World Bank, and the IMF. I could be wrong about this, of course. But it seems to me that the leading lights of these institutions routinely ignore the corruption that is responsible for the economic sicknesses they purport to be curing. Instead, they concentrate on treating the symptoms with what I would argue is a goofy admixture of economically archaic currency manipulations, capital controls, and creditor bailouts.

As such, I was pleasantly surprised late one night last week as I was plowing through a huge “to be read” file, and found a fascinating series of articles in the Winter, 1998 edition of the quarterly journal, *Trends in Organized Crime*, which reinforce my concerns with thoughts and observations from several highly authoritative sources on the international narcotics trade. So this week I thought I’d pass along some observations from these articles. They are, I believe, immensely important.

But first, I want to present the following quote from a February 25, 1997 *Wall Street Journal* article by Thomas J. Duesterberg, a senior fellow of the Hudson Institute. By calling attention to the importance of the remarkable legal infrastructure that supports and facilitates international commerce today, Duesterberg highlights how vulnerable this trade would be should the system be corrupted.

In fact, it was this article by Duesterberg that started me thinking about the consequences to the financial markets of a spreading contagion of corruption around the world. It also formed the centerpiece of one of my first articles on the subject, entitled “Guanxi, Schmanxi . . . Enough Already.”

Out of the ashes of World War II, the U.S. and its allies erected a new economic order *that has produced the broadest and most sustained period of prosperity in world history* (emphasis added). Its basis is a system of rules to govern, facilitate and promote commerce. The U.S. and its allies assisted many nations, starting with Japan and Germany, in building domestic commercial and legal codes that assure property rights, promote the free exchange of goods and services and facilitate enforcement of contracts. International trade was fostered by a parallel system of rules covering the exchange of goods and (later) services embodied first in the General Agreement on Tariffs and Trade and its successor, the World Trade Organization (WTO).

Starting with a core group of like minded nations, the WTO has grown, in terms both of the commerce covered by its agreements and of the proportion of the world's population voluntarily abiding by its rules. The U.S. has remained an acknowledged champion of that system, despite domestic political pressures to stray. Frequently, it has been a lonely champion patiently lobbying both its allies and potential members of the GATT-WTO system to be more rigorous in abiding by the agreed rules. Thus the U.S. has for years sought to reduce the prevalence of bribery, high-handed government influence and unfair commercial practices as a means to win international business.

With Duesterberg's thoughts in mind, I'll begin with some quotes from *Trends in Organized Crime*. The first is from the "World Drug Report," from the United Nations International Drug Control Programme.

Many estimates have been made of the total revenue accruing to the illicit drug industry . . . a growing body of evidence suggests that the true figure lies somewhere around the US \$400bn level. A US \$400bn turnover would be equivalent to approximately 8 percent of total international trade. In 1994 this figure would have been larger than the international trade in iron and steel and motor vehicles and about the same size as the total international trade in textiles . . .

The need to legitimize ill-gotten gains has grown in proportion to the expansion of the illicit drug industry and to the propensity of criminals to operate in the legitimate business world . . .

Two trends have characterized money laundering in recent years. The first of these is the increasing professionalization of the function. The internationalization of money laundering is the second major trend, and has been brought about by two factors--first, the integration of financial markets into a complex, global entity; and, second, the effort by traffickers to avoid detection by concentrating operations in countries where enforcement is weak and legislation absent or embryonic.

Overall, perhaps the single most significant impact of money laundering on the legitimate economy is that it undermines the integrity of the financial system and this, depending on the extent and the rapidity of the loss of confidence, can have devastating consequences at national and international level.

Next, I'll turn to a 1997 report from the U.S. State Department's Bureau for International Narcotics and Law Enforcement Affairs.

Inordinate wealth gives the large trafficking organizations an almost unlimited capacity to corrupt. In many ways, they are a less obvious threat to democratic government than many insurgent movements. Guerrilla armies or terrorist organizations openly seek to topple and replace governments through overt violence. The drug syndicates only want to manipulate governments to their advantage and guarantee themselves a secure operating environment. They do so by co-opting key officials. A real fear of democratic leaders should be that one day the drug trade might take *de facto* control of a country by putting a majority of elected officials, including the president, directly or indirectly, on its payroll. Though it has yet to happen, there have been some disquieting near-misses.

Next I'll present some quotes from a September, 1998 interview with Ramachandra Sundaralingam, a Senior Drug Expert at Interpol, who presents a frightening run down of specifics on the worldwide narcotics hot spots, then concludes as follows.

The fast moving world, the transport revolution, and the development of electronic global banking and free market economies have caused dramatic changes in illegal drugs. The drug trafficking groups themselves have changed; only the fittest survive. If one group floods the market, it can eliminate the competition. Several new criminal groups have surfaced world-wide dealing in drugs alongside other forms of criminality. . . . The drug trade is an international phenomenon and is increasingly linked to other forms of criminality. Drug traffickers also traffic in arms and in human beings . . . No continent and no hemisphere has managed to control its drug problem. There are always new routes and new frontiers in crime. There is even the possibility of ordering chemicals and drugs over the Internet.

Finally, I come to the meatiest document of all, in my opinion. It is the 1998 annual report from the Paris-based “Geopolitical Observatory of Drugs,” which describes itself as the only truly independent organization that monitors the worldwide narcotics trade. The following section from this report is long, but I believe that anyone who invests internationally should closely consider its assertions.

Several major countries, like Russia (and many former Soviet Republics), Turkey, Mexico, etc., are now at the center of an increasingly conspicuous alliance between organized criminal structures and high levels of the state itself. *In Japan, organized crime (yakuza) is behind 30% of the bad debt which has provoked the current financial crisis.* (emphasis added) In less developed countries, particularly on the African continent, the privatization of state-owned companies is now the main vehicle for recycling drug money thanks to corruption. In this way a new and distorted “development” model is emerging which, while enriching the elite classes, also encourages chaos. This ‘criminalization of politics’ is beginning to act as a brake on development as mafia activities produce much larger and especially quicker profits than legitimate activities do.

When legitimate businesses survive, it is often as “fronts” for criminal activities. In many countries of the South, the same operators frequently control, or even monopolize, the most lucrative activities whether formal or informal, legal or illegal. Legitimate and criminal interests have become so intertwined in some parts of the world that the frontier between the two has become purely theoretical. The result is that whole sectors of the legitimate economy and millions of jobs depend on the continuation of illegal dealings, including the most lucrative of all, drug trafficking. Informality, which is the main form of economic activity in the majority of less developed countries, has also penetrated whole sectors of the economy in developed countries. It is thus becoming the forerunner of drug trafficking and the laundering of its profits . . .

The crash of the Mexican economy in 1995 (and again in 1998) and similar problems experienced in Russia and Japan since late summer 1998 probably constitute the first major financial crises in the history of contemporary society, whose principal catalyst is a mafia-like management of the economy. (emphasis added) The problems are no longer of a quantitative nature, such as the percentage of profits stemming from criminal activities (and more specifically from drug trafficking) and redistributed within state institutions or laundered through the economy. The problems are much more

fundamental now and revolve around the major barrier presented to rational economic development and democratic institutions as a whole.

Like in Russia, mafia-like practices characterize the management of two large economies linked to the world's two leading economic powers: Mexico (linked to the United States through NAFTA) and Turkey (linked to Europe via trade agreements). Corruption, which has long been endemic south of the Rio Bravo and on the shores of the Bosphorus, has changed in nature during the last few years. On this fertile ground, the debt crisis, structural adjustment imposing market reforms without fundamental political change and local conflicts have resulted in alliances being forged between governments, political parties, the financial sector, and mafia entities, or even the transformation of political parties into criminal organizations.

Far from being isolated cases, the countries defined by the OGD as "narc-states", such as Burma and Pakistan, can in retrospect be seen as precursors of the situation now prevailing in Mexico and Turkey. In these countries, old but anecdotal links between politics and crime, between drug money and banking institutions, function as structurally complimentary elements today. This logic makes "informality" not only the source of capital accumulation, but also the solution to "difficulties" inherent to the state and to the rule of law. . . .

This intertwining of state interests and mafia interests is nothing new. Rich countries . . . have practiced it in the past. But, perhaps with the exception of Italy, they have not allowed criminal organizations to gain access to the highest spheres of the state to such an extent that they become one and the same, as is happening in Mexico and Turkey. Nor have Japan, France, the US and Italy paid for this momentary drift with the paralysis of their political, legal and banking systems (even though this is to be qualified in the case of Japan). This system of complementarity between politics and crime, while it defines new narco-states and new mafia aristocracies, destabilizes entire countries, whose still-fragile institutions are caught in the storm of globalization. Although Russia, Mexico and Turkey have more destabilizing potential for the international system, Africa is where the largest number of acute cases of the "mafia syndrome" are to be found. . . .

This collusion between states and criminal elements has become so widespread that it is expanding into the open. World powers, at least those which would like to, are usually unable to censure it because they would find themselves without "credible" negotiating partners in sensitive areas of the world. This problem of credibility was expressed in its crudest form at the United Nations General Assembly Special Session on Drugs (UNGASS) in New York in June 1998. The slogan for the special session was "United Against Drugs" but several dozen speakers (from heads of state, to prime ministers or their representatives) had, or had had, links to criminal organizations, drug trafficking, or money laundering, either personally or indirectly as authorities of the countries they represented.

And now I'll close with a few thoughts from Pino Arlacchi, Under Secretary-General, Executive Director, United Nations Office for Drug Control and Crime Prevention.

The world's fight against large-scale crime and the global drug problem coincides with the need for greater oversight of the global financial order. The infiltration of illegal capital--albeit in modest amounts in terms of today's gigantic financial markets--may prove a catalyst for a chain reaction whose gravity nobody can foresee. By bringing entrepreneurs, linked to the "uncivil society," into the legal systems, fresh strains of adventurism and anarchy are placed in the market. Their presence has the potential to trigger an explosive world-wide financial breakdown that so many people fear.

Oh! The headline? It comes from Pope's Moral Essays. He was concerned about the corrupting influence of what he called paper-credit in the early 18th century.

Blest paper-credit! Last and lest supply!
That lends corruption lighter wings fly!

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