

High time to revive the domino theory

By Stefan Fölster

One democracy after the other is undermined or falls victim to authoritarian schemers. These cabals have overwhelming incentives to weaken the rule of law in further countries around the globe. Potentially the new domino effect threatens to put an end to the short history of democracy.

During several decades after the second world war the Soviet Union brought a growing number of countries under its sphere of influence, often by supplying arms to sympathizers. Fear of this domino effect subsided as communism collapsed under its own insufficiencies. Many argue today that the anxiety was overblown.

Really? The new rulers in many formerly communist countries may have shed reckless ideology. Instead they often take corruption to a new level, not just to enrich themselves but also to ensure loyalty from cronies. Yet these new kleptocrats face a challenge. If they were to lose power they would probably be disowned and put on trial. Therefore, they need to move their loot to other countries, preferably western democracies with deep and free capital markets.

Many western countries are putting up obstacles in the form of laws against money laundering and bank secrecy, or even sanctions such as the Magnitsky laws. The keystone of the European system remains the Third Anti-Money Laundering Directive, adopted in 2005, which requires financial operators and some non-financial operators – the so-called "gatekeepers" – to report any suspicious or unusual transactions or activities. The Directive incorporates into EU law the revised Forty Recommendations of the Financial Action Task Force (FATF), which in some ways remains the international standard setter in the fight against money laundering and terrorist financing.

Sweden has been slow to respond. But in recent years a new legal framework to prevent money laundering has come into effect and funding has been bolstered at Sweden's financial supervisory authority.

Still, democracies' response is too little too late. Kleptocrats' aim is to slow down or reverse new regulation and to open up alternatives. In fact, they are succeeding.

Most famously they influenced the US election that put Donald Trump into power. Less noticed, Russian agents were recently tried for instigating a coup in Montenegro that nearly succeeded. There is proof or inquiries into Russian financing of the rightwing populist parties in Austria, Germany, France, Italy, Hungary as well as the Brexit movement in Britain. Leftist parties also receive support. Russian trolls do well in social media. Even mainstream media in Europe and the US regularly fall for the Russian narrative.

When the United States and the EU finally agreed on sanctions, they carefully engineered them to concentrate pressure on the key decision-makers in Moscow while leaving Russia's energy exports to Europe intact. The early sanctions, enacted in the initial months of 2014, targeted influential individuals around Russian President Vladimir Putin and their preferred financial institution, Bank Rossiya. As Russia moved deeper into Ukraine throughout 2014, the campaign intensified, with the United States, the EU, and other allies passing new sanctions limiting Russian access to international debt and equity financing.

While the west is gradually reacting, the kleptocrats are successfully opening another route that is less vulnerable to western sanctions. An important part of this strategy is that Russia has developed its own system for financial transfers, NSPK, that would protect it from a potential shutout of the SWIFT global transfer system in the event of harsher U.S. sanctions. SWIFT, the Society for Worldwide Interbank Financial Telecommunication, is a global financial network that enables high-value cross-border transfers among its members. Most interbank messages are transferred using SWIFT, which links more than 11,000 financial institutions in over 200 countries and territories. Based in Belgium, the cooperative has in rare instances disconnected countries' banks from its network as a tool of financial sanctions — notably on Iran in 2012, which was consequently denied access to billions of dollars in revenue.

As an extension of Russia's independent payment structure, a new bank card, known as Mir card, allows Russians to pay independent of western payment structures even in foreign markets where Russian nationals live and travel. NSPK said Turkey's Isbank had started accepting Mir cards, and it is operational at some banks in 11 other countries already. Mir cards currently make up more than 20 percent of Russia's bank card market, and there is now a "Mir Pay" smartphone application available on Samsung Pay.

While these independent payment structures make the Russian economy somewhat less vulnerable to western sanctions, their import is huge for Russian kleptocrats. They can now move funds with little worry of being monitored or constrained by regulation in western countries to the new centres of international finance that can easily swallow billions of stolen dollars such as Hong Kong or Singapore.

Similarly, the Chinese have developed an Alternative Global Payments System (CIPS). Another burgeoning payment system competitor is Ripple Inc., a company that aims to revolutionize the cross-border payment space using blockchain technology, enabling transactions to be carried out faster and with fewer fees involved. The launch of products such as xRapid is geared towards improving transactions between banks. Over a hundred SWIFT-connected banks including the likes of the Spanish bank Santander have already deployed the xCurrent product offered by Ripple. The sanctions imposed by SWIFT on countries such as Russia and Venezuela have pushed those countries to find alternatives, especially with cryptocurrencies. Venezuela has now become one of the most popular cryptocurrency-friendly countries in the world.

Autocracies are not only testing SWIFT alternatives, but are building their very own autonomous internet, which also allows kleptocrats to operate with less risk of being monitored. Russia aims to free Runet, its domestic internet from the global network, allowing disconnecting itself from the internet whose good portion is US-owned. What Russia wants to do is to bring those router points that handle data entering or exiting the country within its borders and under its control- so that it can then pull up the drawbridge, as it were, to external traffic if it's under threat – or if it decides to censor what outside information people can access. This is similar to the impenetrable Chinese firewall, a highly effective censorship tool.

In theory Chinese are not allowed to transfer money out of the country. In practice, China leads the world in “illicit capital flows”. Rich Chinese are estimated to have exported a stunning \$1.4 trillion between 2002 and today; while Russia, with \$800 billion hidden outside the country, is runner-up. So much money is fleeing China — \$10 billion a month — that it's distorting the global economy, particularly in the art market and with real-estate booms in cities like New York.

Some Chinese money launderers fall foul of the government, such as the politician Bo Xilai, convicted for bribery and corruption and his wife for murder. But the well-connected are not affected. The Chinese parliament, the National People's Congress, has more dollar billionaires than any other parliament in the world. For most of these money laundering remains easy. Apart from bribing a bank, some of the most straight forward methods are the following. Macao has a casino industry with six times the gaming revenue of the Las Vegas Strip, and Hong Kong has obliging banks. In China, the cash doesn't have to go to the casino because intermediaries called “junkets” will swap Yuan for gambling chips that can be cashed into Hong Kong or Macao currency at the casino, then wired by Hong Kong banks to other countries, typically a US trust managed by a shell company in Grand Cayman, owned by another trust in Guernsey with an account in Luxembourg managed by a Swiss banker who doesn't know who the owner is.

Alternatively, a Chinese can use a master or visa credit cards for purchasing luxury goods and then cancel the transaction by asking the vendors to return money in USD into an account with a Cayman insurance company in their own name, or perhaps their children. Chinese customers don't have to travel abroad to swipe their credit cards.

Money Swaps are also easy. For example, if a Chinese wants to invest a certain amount of USD in the USA, he can give the equivalent amount of RMB in China to a person who needs RMB and that person will transfer the desired amount of USD to his bank account in Hongkong, Singapore and USA.

The really big money uses the trading route. The deal flows in much the same way of money swap where the client (Chinese people who need to transfer money outside China) pays a certain amount of RMB to a company in China that is engaged in huge international trading business (energies, minerals) and the company will later on transfer an equivalent USD to the

bank account designated by the client in the foreign country. The cost is generally 2-3% of the total amount so moved.

These various routes imply that it remains easy for kleptocrats to launder funds into western countries in spite of new regulation. Most importantly, however, it is less and less important to move fortunes to the west, as an increasing number of non-democracies around the world offer pleasant living conditions, easy regulation and deep capital markets. From a base such as Singapore or Dubai a Russian or Chinese can then proceed to donate to political campaigns in democracies that undermine the rule of law and lower the risk of future sanctions.

What should democracies do? The first answer is to admit that current policies to protect democracies is evolving more slowly than the kleptocrats' efforts to undermine the west. The second answer may be to avoid being squeezed into corner where democracies feel forced to use the same repressive tactics as the autocracies.

The most interesting solutions go in the opposite directions – requiring complete transparency. Some examples are the following:

- A) Unexplained wealth policy. For example, Britain has recently enacted a law allowing confiscation of wealth for which origin cannot be explained. So far, the law has only been applied in a few cases, but has wider scope.
- B) Transparency for the use of shell companies has been expanded in recent years, but it is still not difficult to hide financial transactions for somewhat sophisticated kleptocrats.
- C) Enforcing a real-name policy. Social media like Facebook already claim to enforce a real-name policy. In practice it remains easy to circumvent, in particular for professional trolls. It might be reasonable to demand that large platforms use e-identification or a know-thy-customer policy similar to that required of banks.
- D) Greater transparency in campaign financing.

While each of these proposals have pros and cons, partly depending on how exactly they are implemented, western democracies must start formulating an effective plan B, to put into action if current defenses are not sufficiently effective. Like in the case of the earlier domino theory, it may turn out that kleptocracies eventually collapse under their own insufficiencies. Until then democracies are well advised to step up their defenses.