Illicit Financial Flows in Authoritarian States

When There is No Rule of Law

By Jodi Vittori

The COVID-19 pandemic is proving a boon for corrupt, authoritarian leaders and their cronies, allowing them to expand opportunities for crime and graft while curtailing oversight and accountability. Worldwide, Freedom House has assessed that democracy and human rights have deteriorated in eighty countries since the new coronavirus outbreak began.[1] The problem is at its worst in highly repressive states and weak democracies where safeguards on democracy already were insufficient.[2]

As many kleptocratic regimes use the pandemic as an excuse to clamp down on media and civil society freedoms, transparency, and accountability, it becomes all the more important to recognize the roles that authoritarian illicit financial flow hubs play in laundering ill-gotten gains.

At the same time, as Transparency International notes, the monumental influx of domestic and foreign resources provided to fight the pandemic have opened up more opportunities for rent-seeking activity and its deleterious effects. Meanwhile, governments often have even more discretion to allocate resources and funds with weaker transparency, accountability, and anticorruption oversight and enforcement mechanisms to provide checks on their behavior.[3] It is thus no surprise that according to the aforementioned October 2020 Freedom House report, respondents in 45 countries considered "corruption and money in politics" to be among the top three issues associated with the COVID-19 response.[4]

As opportunities for kleptocracy increase, efforts to expose and reform illicit financial flows focus usually—and often correctly—on financial centers situated in democracies. Those who engage in kleptocratic activity are assumed to prize the overall, long-term political stability that derives from consolidated democratic systems and rule of law. Consequently, they choose to store their wealth in banks in key financial centers such as London and New York, buy real estate in Miami and Paris, educate their children in the famed schools of the United Kingdom and the United States, and invest in businesses and sports teams throughout Europe and the United States.

Democracies are not the only destinations for kleptocratic wealth, however. Plenty of illicit finance networks span a variety of (semi) authoritarian states. Some of these states act as waystations for resources earmarked for final deposit in Western repositories, but others are financial centers themselves. As many kleptocratic regimes use the pandemic as an excuse to clamp down on media and civil society freedoms, transparency, and accountability, it becomes all the more important to recognize the roles that authoritarian illicit financial flow hubs play in laundering ill-gotten gains.

The journey . . .

Illicit finance hubs run by authoritarian regimes make attractive holding areas and destinations for illicit financial flows from fellow dictators. These authoritarian hubs have in some cases used their implicit willingness to overlook questionable transactions to attract investment in their countries. Without a free press, robust legislative oversight, or independent institutions, there are few checks to prevent kleptocratic actors from further taking advantage of these authoritarian hubs' deliberate weaknesses. Without the rule of law, it is all the more difficult to hold elites accountable for engaging in or encouraging illicit financial flows, not least because of the lack of extradition treaties and sovereign immunity for many of those involved.

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Sometimes, individuals in the highest circles appear to demonstrate their country's willingness to launder elites' ill-gotten gains. For instance, members of the royal families of Saudi Arabia, Kuwait, and the United Arab Emirates reportedly helped launder funds from the Malaysian 1MDB (1Malaysia Development Berhad) scandal through their sovereign wealth funds and state-owned enterprises, apparently with help from certain Western banks.[5] Chinese officials then allegedly offered to help bail out the Malaysian prime minister at the center of the scandal, Najib Razak, in return for Chinese stakes in various railway and pipeline projects—a charge the Chinese government denies.[6] It is vexingly complicated to investigate such allegations when those involved are high-level political and financial actors based in a multitude of settings.

Or, take the example of the so-called Moldovan Laundromat. Moldova is the poorest country in Europe, and yet between $20 billion and $80 billion allegedly were laundered through its banks from 2010 to 2014.[7] According to reporting by the Organized Crime and Corruption Reporting Project (OCCRP), shell companies were created in the United Kingdom, Cyprus, and New Zealand in which a fake "lender" company would use a Moldovan court to collect debts from a defaulting fake Russian "debtor." The Russian shell company would then allegedly wire the money through a Moldovan bank to accounts of the "lender" in a bank in Latvia; from there, the funds were wired to 5,140 companies in 96 countries. Although the United States, United Kingdom, and European Union could have done more to help prevent this immense theft, it nonetheless demonstrates how weaker jurisdictions like Moldova and Latvia can be used for massive money laundering scenarios.[8]

. . . Or the destination

Authoritarian states that act as willing nodes in illicit laundering networks may also at times be a destination themselves. Those that are best suited for this role often are locales that can be desirable places for those with means, where both kleptocratic elites and the gatekeepers they rely on are willing to take up residence. They are both trade and financial hubs, enabling both illicit finance and trade-based money laundering networks to easily and efficiently overlap and intermingle.

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One illicit finance destination in particular stands out today: the United Arab Emirates (UAE). It has a long history of dubious trade and financial activities. For instance, its lucrative property market is a haven for those who might use real estate to launder illicit finances, and its more than two dozen free-trade zones operate with minimal regulatory oversight or customs enforcement activity.[9] At the same time, it is also in deep financial straits, not just from the pandemic, but also from preexisting structural weaknesses. The UAE was already suffering from low oil prices just as the COVID-19 pandemic hit its tourism, trade, and finance sectors. As a result, the International Monetary Fund expects its economy to shrink by at least 6 percent this year.[10] In the post-pandemic world, the UAE may thus be especially susceptible to the temptation to look the other way if various forms of illicit resources and associated corruption were to attempt to flow in.

The UAE is currently undertaking anti-money laundering reforms in order to comply with the standards set forth by the Financial Action Task Force, which had placed the country on its grey list as a major money laundering haven. Despite these efforts, money laundering-related scandals have continued during the pandemic. For example, Bulgarian investigative reporters found highly questionable trade between Bulgarian companies associated with senior political figures and personal protective equipment (PPE) shipments from the UAE, whereby Bulgarian foodstuffs had been traded to the UAE for what was supposed to be fifteen tons of PPE instead of the mere three tons that was actually delivered.[11] Meanwhile, a Reuters investigation has demonstrated how oil tankers registered in UAE's Fujairah free-trade zone in 2019 have been shipping Venezuelan oil despite sanctions since summer 2020, thereby helping to prop up Venezuelan President Maduro's regime. The Fujairah Free Zone Authority's director general noted that, while the free zone will provide beneficial ownership information if specifically requested by law enforcement, the free zone was not responsible for monitoring the activities of companies registered there.[12]

Dubai, the financial, real estate, and trade capital of the UAE, is expecting an especially rocky economic path in the coming years. It never fully recovered from the 2008 financial crisis, and the fallout from the COVID-19 pandemic is expected to cause the city's economy to contract by 11 percent this year.[13] These vulnerabilities have not gone unnoticed. As the *Economist* recently summed up, "Of all the big global financial centres, [Dubai] is the shadiest—not only a haven for clean money seeking investments or fleeing turmoil elsewhere, but also for the dirty stuff. It is used by kleptocrats, money-launderers, arms-smugglers, sanctions-busters and other criminals."[14] Yet, Western governments often have ignored some of Dubai's myriad shortcomings because it is an important regional hub for Western businesses. In addition, it has perhaps the most competent military in the region, and as such the UAE is considered a bulwark against Iran. Unsurprisingly, the "Little Sparta"—to use the phrase coined by General Jim Mattis, then the head of U.S. Central Command[15]—is considered an important regional security partner for the United States and United Kingdom in particular. Any possible crackdown on potentially kleptocratic activity in the UAE might easily have unintended repercussions for regional economic, political, and military stability in the Middle East as a whole.

The publication of the recent so-called FinCEN Files, exposing suspicious activity involving major international financial institutions, has led to calls from politicians and civil society alike in democratic financial centers to clean up the global anti-money laundering system.[16] Efforts are rightly focused on apparent gross malfeasance by major U.S. and European banks. Yet, in the process, the role of banks and businesses in places such as the Gulf States and in Eastern Europe must be kept in view. Popular pressure to clean up these financial and business centers will be more difficult because their authoritarian governance limits bottom-up pressure to push for much-needed reforms. It is difficult for investigative journalism or government agencies to shine a light into the affairs of states that routinely intimidate and arrest the media and civil society. Often, these states are also important security partners for Western countries, allowing them a "pass" on many illicit financial flow controversies.

Thus, as financial centers in democracies debate how to respond to the clear breakdown of the global anti-money laundering system, how to respond to illicit financial flows in authoritarian states must be part of the conversation.

Thus, as financial centers in democracies debate how to respond to the clear breakdown of the global anti-money laundering system, identifying a response to illicit financial flows in authoritarian states must be part of the conversation. Democracies must strengthen their own anticorruption and anti-money laundering institutions to minimize their attractiveness as a destination for dictators' corrosive wealth. It also means that democratic, rule-of-law states will need to make curtailing illicit financial flows from authoritarian states an important foreign policy priority. This should include a combination of isolation and threat mitigation for states where there may be little hope of substantial, domestically-led reform efforts. If democracies are serious about minimizing democratic and economic backsliding as a result of the COVID-19 pandemic, then the ability of authoritarian elites to benefit from the financial flows associated with the global response to the new coronavirus must be reduced.

Endnotes

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