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Financial enmeshment – banking systems in Western, and Central and South-Eastern Europe

The interacting factors of anti-money laundering, the rigours of transitional economy, and the underground illicit economy

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Abstract

Purpose – The purpose of this paper is to analyse the banking systems in Western, and Central and Southeastern Europe, focusing on the interactive factors of anti-money laundering, transitional economies and the underground illicit economy.

Design/methodology/approach – Provides a comparative analysis of the banking systems in Western, and Central and Southeastern Europe.

Findings – The transition economies of central and Southeastern Europe face, and have been confronted for over a generation by, the interlinked problems of the transition stage post-1989, the alternative or illegal economy, and the vulnerability of banking systems to money laundering. In contrast, by the 1990s, Western European central banks have become established as an essential government organ in macro-economic policies.

Originality/value – Suggests an interesting lesson that might be gained from the experiences of central and Southeastern Europe and anti-money laundering since the late-1990s, where a national bank or central bank has not been essential, indeed has been comparatively unimportant, compared to the developed banking system led by the individual banks.

Keywords Financial institutions, Banking, Money laundering, Europe

Paper type Case study

> History unfolds at a pace which leaves one breathless and renders writing at speed useless.

This quotation was that of a solid and reliable historian in the 1960s whose work of XX century history up to the 1950s were a tour de force in terms of interpreting the cataclysmic events of the XX century and making the events both intelligible and simplified and understandable. His works appealed to scholars and popular readers alike. His judgement would be fully appropriate to the events of the 1980s the 1990s and the post 9/11 events. With the constant fluctuations and changes this paper will avoid political divisions and national terms, and will use the general terms "Western" and "Central and South-Eastern" Europe, a convenient division of the varying sizes of the EU and the old Soviet bloc and transition economy states, all of whom face, and have been confronted for over a generation by, the interlinked problems of the transition stage of their economies post-1989, the alternative or illegal economy, and the vulnerability of banking systems to money laundering.

Journal of Money Laundering Control
Vol. 9 No. 1, 2006
pp. 89-98
© Emerald Group Publishing Limited
1368-5201
DOI 10.1108/13685200610645247

Within Central and Eastern Europe up to and beyond the events of 1989, the central bank and the banking sector had a significant role, in terms of regulating the economy, and ensuring enough funds-or credit-was available to the regime. The general absence of a strong central bank in the pre 1989 era within Central and Eastern European countries was itself partially due, paradoxically, to a modernistic trend. Within these countries the central planners were no strangers to international capital markets, and were by no means ideologically constrained to engaging in international capitalism. The USSR, Poland, Hungary, the federal government of Yugoslavia, and in the late-1980s Bulgaria, – all participated in the syndicated loan market, consisting of combined international borrowing of fixed term loans from western capitalist regimes. (The German Democratic Republic or East Germany, was the exception; it preferred to obtain bi-lateral credits from the German Federal Republic.) This policy was necessary in as an attempt to sustain domestic levels of consumption, in the face of ever increasing investment markets having to be fuelled by simultaneously and steadily decreasing productivity of gross domestic capital available in the 1970s and 1980s. The financial vehicle utilised by these countries to engage in these international capital markets was the individual country's foreign exchange bank, which carried out both the financial instruments and decided upon the mid term financial policy. Therefore, to some extent the central banks of central and eastern Europe were sidelined by the role of the country's foreign exchange bank(s) in this vital role of gaining mid term credits on the international capital markets. Within the overall economic development of the countries of Central and South-Eastern Europe the banks and banking systems were particularly crucial in the 1980s. The dilemma of Central and Eastern European banks during this period was that they were caught up in the responsibility to exert more sway over the regulation of the economy in their position as the increasingly important provider of credit. However, this increasing economic regulatory responsibility involved refusing further riskier and uncertain credit and in doing so put all existing loans at risk and retarding all development. Individual banks faced this macro economic dilemma without the guidance of a strong central bank. It was a dilemma faced by nearly all large-scale banking institutions in Central and Eastern European countries, and resulting in untrammeled credit flow. The opening up of capital markets in emerging economies must be carried out in a careful and well-sequenced manner if countries are to benefit from closer integration into the global economy. In the early-1990s, with central and South-Eastern Europe wide open to entrepreneurial initiatives, and economic atavism from a myriad of international small businesses, capital flow and enterprise flourished. But it was unsupervised, with financial regulatory organisations and agencies only formed in the new regimes only years later. As such the new developments, economically beneficial in the short term, were fully vulnerable to financial crime and money laundering.

In terms of central banking, the case of the former Federation of Yugoslavia is instructive. Authorities such as Lampe traced the traditional banking alignments and a potential central bank in Yugoslavia. He pointed out that during the early as the period 1919 up to 1930, the central bank was used by the Serbian government to alter and manipulate Serb/Croatian currency rates of exchange in a 5-1 imbalance in favour of Serbia. Coming forward in time, Lampe continues by pointing out that from 1956 onwards the Yugoslav Investment Bank based in Belgrade, handled the Yugoslav government's national investment funds. Tracing further forward in time, in 1965, he points out that, still the issue remained of whether the major banks operated upon commercial principles, or whether they, "catered" to the demands of the Serb republic amid its federal hegemony. In this there were the three largest Belgrade banks, Investment Bank, Foreign Trade Bank and Agricultural Bank who had no worthy commercial competitors, and enjoyed a near-monopoly of state assets. Finally in 1987 the IMF as part of relief package deal, requested the federal government to assert central control over the money supply, and enforce bankruptcy regulations, revealing how, a true federal central bank of the whole of Yugoslavia, had not yet been established. Indeed the situation had grown whereby the central bank was a tool for Serbian dominance, causing hostility in the other parts of Yugoslavia. By 1987, according to Lampe:

> ... the Belgrade location of the only institution capable of such control, the National Bank of Yugoslav, guaranteed resistance from the western republics.

This serves as an example of the type of central bank in Central and South-Eastern Europe, which was perceived as a symbol of centralised financial federal oppression and in doing so exercised a strong but stultifying influence upon the banking system. How much of a constraining, or supervisory role, this influence is remains a different question. After the civil wars, and the eventual break up of Yugoslavia, Croatia attempted to regulate the banking sector from the start of its existence as a nation state. It attempted this by having the Central Bank separated from another governmental body, the Bank Rehabilitation Agency. This agency was supposed to maintain financial and economic intelligence regarding the development and recovery of the banking system and failing banks. However, this role of enacting in tandem with the Central Bank resulted in an ambiguous situation, conflicting roles and resulted in policies of hesitation. One of the long terms results was individual banks having much independence of operational practices. This independence led to some unorthodox banking practices and operations-by Western European standards and certain banking institutions became vulnerable to criminal exploitation.

Another interesting example of banking systems in central and South-Eastern Europe is afforded by Hungary. Hungary, together with the Czech Republic, and Poland, in 1996 accounted for no less than 68 per cent of the entire incoming foreign direct investment – originating on a global scale from Europe Asia and the USA – of the all Central and Eastern Europe. Indeed even by 1989 Hungary was in the fortunate position whereby the general economic reforms and economic positivism of the 1970s and 1980s had led to the establishment of many financial institutions generating economic practices of a wider market economy. These institutions had been particularly successful in converting and transforming state enterprises into joint stock companies. The whole achievement of a wider market economy by 1989 was due in no small way to development of political reforms in this 1970s being strongly tied to economic reforms, which included reform and streamlining of its banks in the late-1980s. By 1995, of the entire global nations Hungary was in eighth position of the ten developing countries in terms of largest amounts of foreign direct investment. Yet Hungarian government of the early-1990s failed to accommodate and deploy such an increase in circulating capital to good economic effect, partly by failing in economic reforms, at the very period when such a boost was needed to maintain Hungarian primary economic position amongst potential aspiring EU states. Moreover, such comparatively sudden intensive periods of large amounts of circulating capital is economically inflationary, and also affords many opportunities for money laundering and illicit transfer of large potentially criminal monies.

Hungary by the early-1990s established a central bank and its role was officially designated as an essential component, and generator of advancing the economy. This was carried out by regulating the overall amounts of circulating domestic capital and by regulating the banking sector. Regulation of the banking sector in Hungary at comparatively early stage in the post-1989 era an interventionist and supervisory role in co-operating with law enforcement in anti money laundering measures.

These two examples of banking in Central and South-Eastern Europe have not been made from a specialist banking point of view. They have been outlined, through two differing countries of Central and South-Eastern Europe in order to emphasise the importance but varied fundamental role of the central bank, in accordance with economic conditions in the immediate post-1989 era, for regulating the economy, and for sheer *raisons d'etat.*. Both example countries and indeed all of Central and South-Eastern Europe had a significant unofficial, or alternative economy operating in parallel, causing adverse and unpredictable fluctuations in the economy, rendering impossible intervention by the central banks in macro-economic regulation.

The "alternative" or, "second" economy within the European Union tends to relate to unofficial or untaxed labour, or illegal goods. underpaid, and unregulated, working for the mainly in the service industries or the manual construction and building trades, and the various forms of sex industry. A large proportion of the individuals involved within the EU are illegal immigrants, to whom unregulated and unregistered employment is essential for concealment of their illegal presence in the country. In the case of the European Union, such an illicit labour sector has advantages in that the entrants are gainfully employed, albeit grossly underpaid, and a certain proportion of such illegals are tacitly accepted by the state. Also the use of such labour covers and solves certain short-term labour shortages, i.e. in certain types of agricultural harvesting or certain building and construction projects, enabling business and state alike to gain a temporary boost in competitiveness. In Central and South-Eastern Europe the importance of the second economy can be viewed in Rose citing an individual to ensure him or herself in a position whereby income was obtained by a regular wage combined with money earned in the unofficial shadow economy as the most important priority of a Hungarian in the immediate post-1989 Hungary. Bafoil, taking a long-term view in 2002 starkly divides those transition economies into two. These are those who have efficient units of production, and were able to function within international economic rules, and those whose production units were dependent upon irregular, clandestine production and engaging in the international irregular or second alternative economy. An illegal or second economy of necessity is dependent upon the circulation of illegal monies, i.e. monies that should have neither been invested for services given, nor taken for unregulated services performed. In this context it sits under the overall umbrella of financial crime. Paradoxically financial crime, as a whole, does not have the objective of irreparably damaging the economy; indeed it may be argued that it is in the interests of organised financial crime to maintain a comparatively strong economy in order that lucrative gains can be made from individual crimes, yet such losses still remain comparatively obscure within the overall macro – framework of a strong and vibrant economy.

There were differences between the alternative economies within the European Union and alternative economies within Central and South-Eastern Europe. One difference was that, within Central and South-Eastern Europe such illegal employment is engaged in, for the most part by the country's own populace, and there are few illegal immigrant elements. Any foreign workers are principally migrant workers from other central and eastern European countries. Secondly, in many cases the particular economic sector concerned, or even the transition economy itself, is dependent upon such unofficial labour. Indeed, unless the situation is recognised early by governments, a vicious circle can ensue, whereby as economies slide into decline, state enterprises become increasingly less able to guarantee the expected current norms of wages and benefits, and workers direct their efforts more and more to the second or alternative economy; taken to its extreme development, the very credibility and legitimacy of the state is called into question by the very economic workers on whose allegiance the state is dependent.

Hungary and Poland during the 1980s recognised the importance of a second economy as means to maintain stability, or at least prevent a sharp decline in overall standards of living. In the 1980s Hungary tacitly accepted the existence of the alternative market whilst enjoying the success of her tentative small moves towards a free market economy, and expanding her output accordingly. By 1983 it was estimated that 16-18 per cent of the total domestic income generated was due to the unofficial or alternative economy. This was prevalent in the agricultural and construction sectors, where between 32-37 per cent of product in both sectors was due to the unofficial labour force In the case of Croatia, political dictates in the post independence period meant that the shipyards of Rijeka, formerly part of the a major global shipbuilding complex in the era of the Yugoslav Federation, were retained with grossly inflated employment levels, even though production and demand within the nascent Croatian state entrepreneurs who gained favourable concessions from the Tudjman government meant that production could only be maintained to meet demand with the use of unofficial labour.

Within Central and South-Eastern Europe the unregulated labour sector become vulnerable to criminal exploitation, or even criminal monopolies which arose in terms of employment placing-or even fictitious employees whose regular pay is, "skimmed" by organised crime. Such a criminal control may even lead to an overall control as whether that particular business or even the entire economic sector functions efficiently. In the 1990s for example senior Hungarian law enforcement officers became extremely concerned due the fact that one organised crime group had insidiously gained control of many of the ancillary defense services, such as supply companies, manufacture of small but essential military equipment, to such an extent that the entire Hungarian land defense forces would not be able to function.

The implications for the central bank institutions in Central and Eastern Europe, were that the existence of an alternative economy meant that large amounts of circulating monies remained uncalculated in terms of potential government revenue, and cannot be factored in the calculation of capital generation and investment into various economic sectors. For its role within the state, macro economic capital planning and regulation by the central bank is difficult. Also an unregulated alternative economy means a hidden amount of circulating capital, whose flow and fluctuating amounts are unregulated. This can be exploited for criminal purposes, both utilising criminal monies and eventually laundering sums of monies after they have been transacted discreetly several times, and re-surface in the regular economy as consumer spending or legitimate bloc investment. For the central bank, and indeed the banking system, the very existence and extent of such large sums of monies is undetected until they come to light as part of the regular economy. Therefore, not only the very existence of large sums of criminal monies remains unknown, but also the movements and transfers are unknown, and the sums only come to light at the reintegration stage.

Any attempt to or approach the issues or assess the transition economies of central and eastern Europe and anti-money laundering efforts within the banking systems must take into account several essential factors. These are, firstly, – and to return to the bewildered historian of the 1960s, – the simple basic time scale of political and economic change. The second is the economic development of the Central and South-Eastern European countries. This economic development forms an essential backcloth when regarding and viewing those countries in implementing the anti-money laundering procedures, both as part of the domestic law enforcement policy, and as part of adopting EU standards and regulatory procedures as part of the those countries joining and becoming integrated into the expanding European Union. The third is those very anti money laundering policies, and how they are subject to near automatic assumptions of what are the accepted norms and criteria. These norms and criteria for such anti money laundering regulatory measures are essentially defined according to Western European, or pre-25 Member States European Union standards and assumptions; they may not be automatically applicable or feasible to transition economies of Central and South-Eastern Europe.

In practical terms, the second essential factor, the contrasting time scale between Central and South-Eastern Europe, and Western Europe is the simplest yet most important point in making a valid judgement on the anti money laundering progress of Central and South-Eastern Europe. The period of transition in central and eastern Europe banking institutions themselves evolved in terms of the composition of international financial flow. Indeed, it was the transition process itself which was one cause of the radical composition of both the volume and composition of external (international) capital flows. During this period, the late-1980s and the early-1990s syndicated bank loans were reduced from 55 per cent of the international borrowing to 20 per cent, by 1996. This was combined with an increased reliance on bank lending over the same period as greater for emerging international market borrowers, including business enterprises in central and eastern Europe resulting in direct lending and disintermediation of international banking sector. There was a decline in importance of traditional bank lending policies during the period 1985-1994, leading to an overall tightening of deterioration of credit quality and credit rating of financial institutions, in relation to potential corporate borrowers. This meant that at the very period when central and eastern European banks were aspiring to increasingly engage in international capital flow markets, usually as lending intermediaries, the credit rating issuing criteria of banking institutions were tightened. This in turn, by increased demand for international investment credit, particularly to transition economies, resulted in a strengthening of borrower incentive to access international capital markets, or, in short term adverse economic times, a reversion to heavy bank borrowing. Banking institutions themselves became lenders of next to last resort, requiring in turn the central bank to be available to be available to reliably fulfil the role of lender of last resort. In the assessment of Gros and Steiner, in a 2004 evaluation, 15 years after 1989 and the break up of Eastern Europe, Central and South-Eastern European basic banking systems still require to a certain extent to be reconfigured and strengthened as much as possible in line with their Western European counterparts.

By contrast, the work and supervisory role of the central bank within the European Union has been enhanced and assisted by the measures taken as far back in time as the 1970s and 1980s to establish international standards in banking practice. This came about of necessity, caused by a series of banking crisis. These were the Bankhaus Herstatt crisis in 1974, Shroeder Munchmayer Hengst in 1983, of Banco Ambrosiano in 1982-1983, of Johnson Matthey in 1984 and of BCCI in 1989-1991. This series of crisis involved literally millions of losses, and highlighted uncertain areas needs and banking anomalies, particularly those raised by BCCI. They were rectified by a series of measures on an EU basis consisting of the First EU Banking Directive 1977, the ground breaking Second EU Banking Directive 1989, the Directive of own Funds and Directive on Bank Solvency from 1986-1989, the Deposit Guarantee Schemes and Monitoring of Large Risk Exposure Recommendations 1989. Collectively, these resolved and regulated responsibilities of parent bank and foreign located subsidiary bank limits of risk exposure, capital adequacy, transparency of ownership, and numbers of directors required for collective action and bank policies. Together, centering on the monumental Second EU Banking Directive, they built a framework of standardised banking practices throughout the European Union. The Second EU Banking Directive paved the way for single banking license, which would authorise financial institutions to begin and operate banking services and banks in any EU Member State. With such a framework, the tasks of the differing national central banks supervising their respective national banking practices was greatly facilitated. Standardisation of transaction reporting systems and financial intelligence exchange could be based on a European Union wide bedrock of standardised banking operational practice. All these pan EU Directives on the banking system were added to by the ground breaking EU Money Laundering Directive of 1991. This is viewed as:

> ... part of the European Union's contribution to efforts to prevent the spread of drug trafficking and organized crime in general, though it is not overtly a security measure, but one designed to protect the Union's financial market.

The Directive imposes certain obligation, via the national legislation of EU Member States. Enhanced by further Directives it laid down provisions concerning customer identification, reporting suspicious transactions, general standards of due diligence, regular training sessions by financial institutions and the designated Money Laundering Reporting Officer. Later all the anti money laundering provisions were extended to principal non-banking institutions. Such institutions are auditors, external accounts supervisors, estate agents, the legal profession, dealers in high value goods such as precious metals, gold, and casinos.

The role of Western European central banks is clear. By the 1990s Western European central banks have become established as an essential government organ in macro-economic policies. Indeed it has been necessary to differentiate between the instrumental independence of the central bank which must be total and is fully essential but, "goal independence", (that is formulating and shaping policy), is not.

Their principal role is that of economic advisor to the government of the day, regulating the macro flow of monies on a national and international basis. However, there is, "a crucial prohibition" against central bank lending to government, centrally and locally. They can purchase government securities in international markets but strictly at market rates for monetary as a counter balance to monetary trends, to regulate or generate the macro international money flows. A second important role is that of and overall economic regulatory role over the banking system and the responsibility to law enforcement for ensuring the banks comply with reporting and anti money laundering procedures and obligations, including the banks' operations and business relations with those sectors and professions falling under the Second EU Money Laundering Directive. In this role, their impartiality as an institution, and their functional independence, must be free from internal political and/or governmental interference. It has been found that central bankers operate best in institutions which have a clear objective and are held accountable to the public. Such independence is necessary for banking supervision, and for the means to control either the quantity or the price of the money. As the optimal central bank independence is higher, the higher the natural rate of unemployment, smaller the variance of productivity shocks. Therefore, for both supervisory and regulatory purposes, and for the overall long-term economic factors, central bank independence is essential. Such independence with Central and South-Eastern European countries during this period was singularly lacking.

These are the issues surrounding the changing role of the central bank. They are essential considerations in the background to the development of Central and South-Eastern European banking systems in the context of contrast with Western Europe, or the pre 2005 European Union. Within central and Eastern Europe throughout the post-1950 up the events of 1989, the central bank and the banking sector had a significant role, in terms of regulating the economy, and ensuring enough funds – or credit – was available to the regime.

Within the overall economic development of the countries of Central and South-Eastern Europe the banks and banking systems were particularly crucial in the 1980s. The dilemma of Central and South-Eastern European banks during this period was, that they were caught up in the responsibility to exert more sway over the regulation of the economy in their position as the increasingly important provider of credit. However, this increasing economic regulatory responsibility involved refusing further riskier and uncertain credit and in doing so put all existing loans at risk and retarding all development. Individual banks faced this macro economic dilemma without the guidance of a strong central bank. It was a dilemma faced by nearly all large-scale banking institutions in central and eastern European countries, and resulting in untrammeled credit flow. It is established that the opening up of capital markets in emerging economies must be carried out in a careful and well-sequenced manner if countries are to benefit from closer integration into the global economy. Hungary, for example, together with the Czech Republic, and Poland, in 1996 accounted for no less than 68 per cent of the entire incoming foreign direct investment – originating on a global scale from Europe Asia and the USA – of the all Central and Eastern Europe. Indeed even by 1989 Hungary was in the fortunate position whereby the general economic reforms and economic positivism of the 1970s and 1980s had led to the establishment of many financial institutions generating economic practices of a wider market economy. These institutions had been particularly successful in converting and transforming state enterprises into joint stock companies. The whole achievement of a wider market economy by 1989 was due in no small way to development of political reforms in this 1970s being strongly tied to economic reforms. By 1995, of the entire global nations Hungary was in eighth position of the 10 developing countries in terms of largest amounts of foreign direct investment. Yet, as will be pointed out in the chapter on Hungary, the government of that period failed to accommodate and deploy such an increase in circulating capital to good economic effect, partly by failing in economic reforms, at the very period when such a boost was needed to maintain Hungarian primary economic position amongst potential aspiring EU states. Moreover, such comparatively sudden intensive periods of large amounts of circulating capital is economically inflationary, and also affords many opportunities for money laundering and illicit transfer of large potentially criminal monies.

The general absence of a strong central bank in the pre 1989 era within central and eastern European countries was itself partially due, paradoxically, to a modernistic trend. Within these countries the central planners were no strangers to international capital markets, and were by no means ideologically constrained to engaging in international capitalism. The USSR, Poland, Hungary, the federal government of Yugoslavia, and in the late-1980s Bulgaria, all participated in the syndicated loan market, consisting of combined international borrowing of fixed term loans from western capitalist regimes. (The German Democratic Republic or East Germany, was the exception; it preferred to obtain bi-lateral credits from the German Federal Republic.) This policy was necessary in as an attempt to sustain domestic levels of consumption, in the face of ever increasing investment markets having to be fuelled by simultaneously and steadily decreasing productivity of gross domestic capital available in the 1970s and 1980s. The financial vehicle utilised by these countries to engage in these international capital markets was the individual country's foreign exchange bank, which carried out both the financial instruments and decided upon the mid term financial policy. Therefore, to some extent the central banks of Central and South-Eastern Europe were sidelined by the role of the country's foreign exchange bank(s) in this vital role of gaining mid term credits on the international capital markets.

Time and macro-economic circumstances have not favoured those transition economies of Central and South-Eastern Europe, therefore their efforts in anti money laundering by their banking systems should not be judged harshly. During the compressed time scale of the late-1970s and 1980s European Union banking reform and standardisation was achieved in a short period of two rushed decades, and European Union law enforcement efforts against financial crime and money laundering radically intensified. Each of these progressive trends exerted more responsibility and pressure on the banking sector and involved the Central Bank. In Central and South-Eastern Europe this same progress was not and could not be emulated. In the experience of these countries the role of the Central Banks in anti money laundering remained negligible. It would be unfair of posterity to expect any other.

Most of these countries have since the late-1990s, or the late transition economy period, made substantial progress in the field of anti money laundering. Such progress has been mainly achieved by the development of a comparatively stable banking system, which consisted of innovative individual banks, which enjoyed economic power with anti crime responsibility. In this process a National or Central Bank has not been essential, indeed has been comparatively unimportant compared to the developed banking system led by the individual banks. Perhaps this is an interesting lesson that may be gained from the experience of Central and South-Eastern Europe and anti money laundering during this period.

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