



Munich Personal RePEc Archive

Unparallel View of Parallel Economy

Batabyal, Partha

Amity Business School

3 February 2009

Online at <https://mpra.ub.uni-muenchen.de/14310/>
MPRA Paper No. 14310, posted 27 Mar 2009 14:08 UTC

An Unparallel View of Parallel Economy

Parallel Economy, Recession and Future Financial Structure

Mr. Partha Batabyal

Amity Business School, Noida

Keywords: Parallel Economy, Recession in India and Parallel Economy, Future Financial Structure

Index

Serial .No	Description	Page No
1	Executive Summary	3
2	Introduction	4
	Literature review	5
	Recession Timeline	5
3	Parallel Economy and Recession	6
	World view	6
4	Preamble of money laundering	10
	How it happens	10
	Money laundering in Asia and India	10
5	Analyzing and Interpretation	15
6	Basic Financial Structure and Loopholes	18
7	Conclusion and Suggestions	20
8	Limitations	22
9	References	23

Executive Summary

Despite the considerable media attention being given to the financial meltdown there has been little attention on why this happened. This paper investigates into this matter and takes a very unique point of view. Whenever we talk about this matter we thought of liquidity crunch, sub prime crisis, high fiscal and trade deficit etc but we never think about parallel economy and money laundering. Here are some facts regarding this aspect: the amount of money laundered in the whole world is close to \$2.85 trillion per year. As per an estimate of International Monetary Fund the aggregate size of this underground and illegitimate market is between 2 to 5 percent of world's gross domestic product. Criminals become wealthy enough to bribe officials and ensure their continuing profitability. Bribed officials becomes a mere puppet in their hands and act accordingly to their needs. Key media are controlled which prevents any publicity. Terrorist financing, drug trafficking and the black economy are nothing but the pitfalls of this growing menace. This is the biggest industry in the whole world. It is bigger than oil or arms for that matter. Many international money laundering rackets control the whole procedure. In this paper we have presented how parallel economy is affecting various developed and developing countries like U.S.A, U.K, Australia, India, China etc. We have also showed that how it is being done and who the main players behind conspiracy are. This paper also prescribes the steps that are needed to be taken by the regulatory bodies to control and regulate this matter. What financial restructuring that are needed to be done. We have also portrayed what are the loopholes that we have in our economy especially in money market and forex market. We have also analyzed and interpreted what are the levels of intensity of anti money laundering laws and what effects they are having in their respective economy. We have suggested in this paper how we can cope with this situation by bringing some technical changes in our financial system. The main purpose of our paper is to show the areas we need to look at, to build a concrete economy, free of any type of black money. The new financial system should be equipped to tackle these frauds and take productive steps to counter them. There should be transparency in this whole process and no one should be spared if they are found guilty irrespective of position.

Introduction

Today's world economy is global economy and it is not restricted to one place or one country. It is not US economy, UK economy or only Indian economy. Due to globalisation one country's economical conditions effect others. There are several factors that impacts economy of a country – export, import, foreign direct investments, parallel economy, ill effect of other related economies etc. It is a trend that an economy grows for several years like 7 to 10 years and then there comes a fall-recession-which stays for a year or two and after that growth begins again. Something in Indian policy making was not right and the country could not react well. An economy is less effected when it is strong from inside but it was not the case for India; existence of parallel economy, black money, fake currency problem, political crisis, high population and high unemployment rate acted as catalysts. In this era of globalisation a high volume of illegitimate commercial and financial transactions are going on. Banking and investment institutions of US and European countries are being flooded with this type of illegitimate activities. The amount is trillion of dollars and it is being generated via bonding between distinct but cooperating private sector entities. The existing legal policies and code of action has failed to deal with the situation. These hidden resources possess a major threat to democracy, state security, corporate stability, effectiveness of international aid programmes and economy of a nation. It has not been possible to trace the financial statistics and magnitude of total amount of illegal money. The drug trade has moved hundreds of billion of dollars out of Russia in recent years. Such type of money also finances wars and conflicts between nations. Financial system contains several flaws and given political will, these flaws could be largely corrected¹. Estimation shows that India's parallel economy has risen from a mere 3 percent of the GDP in the mid 50s to around 50 percent today. Though the components of parallel economy are many in number, tax-evasion, smuggling, bribe-taking, foreign-currency racketeering are some of the most talked about forms¹³.

Literature Review

Carlos M. Asilis and V. Hugo Juan-Ramon of INTERNATIONAL MONETARY FUND Institute presented a paper on Corruption and Capital Accumulation. They showed in their infinite horizon continuous time model that in competitive economy with capital accumulation, corruption emerges endogenously. Agents can be of four types firms, government, bureaucratic (consumers/investors/bribe taking agent) and non bureaucrats (customers and investors). The sum of the mass of bureaucrats and non bureaucrats is normalised to one for every time period. In particular $u_B(t)$ denotes the mass of bureaucrats at time t while the mass of non bureaucrats is given by $u_N(t) = 1 - u_B(t)$. For simplicity, we let the size of the state $u_B(t)$ constant for all t . Finally there exists one government player who is infinitely – lead. The (representative) bureaucrat owns $K^B(t)$ units of capital at time t . While the non bureaucrat owns $K^N(t)$. The bureaucrat can choose appropriate share $b(t)$ of the interest income earned by the non bureaucrats, $b(t) = b(t) K^N(t)$. $b(t)$ is a continuous function of time. f is defined over the ratio of current stock of capital to total labour effort L . Thus period t output is given by F and output per capita is given by f omitting the period of t arguments.

$$F [u_N K^N + u_B K^B] = 1/L F (u_N L K^N + u_B L K^B, L) = F (u_N K^N + u_B K^B, 1)$$

The production sector is competitive. Therefore the period t interest rate $i(t) = f' [K(t)]$, in equilibrium were $K(t) = u_N K^N(t) + u_B K^B(t)$. $K(t)$ corresponds to the period t average per capita stock of capital available for production. This model illustrates the level and the cost of corruption. This model also finds that economic cost of production is higher in developing countries than developed countries².

Recession 2008-2009 Timeline

July 1, 2008: DENMARK----> Aug. 13: ESTONIA ----> Sept. 8: LATVIA----> Sept 25: IRELAND---->Sept 26: NEW ZEALAND ---->Oct 10: SINGAPORE ---->Nov 13: GERMANY --->Nov 14: ITALY, HONG KONG, and the EURO ZONE ----> Nov 17: JAPAN ---->NOV 28: SWEDEN ---->DEC 1: UNITED STATES ---->Jan 21: India

(Reuters UK TIMELINE - World economies slide into recession Tue Dec 23, 2008 6:04am GMT)³

Parallel Economy and Recession:

Parallel economy often could be demonstrated as hidden economy of a country. People or business entities when do not show their exact income as per government rules the income comes under parallel economy. According to Feige when economic activities goes unreported or not measured by societies current techniques to monitor economic activity it falls under parallel or hidden economy⁵. Parallel economy exists due to various reasons and they are as follows

- High tax rate implemented by government
- Complicated tax paying procedures and policies
- People believe that their money is not going to be properly utilized by government as their trust on government is less.
- High inflation which put tax payers under high tax paying brackets.
- People don't get enough return from their paid taxes

In case of underground economies of US, UK and Germany, people in order to get government benefits tries to indulge in social security frauds. When parallel economy exists government does not get the actual amount it should get from the tax payers and the actual GDP falls and it will increase fiscal deposit of the country.

World View

In case of India according to news reported in Financial Express⁴ estimation of black money, unrecorded and untaxed, circulating in the economy has varied widely from time to time. In 1967-68, it was placed at Rs 3,034 crore. But by 1978-79, it had soared to Rs 46,867 crores more than 15 times in just 12 years. Black money was estimated to be 9.5% of GDP in 1967-68, rising to 49% of GDP in 1978-79 and 50.7% in 1987-88. This is an alarming rise. By the early 1980s, the problem was virtually blaring bright red danger signals. By one count, the rate of growth in the parallel economy was higher than that of GDP in the period from 1980-81 to 1987-89; the former rose by 46.7% and the latter by 40%. Transparency International, which publishes a Corruption Perception

Index, covering 146 countries, places India at rank 91. Some Rs 21,000 crore annually is estimated to exchange hands in the form of bribery in the country, which indicates the extent of the problem. For example, the real estate sector, high taxes result in widespread cash transactions and under-declaration of deals, which skews market information and hurts the process of capital allocation. The existence of black money is injurious not just for tax revenues. It distorts the systematic resource allocation process and upsets the accuracy of economic forecasts. Good economic management requires precise and reliable data. Industry, meanwhile, needs a business environment that is free of arbitrary controls that may squeeze out bribes.

Estimates of Parallel Economy in Developing Countries *Period: 1990-93(table 1)*

Country	Percentage of GDP consisting of parallel economy
Nigeria and Egypt	68-76
Tunisia and Morocco	39-45
Guatemala, Mexico, Peru and Panama	40-60
Chile, Costa Rica, Venezuela, Brazil, Paraguay	25-35
Thailand	70
Philippines, Sri Lanka, Malaysia and South Korea	38-50
Hong Kong and Singapore	13

(Source:http://www.crisil.com/youngthoughtleader/winners/2002/topic4_Jyoti_Agarwal_IIm_CAL.PDF)

Estimates of Parallel Economy in Developed Countries (table 2)

Country	Percentage of GDP in parallel economy
Sweden, Norway, Denmark, Ireland, France, The Netherlands, Germany and Great Britain	13-23
Japan, USA, Austria and Switzerland	8-10

(Source:http://www.crisil.com/youngthoughtleader/winners/2002/topic4_Jyoti_Agarwal_IIm_CAL.PDF)

India is similarly hit by parallel economy for a long time. People not ready to pay their taxes, tries to escape from taxes by every way possible. Big business, service holders everyone always try to pay lower taxes and eventually nothing at all. Think about a school teacher who tries to go home early, not giving enough potential in the school because he knows when he will reach home a huge number of students will be waiting for private coaching. Doctors skip hospital hours and go for private practicing as for these they do not have to pay taxes. Hidden economy also includes bribing, black marketing, fake currency etc.

Economic policies have to go through major consequences as a result of the existence of a parallel economy. As this activity is unrecorded, the official national income accounts statistics do not accurately represent the true state of a nation's economy. Given that these statistics are used to generate economic policies and thus act as an essential guide to policy, if the guide is significantly in error, so also might the policy. Fiege has described this phenomenon as the **unobserved income hypothesis (UIH)** and suggests that systematic biases, unwittingly introduced into the official data have fundamentally distorted our perception of economic realities. A distorted information system leads rational individuals and well intended policy makers to undertake actions that transform initial statistical illusions into real economic maladies.

Corruption Perception Index published by Transparency International, covering 146 countries, places India at rank 91. It has been estimated that about Rs 21,000 crore annually exchange hands in the form of bribery in the country. This shows the problem which deep down into people's morality of the country. Tax rate of the country in moderate, government does not provide so many benefits like developed countries as US, UK but still people are not willing to pay taxes. Big business houses who earn a lot of profit try to escape taxes and contribution to national income by any means possible.

Parallel Economy and Regulation Intensity of selected countries ⁶-(Table 3)

Country	% Parallel Economy	% Regulation Intensity
Singapore	7.76	6.86
Japan	7.23	5.68
Canada	6.97	5.82
New Zealand	6.96	5.61
U.S.A	6.31	5.64
UK	4.96	4.38
India	2.94	5.09

(Source: www.dubaided.gov.ae/statistics2006/wcy/Statistics/2.4.13.pdf)

Preamble of Money Laundering

Money laundering is an illegal practice which engages in specific financial transactions, in order to conceal the identity, source and destination of money. After the attack on the World Trade Center in the US, the world has started giving attention on the entire concept of money laundering and recognized how deadly it can be to this world. As per an estimate of the International monetary fund (IMF) the aggregate size of this underground market is somewhere between two to five percent of the worlds gross domestic product. The aggregate money laundered in the whole world could be approximately \$800 billion to \$2 trillion each year. Mexicans both working illegally and legally staying in America sent an estimated \$28.1 billion to relatives in Mexico alone. Money sent home to countries in Latin America and the Caribbean represents 70% of the world's total amount of remittances¹¹.

How It Happens

The basic concept of money laundering originated in U.S. It basically consists of three steps i.e. placement, layering and integration. Placement means physical disposal of cash derived from unlawful activity. Layering refers to the separation of illicit proceeds from their source by creating complex layers of financial transactions. Integration means re-injection of money after it has been laundered in a way that it looks as if it is proceeds from normal business activities. The Hawala mechanism is another way of laundering money. At first they find a bank in a foreign country which is lenient in their banking laws and they strike some deals with the bank to obtain some property. After that the funds are converted into white money and then they are retained where they actually belong to. For money laundering there are some strict rules in U.S and U.K. There is no lower limit concerning what would be the criteria for reporting an illegal or suspicious transaction. In these countries money laundering is not basically concerning money alone it could involve moveable and immoveable assets or properties¹².

Money Laundering in India and Asia

In India, money laundering is basically involved in terrorist activities and drug trafficking. The effect of money laundering in India is really magnanimous. According to KPMG study money laundered in India consists of 2% to 3 % of our GDP. The culprits

ensure that the money does not reach any financial institution by using underground banking which does not need any papers. People deposit money here and obtain a ‘chit’ or a ‘seal’. By submitting these papers money is remitted to the concerned person. Black money in India is estimated to be around 40% of the GDP. We have seen that how Ketan Parekh and many politicians have used this methodology to launder money

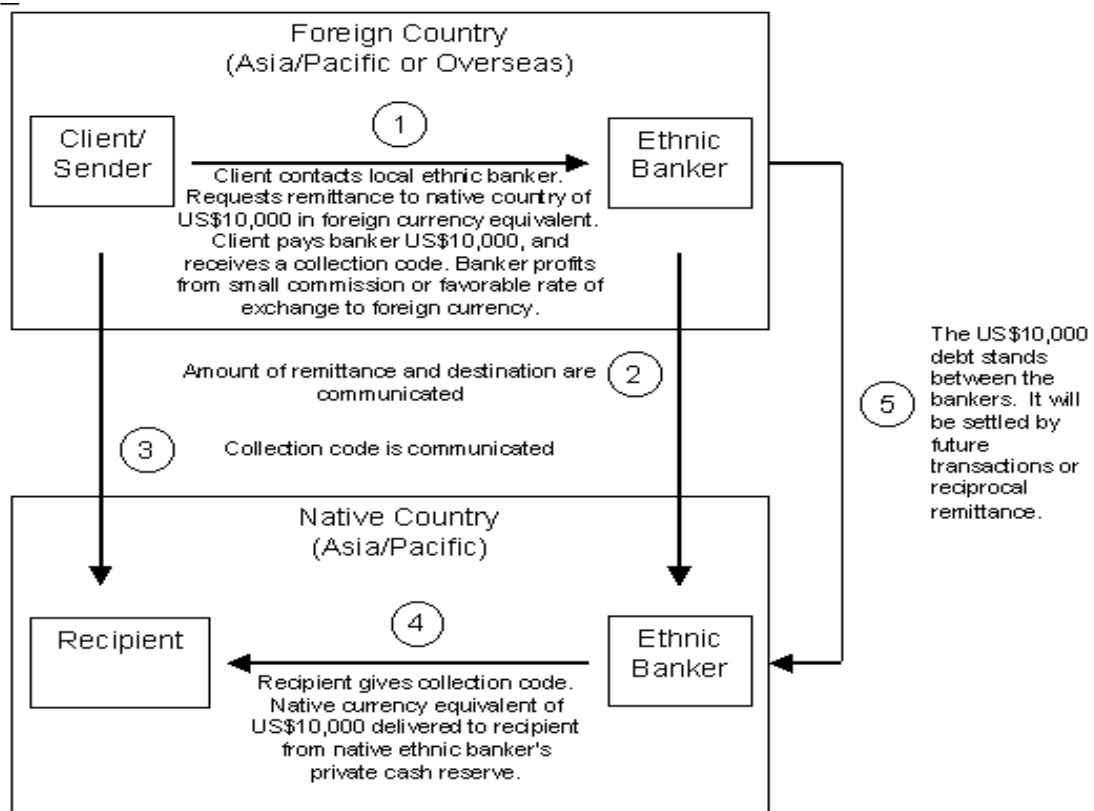
12

Name of the Person	Rs. In Crores
Ramalinga Raju	8000
Harshad Mehta	4000
Ketan Parekh	1250
C R Bhansali	1200
Dinesh Dalmia	595
Abdul Karim Telgi	171
The UTI Scam	32

Top seven money laundering in corporate sector of India- table 4

(Source: <http://www.drishtikone.com/?q=blog/indias-top-10-scams>)

These transactions are really just the tip of the iceberg. Casinos, payment gateways like Western Union, MasterCard or even credit or debit cards are being used extensively for this purpose. Moreover after 1991 the risk of money laundering in India has increased manifold because money can now be laundered via banks and other financial institutions. Union revenue department discovered 900 bank accounts, which consists of Rs. 1000 crore being operated with fabricating names of companies and persons.



Basic sequence of alternative remittance (fig-1)

Source: <http://www.interpol.int/public/FinancialCrime/MoneyLaundering/EthnicMoney>

A recent study by Interpol¹² showed two types of alternative remittance systems; grouping hawala/hundi banking and the chithi/chop shop system. Both these systems are based on trust and communities of the whole world are part of it; network system prevailing in China, Southeast Asia and North America and the larger hawala system covering the Indian sub continent. China uncovered 89 cases of money laundering involving a total of 28.8 billion yuan (\$4.17 billion) last year, the People's Bank of China said. A total of 350 financial institutions in 2007 were punished for violations of anti-money laundering rules and regulations, including 341 banks, four securities and futures firms, and five insurers. Meanwhile, the police and the central bank launched more than 50 campaigns to clamp down on 43 underground banks and detained 180 suspects."The year 2007 marked the establishment of China's anti-money laundering system," said Su Ning, vice-governor of the central bank.

As in Russia and Mexico, the Thai crisis, which triggered the Asian crisis of 1997, is no stranger to money laundering. According to a study published in 1997 by three researchers at Ulalongkorn University, discovered that equivalent of 8 to 11% of the Thai GDP was controlled, by organized crime, which derived its profits mostly from gambling and prostitution, and also from drug traffic out of Burma¹².

Top ten Origins of laundered money (table 5)

Rank	Origin	Amount (\$Us mill/yr)	% of Total Laundered Money
1	United States	1320228	46.3%
2	Italy	150054	5.3%
3	Russia	147187	5.2%
4	China	131360	4.6%
5	Germany	128266	4.5%
6	France	124748	4.4%
7	Romania	115585	4.1%
8	Canada	82374	2.9%
9	United Kingdom	68740	2.4%
10	Hong Kong	62856	2.2%

(Source: www.johnwalkercrimetrendsanalysis.com.au/ML%20method.htm)

Top five destinations of laundered money (table 6)

Rank	Destination	Amount (\$US mill/yr)	% of Total
1	United States	538145	18.9%
2	Cayman Islands	138329	4.9%
3	Russia	120493	4.2%
4	Italy	105688	3.7%
5	China	94726	3.3%

(Source: www.johnwalkercrimetrendsanalysis.com.au/ML%20method.htm)

Attractiveness of money launders for some important nations (table 7)

The higher the score the higher the attractiveness

Country	Score
USA	634
United Kingdom	439
Japan	200-249
Canada	250-299
India	0-9

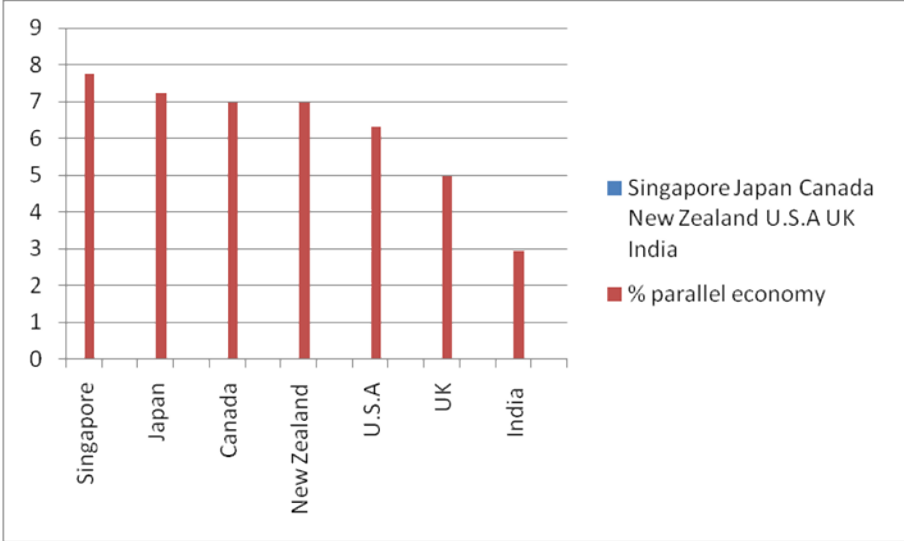
(Source: www.johnwalkercrimetrendsanalysis.com.au/ML%20method.htm)

Top ten flows of money laundering (table 8)

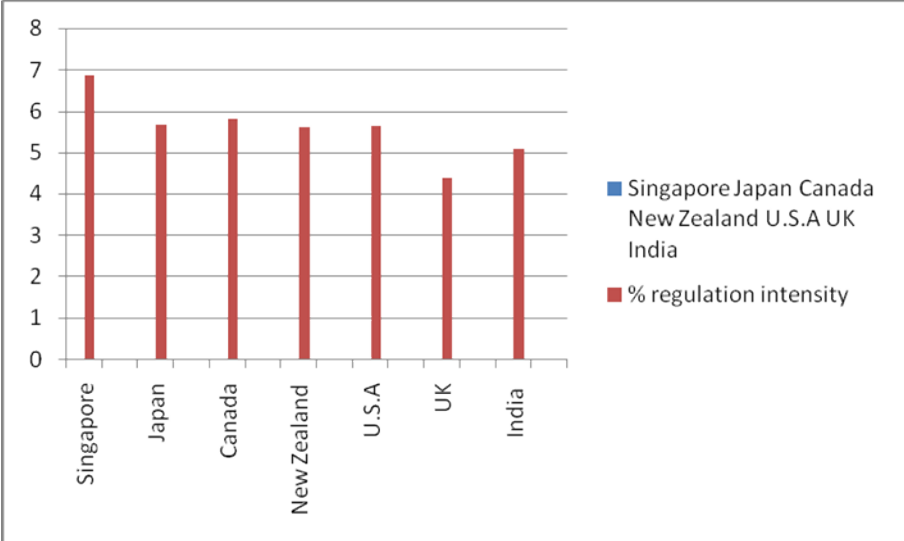
Rank	Origin	Destination	Amount (\$US mill/yr)	% of Total
1	United States	United States	528091	18.5%
2	United States	Cayman Islands	129755	4.6%
3	Russia	Russia	118927	4.2%
4	Italy	Italy	94834	3.3%
5	China	China	94579	3.3%
6	Romania	Romania	87845	3.1%
7	United States	Canada	63087	2.2%
8	United States	Bahamas	61378	2.2%
9	France	France	57883	2.0%
10	Italy	Vatican City	55056	1.9%

(Source: www.johnwalkercrimetrendsanalysis.com.au/ML%20method.htm)

Analyzing and Interpretation

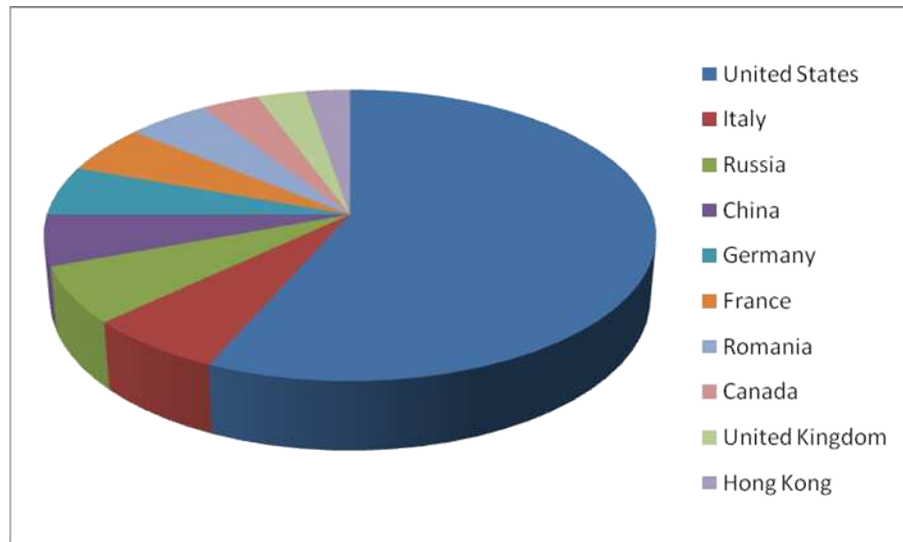


Graphical representation of table 3



Graphical representation of table 3

From the bar charts it could be seen that Singapore, Japan, Canada , New Zealand, USA, UK with higher intensity of regulation and at the same time higher rate of parallel economy and its all because of the known factors like high value of their currency, immigration rate etc. But in India where the currency value is less, less number of immigration and with strict laws to abide the rate of parallel economy is much under control. But this could be a signal of utopia because there is lack of proper data availability and accuracy. Data manipulation is at its highest. That’s why if we compared to other countries India is the only country where the regulation intensity is more than the percentage of parallel economy.

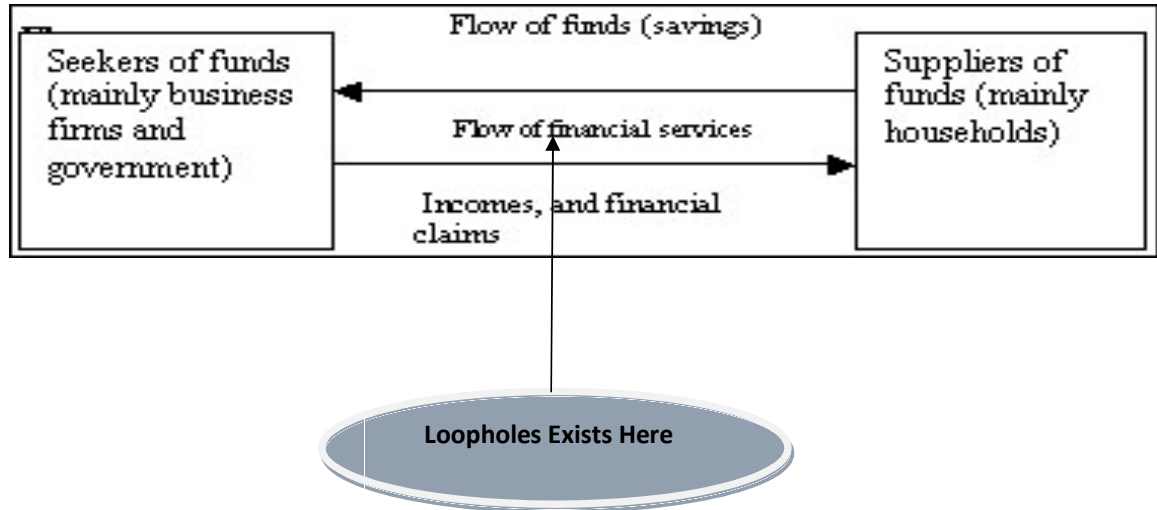


Graphical representation of table 5

As we can see that from the above pie chart that United States has the highest Amount in terms of money laundering. It is no surprise because it is from there that a huge amount of money is transferred illegally to Carrabin and Latino nations especially Mexico. That is why recession has a worst effect in the U.S. There are many reasons behind the huge amount that has been laundered from USA. Firstly we all know that dollar has a prestigious value in world wide economy, secondly the exchange rate of

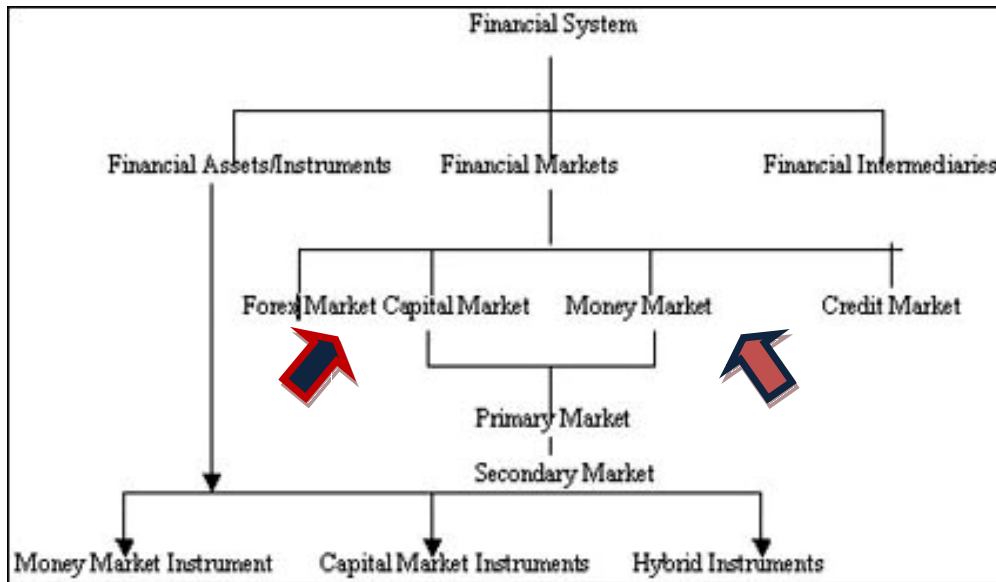
dollar is very high when compared with other currencies. Same for the United Kingdom because of their pound value and immigrants from different countries tries to send money at home via Hundi service. If we analyze closely most of the countries are from the EU and the major reason behind is appreciation of euro during the last five years. Though there are strict rules regarding this matter in these developed countries but still huge amount of illegal money has been transferred from these countries in order to gain more benefits in terms of money value. Another effect that money laundering has is its effects on GDP. Because of the black market, a country's actual GDP is far less than the projected GDP. So after analyzing we can clearly state that there is a connection between the recessionary state in these countries and money laundering.

Financial Structures and Loop holes



(http://www.indianmba.com/Faculty_Column/FC177/fc177.html)⁶

Though the structure looks very simple but the main problem exists here. Several regulatory bodies are here to regulate the process but their efficiency level is questionable. The rules which exist need to be correctly implemented and there is a need of proper, accurate and transparent report generation system which could be easily monitored and available to all the concerned persons. So the existing rules should be implemented as they ought to be without any default.



Existing financial structure of India ⁶

(http://www.indianmba.com/Faculty_Column/FC177/fc177.html)

This is the basic representation of country's financial structure and during this paper the focus was mainly on Forex Market and Money Market. Because parallel economy and money laundering has the most effect in these two markets. Forex market is concerned with laundering of cash and money market is affected by the fake currency. so, we are proposing some rationale should be used by the government to stifle these transactions.

Conclusion and Suggestions

After carefully studying the parallel economy, money laundering and recession it has been found that all are interconnected and parallel economies have a negative influence on a country's economy because it hinders the actual growth and shows a fall in GDP of a country where there is a high possibility of existence of a fiscal budget.

1. Government financial structure needs to be revised in terms of forex and money market.
2. Transparent information systems need to be implemented for better communication.
3. Different financial service providers, banks and legislators are doing much to fight against money laundering. We approach a **3K** solution for these authorities and these would be
 - Know your customer (**KYC**): financial background of customer helps to reduce any concealed risk.
 - Know your transaction (**KYT**): unusual transactions could be identifiable by daily research.
 - Know your process (**KYP**): with the help of intelligent clarification formulas and step-by-step clarification process complete input data could be available.
4. Taxation law should be structured in such a manner that tax evasion becomes impossible.
5. Instead of direct cash transfer, bank transfer should be encouraged. Use of plastic money in UK and other developed countries helped them a lot to prevent parallel economy and money laundering. So that every transaction in terms of money being recorded and maintained efficiently.
6. We suggest focusing on financial literacy and bringing remittance users into the formal financial sector.

7. Need to impose heavy fines or legal actions to those who commits any criminal offense of this kind.
8. Government should launch some programmes regarding financial literacy which can help under privilege persons to get some knowledge about this racket and the pitfalls they have in their daily lives.
9. The Narcotic Department also needs to be on their toes because we all know that most of the illegal wealth is transferred by smugglers using cocaine and band drugs.
10. Terrorism financing is another omen that as been destroying our economy for the last two decades. So the Research and Analysis Wing (**RAW**), Intelligence Bureau (**IB**) and other intelligent agencies need to take adequate actions to prevent terrorism financing.
11. We should focus on reducing the hawala transaction as much as we can by bringing unbanked residence into the financial mainstream.
12. There should be a ceiling of an amount that how much money a person can remit to their home country based on their job or occupation and strict vigilance need to be implemented.
13. Better co-operation should be there between the countries so that they could fight this menace with joint effort.
14. The Government also need to develop separate department which will deal with this matter and can implement new legislations with efficiency.
15. A mechanism of reporting progress need to be established which ensures adequate communication between Law and Finance Ministry.

Having said all that there is a need to take a fresh perspective on how to control parallel economy and money laundering. The approach should be to widen the regulatory coverage without imposing to great a compliance burden on the institutions or to great an increase in government expenditure.

The focus should be to build a proactive financial structure rather tan a reactive one because after analyzing various countries we have seen in India this menace is still at its

infancy. No matter how hard we try to develop our nation and be one of the super powers, this deadly worm will keep on eating its way to our economy making it a hollow one. We should take a leaf out of Mohammad Yunis (Nobel Laureate, Bangladesh) book by reaching to poor people and conduct financial literacy programmes to organise these unorganised sectors.

Limitations

During the project we extensively searched various journals and contents over net and we find the following limitations -

- Shortage of current data regarding parallel economy and money laundering.
- Lack of adequate information regarding this topic as there has been no major study in India conducted beforehand.
- Difficulty in measuring how much money is being laundered and from where.

References

1. International Policy Report; Dirty Money and Its Global Effects, By Raymond Baker and Brionne Dawson, Research Associate. January 2003.
2. INTERNATIONAL MONETARY FUND, IMF Institute, On Corruption and Capital Accumulation, Prepared by Carlos M. Asilis and V. Hugo Juan-Ramon, July 1994
3. Reuters UK TIMELINE - World economies slide into recession Tue Dec 23, 2008 6:04am GMT
4. The Financial Express. The parallel economy in India Posted: 2007-05-02 00:00:00+05:30 I T
5. The parallel economy, its origin size and impact on mainstream economy. (http://www.crisil.com/youngthoughtleader/winners/2002/topic4_Jyoti_Agarwal_IIm_CAL.PDF)
6. www.dubaided.gov.ae/statistics2006/wcy/Statistics/2.4.13.pdf
7. <http://drishtikone.com/?q=blog/indias-top-10-scams>
8. http://www.indianmba.com/Faculty_Column/FC177/fc177.html
9. www.johnwalkercrimetrendsanalysis.com.au/ML%20method.htm
10. <http://mexidata.info/id964.htm>
11. <http://www.interpol.int/public/FinancialCrime/MoneyLaundering/EthnicMoney>
12. <http://www.yourstory.in/resources/legal-talk/1840-money-laundering>
- 13 <http://www.helium.com/items/106169-india-the-black-economy>