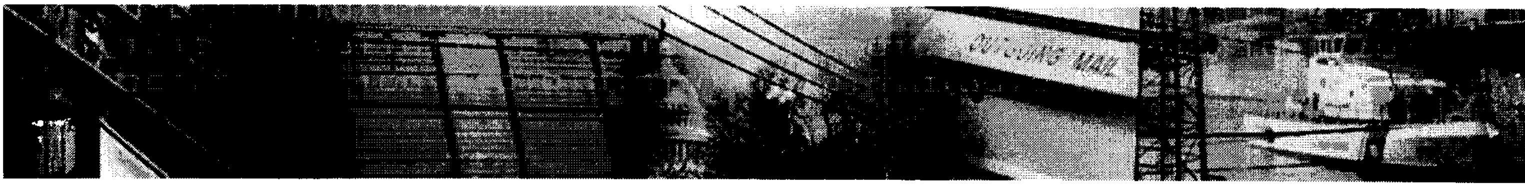

THE CIP REPORT

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TRADE AND INVESTMENT

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CENTER for INFRASTRUCTURE PROTECTION

This month *The CIP Report* focuses on trade and investment. As our economy experiences some instability, we look at how two different centers at George Mason University are applying research in this area. The Interdisciplinary Center for Economic Science (ICES) and The Terrorism, Transnational Crime and Corruption Center (TraCCC) raise interesting questions about the financial situation

Dr. Carl Johnston from ICES discusses correlated risk and disaster insurance, while Dr. Louise Shelley from TraCCC concentrates on what the outcome of the financial crisis will mean to people and who will benefit in the aftermath. An overview of the Organization for Economic Co-operation and Development's (OECD) roundtables is provided. *Legal Insights* summarizes the changes in the Committee of Foreign Investment in the United States (CFIUS) review process, including the new regulations and guidance. This month *Cyber Conflict Perspectives* discusses global cyber security and information sharing.

Next month we will focus on maritime and port security. We welcome and encourage your ideas and thank you for your support.

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The Financial Winners of the Current Crisis

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In every financial downturn and depression, there are some who benefit in the recovery that follows. The regulations enacted after September 11th did an enormous favor for organized criminals and terrorists. It excluded them from the banking system and financial markets as regulations made it harder for bankers and financiers to take their money. Consequently, the criminals and terrorists were forced to remain in cash. Cash is now king. Therefore, many criminals and terrorists are now cash rich and well positioned to buy up assets and influence at bargain prices. They are the major beneficiaries of this financial crisis.

Selective regulation of the banking sector and financial markets led us to this ironic situation. Nearly a decade ago, much of the carefully conceived system of regulation of banks, insurance companies, and financial markets was dismantled. Yet, post-Patriot Act regulation tightened control on financial institutions in regards to receipt of criminal and terrorist capital. Bankers and investment houses understood that they faced enormous penalties and loss of reputation if they were caught laundering money. There were, however, very limited costs in engaging in business practices that threatened the international economy — selling sub-prime loans, securitized mortgages, and conducting risky derivatives trading without oversight. Therefore, they followed the perverse logic of existing regulation. Many formerly prudent banks, insurance companies, and financial institutions embarked on high-risk derivatives trading but went to great lengths to exclude suspicious capital. Banks and financiers complained about the administrative burdens attached to the requirement that they "know their client," but despite this, expanded their compliance departments. A new industry of firms emerged to meet this regulatory need of investigating rich potentially harmful clients. Expanded due diligence on clients kept many criminals and terrorists out of established financial institutions, often the very ones now most threatened in the financial crisis. Citigroup had learned earlier the enormous legal and reputational costs for laundering the money of Raul Salinas, the brother of former Mexican President Carlos Salinas.

The fact that organized crime groups were awash in cash was not lost on some in the law enforcement community. In 2007, $205 million in cash was found in a house in Mexico City, guarded by seven people. Its contents were believed to belong to drug cartels. This seizure of bulk cash was the largest, but U.S. law enforcement believe this was a small fraction of the cash moved back to Mexico in fake compartments of trucks, in the tires of cars moved across the border, and on the bodies of thousands of human couriers. In 2008, federal officials seized less than $1 billion of Mexican cartel cash, out of the estimated $18 to $39 billion of drug profits moved annually from the United States to Mexico.

The Mexican criminals are perfectly positioned in the rapidly declining Mexican economy. Migrants are returning home with no prospect of work, criminal violence has created great personal insecurity, and the Mexican state seems fragile. With their enormous cash reserves, Mexican criminals can buy workers, political influence, and depressed assets both home and abroad at bargain prices. In every crisis, some are winners — in the Mexican case it is the criminals.

The cash-rich Mexican criminals are not alone. Fortunately for the mafia, Italian prosecutors understood their opponents all too well. Prosecutors in Palermo could detect mafia forays into stocks and international financial markets. Past experience with seizure of real estate by Italian law enforcement made many mafiosi shy of investing in land and apartments. Consequently,

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Financial *(Cont. from 4)*

the mafia remained heavily in cash. In Italy, the liquid assets of the mafia and other key crime groups have placed them at an enormous advantage. With frozen credit markets, individuals seeking credit are often forced to seek loans from the mafia. As always, they are charged usurious rates. Legitimate business people are paying as much as 120 percent annual interest a year to stay afloat. Business is down and a loan from the mafia may be the first step towards mafia acquisition of the business. The mafia is perfectly positioned for growth with an expanding portfolio of businesses to generate cash and through which to launder money. In Italy, as well, the success in keeping organized crime out of financial markets has given them an enormous strategic advantage in this current economic crisis.

In Russia, not all organized criminals have profited. The ruble has fallen a third, the prices for oil and other raw commodities have fallen on world markets and businesses, even some mafia controlled businesses have slowed. Despite this fact, according to official Russian sources, Russians moved $200 billion out of the country between October 2008 and the end of January 2009. Not all is criminal capital but it points to the high liquidity of this highly criminalized economy. Unlike the Mexicans and Italian crime groups who are more often national and regional investors, Russian criminal elites are truly global investors. With their enormous cash reserves parked in safe havens, the Russian investors are poised to go on an international buying spree or to repatriate their cash and buy key assets at fire-sale prices as they did after the ruble collapse in 1998. As in Mexico and Italy, the crime groups will come out stronger from this financial crisis.

Is there a possible link between cause and effect? Is there a possibility that criminal actors contributed to this world-wide financial crisis in deliberate ways? Their opportunity to benefit is so large, one is ALMOST tempted to ask: Did the financial and mathematical expertise possessed by some powerful crime groups, cause them to engineer this financial crisis through their manipulation of derivatives markets, thereby enhancing the relative wealth of the cash rich crime groups?

One need look no further than Japan to see the impact that organized crime can have on financial markets. Japan, the world's second largest economy, suffered a lost decade in the 1990s. This decade was preceded by a financial situation that has parallels to the United States and the global economy of 2008 — hugely inflated real estate prices, a record high stock market, and banks weighed down by staggering amounts of bad debt.

The Yakuza, Japanese organized crime, were key players in the real estate speculation of the 1980s and an estimated 40% of bad loans were related to yakuza gangs and their front companies. Organized crime could procure these loans because of their powerful links to the banking sector. The Japanese example reveals that organized crime can help bring down a major economy even one as large as that of Japan. However, the Yakuza were not as global as much of contemporary organized crime two decades later. Therefore, when the Japanese economy sank, so did the Yakuza's fortunes. This is a problem not known by many of the truly global transnational crime groups operating today.

What are the lessons of Japan's lost decade, caused in part by the rapacious activities of Yakuza? What are lessons of partial regulation that excluded criminals and terrorists from the banks and financial markets that are tottering today? As we put back the world economic order, we need to consider that illicit actors are not peripheral figures but increasingly key players in the world's financial markets. Moreover, their power is even greater in countries where the state has little capacity to control organized crime. The most extreme case may be Afghanistan, where 80% of the economy, according to the former finance minister, is based

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TraCCC

Risks *(Cont. from 3)*

than impersonal markets for these tasks? Can we find a way to extend the size of face-to-face markets in order to cover larger risks?
2) What is the best way of dealing with panic in the market place and restoring trust among participants? Economic damage done as a loss of trust in the market is at least as big a problem as the potential damage done by terrorists themselves. Is there a better way of restoring trust after a fearsome disaster? ❖

Financial *(Cont. from 5)*

on illicit trade in drugs, timber, and antiquities. Domination of an economy by crime groups, criminalized warlords, oligarchs, and their state supporters is unfortunately not unique to Afghanistan.

Financial officials working to right the world's economy cannot isolate the problem of criminal capital from their overall strategies to repair financial markets. Nor can we afford to take a single state solution in regards to criminal capital. Federal officials intend to focus on the Mexican cartel's cash to stem their operating capital. This is an important first step, but the problem requires a much more holistic solution that focuses not just on the cash, but on those that facilitate the drug trade and even the high status individuals who launder its money. Moreover, efforts to fight the Mexican drug cartels must not be confined to U.S.-Mexico policy, but must be incorporated into larger efforts to control criminal and terrorist capital in the global economy, particularly in this crisis period.

To ensure that organized crime and terrorists do not benefit even more in this transitional period, we must do more than exclude criminal capital from financial institutions. The international community must try to ensure than criminals do not acquire key assets with their existing wealth or their predatory loans. They must be prevented from cornering the market on key raw commodities which will be in demand when the international community emerges from this global recession. Global economic policies must try to restrict access of crime groups to manpower which can be hired cheaply as desperate and displaced workers are ready to work for anyone, including criminals to survive. We must focus not only on the poor and the vulnerable, but also on restricting the rise of government officials to key positions whose careers have been advanced by criminal capital. The challenge we face from crime groups awash in cash is larger than just the buying power of this money. In this transitional period, this criminal capital will help determine the future allocation of international resources, the deployment of human capital, and the political leadership of key states.

Greater transparency of markets is needed to ensure that criminal capital does not again have a chance to be king. Regulations dismantled must be reinstated. Most important is ensuring that crime groups and criminals do not again have the advantage in international financial markets. Moreover, greater transparency is needed to ensure that sophisticated crime groups cannot bring down financial markets. Without focusing on transnational crime and corruption in the current financial crisis, organized crime groups will emerge even as greater threats in the post-crisis period. ❖