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# Drug money, hot money, and debt

R. Thomas Naylor

**M**uch more than just economics, at least in the narrow meaning of the word, lies behind the events that have marked the unprecedented financial instability in which the world has lived through the last decade. Among its many dramatic manifestations, it is easy to recall the interest rate increases in the late 1970s, the sharp rise and subsequent collapse of the prices of gold and diamonds, and the rapid escalation in the price of oil, and its subsequent plunge.

Furthermore, there were shocks from near default by a host of Third World debtor countries, a string of failures of major commercial and investment banks in the industrialized countries, and, more recently, the stock market collapse of October 19, 1987. As a massive FBI investigation into the state of the American savings banks so well attests,<sup>1</sup> it is not stretching the imagination to see in the crisis of these institutions, currently unfolding in the United States, the makings of another major financial debacle that may have global ramifications.

The increased volatility of financial markets manifests itself, at least in part, in a profound shift in asset-preference, from long term investment vehicles to the instruments of pure speculation. The consequences are both economic and financial. Economically long term investment in some leading industrialized countries, and most developing ones, has been seriously retarded. While economic expansion in the West has continued for several years, it has been carried on the back of a currently faltering consumption boom in the U.S.. At

the same time economic development in many Third World countries not only ceased, but even went into reverse.

Financially the result of this change in asset-preference is a huge ball of hot money that circumnavigates the world seeking sanctuary in short-term deposits, gold, precious stones and blue chip stocks, draining one country's reserves and overwhelming the financial defences of a second, wiping out the market for one type of asset while sending another to unsustainable heights.

### **Hi-tech evasion**

Today foreign exchange markets turn over \$150-175 billion per day, of which no more than 5-10% is directly linked to international trade. The rest represents pure speculation in a market that is notorious for its sensitivity and vulnerability to panic. As experience has unfortunately shown, this also constitutes an opportunity for cabals of foreign exchange traders, journalists and government officials to rig the market for their own profit - by planting false rumours or by conducting strategic bombing attacks on a particular currency to steer the market in directions from which those cabals have already put themselves in a position to profit.<sup>2</sup>

Volatility of financial markets to some degree reflects changes in the technology of international financial flows. Sophisticated electronic funds transfer mechanisms can shift money almost instantaneously from institution to institution, and from place to place. In 1985, the chief executive officer of Canada's oldest and third largest bank, testifying before a committee of the Canadian Senate investigating the efficacy of the regulatory apparatus, modestly claimed: "I can hide money in the twinkling of an eye from all the bloodhounds that could be put on the case, and I would be so far ahead of them that there would never be a hope of unraveling the trail....Technology today means that that sort of thing can be done through electronic means."<sup>3</sup>

Complementing those purely technological changes have come political and geographical ones. Havens offering sanctuary to refugee money have existed for centuries. But in the 1970s and early 1980s the number of places advertising bank and corporate secrecy laws to accommodate money that prefers to sacrifice some potential return for assured anonymity have proliferated almost faster than accountants specializing in tax evasion can keep track of them. This is partly due to the efforts of small Island economies in the

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Caribbean and Pacific to compensate for a lack of natural resources, by generating income and employment in the financial services industry.<sup>4</sup>

Nor can any of these developments be entirely separated from another, more disturbing one - the phenomenal expansion of the global *underground* economy, and of the power of those who prefer their economic activities to be hidden from the fiscal, monetary or legal authorities of their host countries.

### **The arms-drugs network**

There are many distinct elements in the matrix of underground economic activity, many different sources for the great pool of grey - and black - market money that has been pouring into the world financial system over the last decade. But, for simplicity, they can be divided in two. One is the income derived from the markets for contraband goods and services. The contraband traffic that attracts the most attention is illegal drugs. Though it could be argued that the traffic in arms is actually more dangerous, arms trafficking and drug dealing are often so closely interconnected as to constitute a virtual barter exchange network. The second source (which is, in some jurisdictions, regarded as a civil rather than a criminal offence) is the hiding of legally earned money from the fiscal and monetary authorities.

While the first type of activity almost always engenders the second, as criminals seek to hide their incomes from the law-enforcement authorities, the reverse is not true.<sup>5</sup> There is an important legal, if not functional, distinction between money that is dirty from its point of origin and money that becomes soiled only when its holders engage in tax evasion and capital flight.

Assessing the relative amounts of each is an impossible task, since, by definition, a cardinal objective of criminal money of either type is to avoid



detection. Recent estimates of the gross revenues generated in global drug dealing have run as high as \$500 billion per annum, with the profits, stored in obliging banks, spinning out \$3 million in interest per hour.<sup>6</sup>

It is certainly true that many countries' finances have deteriorated to the point where their solvency depends in good measure on the inflow of money from the export of drugs - Jamaica, Bolivia and Colombia, for example. And within countries, particular regions such as Sicily and Florida have, at various points in their recent history, been similarly dependent. Revelations of massive money laundering operations continue to shake the reputations of major banks - witness recent scandals around the Bank of Credit and Commerce in Luxembourg, or the big Swiss banks in the "Lebanese Connection" case.

But estimates of global drug money flows in the half trillion dollar range stories are probably more useful in getting a frightened public to acquiesce in higher law enforcement budgets and more arbitrary police powers than they are in conveying an accurate picture of what really goes on in the drug trade.<sup>7</sup>

### **Allergic to light**

The amount of money that is legally earned but illegally moved to evade taxes or exchange controls is undoubtedly much larger than the sums generated by explicitly illegal activity. By now it is widely accepted that if tax evasion could be curbed, much, if not most, of the budget deficits run by the industrialized countries would vanish. It is also true that if there were no problem of capital flight, there would likely be no developing country debt crisis.

In the United States alone, some estimates of evaded taxes run as high as \$100 billion per annum. Much, though certainly not all, of that evaded tax money hides in the international financial system before returning to the U.S., with its origins disguised.<sup>8</sup>

The existence of underground sectors, and the accompanying problem of tax evasion, is common to all countries, rich and poor alike. In fact its very existence blurs the distinction between rich and poor. It is a common observation that in Italy, the fifth largest industrial country in the Western world, tax evasion is almost a national sport, and the statistical office of the Italian government has officially acknowledged that underground economic activity, once accounted for in the official data, makes Italy's GNP and living

standard higher than that of Britain. On the other side, also a poor country such as India is commonly assumed to have a "black" economic sector that is equal to 50% of the legal GNP. In some countries of Latin America, it seems safe to assume the black sector exceeds the legal in aggregate terms. But the critical issue for international financial relations is how much of the illegal money crosses the frontier without an exit visa and hides out abroad, perhaps subsequently returning with a new identity.

Estimates of capital flight (roughly though not perfectly synonymous with that portion of black money leaving its country of origin) are highly variable, and the techniques for making such calculations are subject to much contention. Indeed there is not even a settled definition of what capital flight is. It is most commonly regarded as money whose movement reflects primarily the desire to



ILLUSTRATION BY CHARLES LIM 1988 FROM AN ORIGINAL CHINESE PRINT

*Cantonese authorities burning opium seized from British traffickers.*

flee circumstances at home rather than primarily the search for higher rates of return abroad. But even then the distinction is far from clear. Money can flee the tax collector in a certain country, hide briefly abroad, then return as “foreign investment” with its yield enhanced by the fact that foreign investment income is not subject to the same level of taxation as domestic. And clearly different countries have widely different experiences with respect to the relative magnitude of the problem of capital flight, however defined.<sup>9</sup>

Most calculations of capital flight focus on the “errors and omissions” in national balance-of-payments data. It is assumed that trade in goods and services is much better captured in the official statistics than are capital movements, and that long term capital movements are better taken into account than short term (though it is a curious statistical convention indeed that classifies flight capital as a “short term” capital movement). Hence otherwise unexplainable discrepancies between current account and capital account balances are provisionally equated with unmeasured capital export. The problem with such approaches is that they likely underestimate, perhaps seriously, the amount of such capital export by failing to take account of phony invoicing of trade and/or outright smuggling. It is often remarked that Mexico’s balance-of-payments statistics ignore both its most important export - drugs - and its most important import - arms.<sup>10</sup>

Nonetheless, the International Monetary Fund calculated that over the decade up to and including 1985, capital flight from developing debtor countries totaled \$300 billion, a sum equal to about 70% of their international bank debt. For the same period, the Morgan Guarantee Bank calculated that the 18 most heavily indebted developing countries added \$450 billion to their total debt (bank and official) and saw a minimum of \$200 billion flee (it is usually assumed that capital flight has eased since 1985). Whoever is right, the sums are enormous. And to the pool of hot money formed by capital flight from developing countries must be added the torrents that have poured in from European countries such as Italy, France and Spain that have traditionally placed legal restrictions on the export of capital.

It must be stressed again that most of the pool of black money is money that is legally earned but illegally moved - to evade taxes and exchange controls. However, once it enters the financial system, money that is legally earned but illegally hidden from view, behaves according to the same principles as money



that is overtly criminal in origin. And to hide its trail, it utilizes techniques developed and refined by those engaged in explicitly criminal acts.

The sophistication of the techniques employed by money that is quick on its feet and allergic to light depends on both the magnitudes involved and the relationship of the criminal group to the broader society.<sup>11</sup>

### **“Creative” accounting**

In its simplest form, the relationship of criminals to society is essentially predatory. This is typical of street gangs engaged in petty theft or extortion, or retail drug dealing. They are typified by a limited, usually urban field of operation. Here the problem of hiding and moving money can be handled with relative ease. The operations may be conducted completely in cash in which case the matter ends there. But often criminals want a more sophisticated method of moving money to avoid the difficulty and the risk of explaining large amounts of cash to the authorities.

For these purposes it usually suffices to control some cash-based legitimate business (laundromats and carwashes were the original preferred choice) through which the flow of earnings from operating in the market for contraband goods and services can be laundered. In essence it is merely a matter of mixing illegal with legal money in the accounts of a legitimate business that can provide a plausible explanation for the sums being generated. Since the illegal money is reported as legal money, it also gets taxed - in effect the act of paying taxes confers the ultimate stamp of legitimacy on the dirty money.

At a more advanced level, the relationship of criminals to society can be viewed as parasitical - the control of unions or the levying of a constant stream of protection payments on an industry like construction. The wholesaling of drugs might well fall into this category too. Here organizational structures become more complex, syndication-combination comes into play, and the field of activity is more likely regional and/or national. A larger cash flow, a broader and/or deeper range of activities and a more extensive market presence demand a more complex and sophisticated financial infrastructure.

At this stage casinos, for example, can play a dual role - not only generating cash but also providing a vehicle through which the funds derived from other

activities can be disguised. At this stage, too, one finds increasingly common mob control of small banks and other financial institutions - as depositories for the revenues from and as a source of working capital for mob-linked enterprises. Granted at this stage, too, the appetite of the tax collector is a factor to be taken into account. But his bite can be blunted by the same creative accounting techniques available to any legitimate business. Business has long understood the simple principle that the more income generated, the easier it is to legally evade taxes.

At some point the relationship between criminals and society will pass from the parasitical to the symbiotic. Here the demarcation between legal and illegal sectors becomes blurred, the territorial reach becomes increasingly international, and banking facilities are used not for local deposit and loan activities, but as a device for blending criminal money with the international flow of funds. The objective becomes to move criminal money offshore and then rechannel it back again, with its geographic and occupational origins obscured. At this stage criminal money joins with and submerges itself into an enormous mass of speculative capital that races around the world searching for tiny interest rate spreads, anticipating exchange rate changes, and fleeing real, imaginary or contrived political instability. Hiding behind a curtain of corporate and banking secrecy laws in one or a host of haven jurisdictions, criminal money now finds itself largely (or, if the techniques were properly applied, entirely) immune to the curiosity of national monetary, fiscal and judicial authorities.

### **The electronic smuggler**

The ultimate objective of the criminal is to enjoy his gains, perhaps in a tropical haven, more likely within the same geographic milieu in which his criminal enterprise operates. The first step in accomplishing that objective is to move the money *away* from the jurisdiction in which it has been earned. There are many ways to do it without leaving a trail that is easy for investigators to follow.

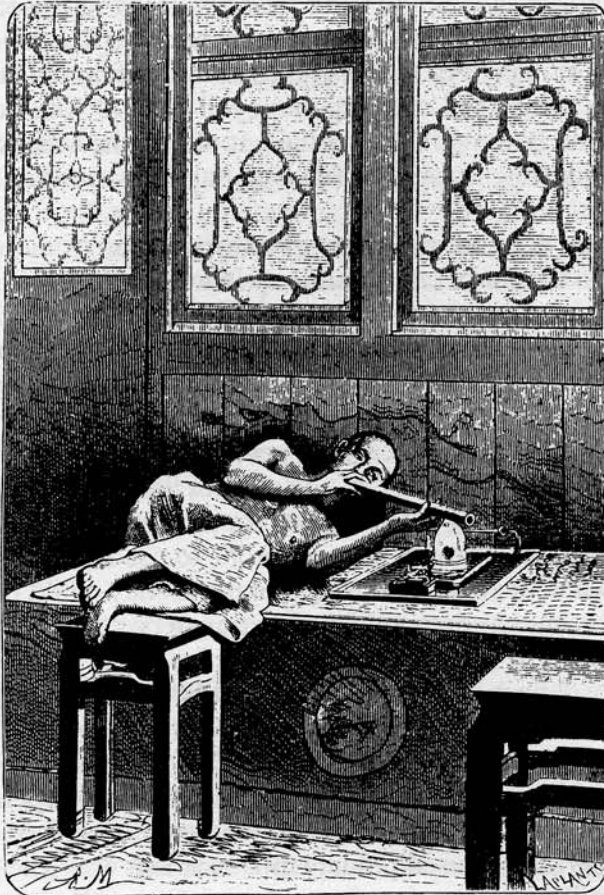
The easiest technique, if the criminal operates in markets whose medium of exchange is internationally convertible, is to have the money physically transported out of the country in high denomination bank notes. Although some countries, the United States for example, require that the physical transportation of cash, above a certain modest amount, be preceded by the



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completion of a currency declaration, in reality Customs rarely searches outgoing baggage, and security checks at airports are focused on the detection of metal objects.



*An opium smoker.*

Almost any valuable object which can be easily liquified will suffice for the clandestine transfer of criminally derived assets - precious metals (subject to the dangers of metal detectors), gem stones, bearer bonds, rare stamps. For small sums blank airline tickets are a popular device - they can be cashed in, in hard currency, at some distant point. Perhaps most desirable as an alternative to cash are cashiers' checks, albeit the domestic conversion of cash into cashiers'

checks prior to their departure for distant havens holds out the threat of leaving a paper trail unless additional evasive action is taken.

The actual transportation of the assets is usually left in the hands of skilled professionals. Some cash couriers work for criminal groups; some work for recipient banks and financial institutions; and some are free-lancers, operating in several milieus at once. For there is no essential difference between handling a heroin trafficker's cash and carrying money to Central America for a CIA covert war, between running flight capital out of a Latin American country or arranging the clandestine transfer of funds to buy arms for the IRA.

There is actually no need for the physical transportation of money or its close substitutes. If a cash balance can be built up in any bank - without the accumulating deposits triggering an investigation - money can then be wire-transferred anywhere in the world. In the U.S., with tighter reporting requirements than are typical of most Western countries, the key is to build up a deposit balance in a bank in the name of a business that is exempt from reporting its cash transactions because it generates so much cash. Although the laws have recently been tightened, historically in the U.S. it was simple to get an exemption from reporting requirements for precisely the type of businesses, such as casinos, criminals would be most prone to use for cover. Once deposited in the bank or financial institution the money could be wired abroad; there was no reporting requirement for wire transfers.

Probably the only danger was that the National Security Agency, the U.S. superspy organization that taps electrical and electronic communications all over the world, might be listening. But it is unlikely the NSA would want to make the results of its activities - a massive illegal wiretap operation - available to law-enforcement officers. Indeed the only time the results of a NSA eavesdropping operation caused public embarrassment was when information regarding \$162 million in transfers from Mexico City to Switzerland was leaked to *Washington Post* columnist Jack Anderson just on the eve of a visit to Washington by a Mexican president seeking debt relief for his country.

The pretext for such transfers is easily provided by a firm engaged in apparently legitimate international trade. If the criminal enterprise has as its legal cover a firm that imports, it suffices for its overseas correspondent to overinvoice the goods sent to the host country; the "balance" then has to be covered by remittance abroad. Alternatively it underinvoices the goods the host

country company sends abroad, accumulating the difference in a secret offshore bank account.

The manipulation of invoices is especially prevalent in countries subject to exchange control. One particularly notorious case came to light in Italy when it was discovered that Italy was exporting machine tools at an invoiced value less than the value of the same weight of scrap metal.<sup>12</sup>

Trade with phony invoices grades into trade with no invoices at all - simple smuggling. The commodities smuggled from developing countries to evade the requirement of depositing foreign exchange with the central monetary authorities, to circumvent government marketing boards, or to dodge export taxes vary from gold and precious stones to bulk commodities like wheat and oil. Thus Brazil, officially the sixth largest gold producer in the world, is estimated to actually produce 30% more than the official data indicate. More than 20 metric tonnes annually evade the government monopoly, flying off to foreign markets on the same planes that ply the cocaine trade. More than \$1 billion worth of Argentina wheat per year is estimated to sneak off to market without going through official channels. And Nigeria, at the peak of the oil boom, may have seen 20% of its total oil revenues lost through smuggling. The examples are legion.

In fact, on one level, illegal drugs can fulfill the same function. Residents of a country whose currency is inconvertible or subject to exchange control buy drugs with the soft currency, smuggle the drugs abroad, and resell them for hard currency. Drugs can thus be viewed, not as the objective of a criminal exercise, but as merely an instrument of illicit asset transfers, albeit one with special social consequences for the recipient country. This shifts the focus away from the "blue collar" operatives to the "white collar" instigators and onto the flow of money rather than the trail of the drugs themselves.

Also popular in countries with exchange controls is the technique of the lateral transfer. With the cooperation of domestic and foreign banks, someone wishing to move money illegally out of a country arranges to sell a local bank balance to someone else who possesses a foreign bank balance, paying at the black market rate. Or the bank itself, seeking to build up domestic deposits, may arrange to laterally transfer a favourite customers' money abroad, gaining the premium on the black market rate.



Whatever the chosen technique, once the money is abroad, most of the battle against disclosure has already been won. But there are still a few potential pitfalls to be avoided.

### **Swiss banks, and cheese**

Only an amateur would trust his money directly to the discretion of a coded account in, for example, a Swiss bank. Granted the Swiss banks have great attractions - the stability of the Swiss franc, the prestige of using Switzerland as a refuge, and the fact that Swiss banks are megabanks, combining commercial and investment banking operations with stock and commodity broking. But over the last decade the famed Swiss secrecy laws have assumed a textural resemblance to Switzerland's equally famous cheese. Mutual assistance treaties in criminal investigations, pre-emptory freezes, breakdowns in computer security, even the embarrassment of having bank officers bribed by antagonistic customs officers from another country have all shaken Switzerland's reputation.

For the intelligent criminal this is of little consequence. He may well choose to use a less well known haven - there are about forty countries now offering the protection of bank secrecy laws, many tighter than those of Switzerland. And even if sentiment or the search for peer-prestige inclines him to use Switzerland, additional protective layers of secrecy are easy to construct. The most important consists of assuring that if the wall of bank secrecy is penetrated, whether by bribery, burglary or juridical fiat, the account under scrutiny is held in the name, not of an individual, but of a company incorporated in another haven country offering corporate secrecy laws.

There are almost as many countries offering the service of instant-corporation manufacturing businesses as there are bank secrecy havens. Panama is likely the most popular. Panamanian lawyers create companies by the hundreds and turn them over to specialized brokers to retail. Companies can be made to order. But it is best to buy one off the shelf, especially if it is second hand. Companies with a corporate history also have a legacy of corporate activity which, if not legal, at least is different from the offences for which the new owners are likely to come under investigation. And to guard against the possibility that the Panamanian lawyer or broker might succumb to the blandishments of investigators, the criminal entrepreneur should ensure first, that the company is capitalized by bearer shares, leaving no owner of record at

all; and second, that the instructions to incorporate it were passed on to the Panamanian lawyer or broker by another corporate entity from somewhere else in the world.

For many the instrument of choice has long been a Liechtenstein *anstalt*, a single shareholder fiduciary company protected by tight corporate secrecy laws (recent changes in Liechtenstein corporate law have only marginally dimmed the country's appeal). Instructions to the Panamanian lawyer thus originate not from the criminal entrepreneur, but from the administrator of his Liechtenstein trust company.

There are now between the criminal investigator and the criminal's money one layer of bank secrecy, two layers of corporate secrecy and the additional guarantees provided by the use of bearer shares, not to mention attorney-client privilege. And any number of additional layers can be added. The money, once deposited in the name of the Panamanian company, can be electronically transferred through a maze of bank accounts in an array of bank secrecy havens, before coming to rest. The corporate cover can be deepened through the use of a series of holding companies.

### **The ticket home**

The money is now ready to be deployed at the will of the owner. At this stage there is usually a difference in objective and behaviour between criminal money from industrialized countries, including the hoards built up by tax evaders, and the flight capital from developing countries. The first usually passes through haven countries with a transit visa before returning home; the second seeks landed immigrant status elsewhere. The net result is that hot money fleeing the major Western countries usually returns home - such behaviour adversely affects the tax receipts of the the country of origin while having little or no net effect on its balance-of-payments. The developing country losing hot money finds both its fiscal and its balance-of-payments positions undermined.

There are several ways to bring the money into the country of ultimate destination, each with advantages and disadvantages.

One popular technique is to arrange for the offshore company in whose name the money is held to put its secret owner on the payroll - as a salaried officer or

consultant. The money can then be repatriated in the form of personal income, on which taxes should duly be paid, along with expense account payments which are tax free.

Another technique involves repatriating the money in the form of corporate income. It is simply the phony invoicing mechanism put in reverse. To move money out, imports are overinvoiced: to move money back, exports are overinvoiced; and the sums paid by the offshore company to the domestic company appear as legitimate revenues, taxable at the corporate rate.

A third approach is to bring the money back in the form of a "loan." It can be done by arranging for the haven bank to lend to a domestic company or individual a sum up to the equivalent of the amount that the company or individual has deposited. For the bank the security is perfect. For the criminal eager for access to his money, the advantages are many. The money is available at a small commission. And by recording the inflow of funds as a loan the criminal can "repay" the money, effectively to himself, while deducting the interest as an expense against his legitimate taxable income. Clearly this "loan-back" method is useful if the criminal seeks to use his money as working capital for a business rather than as personal income to support an opulent life-style.

A fourth technique is much less widely used, requiring as it does much larger sums and a far more sophisticated grasp of the mechanisms by which international economic relations are conducted. It consists of buying and selling commodity and/or currency options between the domestic and offshore companies, the profit appearing as capital gain and therefore taxed at a lower rate than personal income. In fact "profit" and "loss" are merely transfers between the offshore and domestic entities.<sup>13</sup>

### **Vaults and guns**

It is obvious that, given recent developments in the structure and functioning of international financial institutions, opportunities abound for criminal money to move around the world, evading the scrutiny and the grasp of the legal, monetary and fiscal authorities. It is equally obvious, even though no one can give precise measures, that the power of criminals to control the markets for contraband goods and services, to render illegal the operation of legal markets (especially financial markets), and to subvert the political systems that are



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supposed to keep them in check are awesome. With all due respect to Mao Tse Tung, political power speaks more from the vaults of banks than from the mouths of guns, for the obvious reason that control of the first assures an ample supply of the second. But curbing that awesome power has been and will continue to be an exceedingly difficult task.

To begin with, there are a host of technical and legal barriers to be surmounted. While criminal money whizzes around the world at the touch of a computer key, the law enforcement authorities must obtain documents that are usable in court. It is a little like trying to capture a laser-beam in a cardboard box. Moreover success usually requires the cooperation of a whole series of jurisdictions. For many of them the protection of corporate and banking secrecy is a matter of financial survival. Nor is it at all clear that governments of the major industrialized countries are as committed in practice as they are in their public rhetoric to dismantling many of these barriers.

The world's most reputable and politically influential financial institutions share with the haven countries a commitment to defending the institutions through which hot money moves. As a result they act as a powerful lobby on their home governments to protect precisely the financial apparatus that criminals, too, find essential to the successful plying of their craft.

Nor is it clear that all departments of the U.S. government - without whose full cooperation no serious crackdown is possible - agree that breaking down the walls of bank and corporate secrecy should be a top priority. While the FBI, Customs, Justice and other branches of government have attempted to coordinate their efforts in tracing dirty money flows, the CIA has argued that it was none of the agency's business. However, two former investigators from the Justice Department had a different explanation: "It is widely believed that the agency itself uses Swiss and offshore banks to finance its covert operations in much the same manner as organized and white-collar criminals."<sup>14</sup> Much the same could be said about the intelligence agencies of virtually all countries.

Granted, all Western governments concur in the need to root out drug money. But it is virtually impossible in practice to separate hot money derived from drug dealing from that derived from simple, everyday tax evasion and capital flight. Furthermore, given the ever-increasing financial intergration of the world community, and given the energy with which governments have sought "foreign" investment to cover budget and balance-of-payments deficits, there is

always the danger than financial practice will fall well short of moral rhetoric, and that governments, even of some major Western countries, have become too dependent on offshore financing to risk looking too closely at the origins of the money flowing their way.

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