Shadow Finance - Demystifying An Untapped Resource - Archie Alafriz

> *The existence of Shadow Economies is a source of ignominy for us Threat Finance practitioners. Most of us fail to grasp what it is, or how it works. We see it as an affront to our western compliance regimes, stabilization policies and economic control strategies. But can a change in our perspective turn them to gold mines? Are they untapped financial resources with much potential if only we could change their political orientation? Can we actually harness some of the hidden wealth?*

You might know that Market-Based Finance (MBF) is a non-derogatory term for the shadow banking system. Yes, that's what the Brits call it. They seem to have a better grasp of the concept than those of us here in North America. What we call a shadow banking system is no more than a legacy economic system practiced in the far and middle east for millennia. The colonization of these economies and the creation of western financial infrastructures were meant to supersede the legacy systems but not eliminate them entirely. Therefore they had always existed in peripheral regions.

We in the threat finance industry have long witnessed the social stigma attached to shadow finance. This may be from our own lack of understanding and the ensuing paranoia that the absence of regulatory regimes render it pervious to illicit finance. In time we generalized that notion to mean that the shadow banks were the exclusive realm of dirty money. There was a time when I found myself anchored to that premise.

I chair an international body of security and intelligence practitioners, the IOSI. I am constantly reminded by my team that our members conduct research in a vast number of languages, consuming an incredibly wide breadth of global media and perspectives. Because of this, I believe, we produce more balanced narratives and intelligence assessments, far and away from, and often in diametric challenge to, North American-centric rhetoric. We always strive for verifiably balanced perspectives and nothing less.

SAFE

Allow me to get back to my point, the legacy economic system. In 1979, the Chinese government implemented SAFE, which stands for State Administration of Foreign Exchange. China opted to control the exchange rate of the Yuan RMB against foreign currencies (particularly the USD) through fiscal controls in contrast to the floating or market rate model. Today, SAFE limits cash outflows by Chinese individuals to the equivalent of $50,000 USD per annum without a special permit. While China's political system may be described as Communist, its money culture is anything but.

In the 60's and 70's, China was busting at the seams with economic growth, and the weight of prosperity incentivized a relief mechanism of sorts. Like everyone else, the citizenry wanted the ability to diversify investments to other places in the world. SAFE became the unintended fuel that revitalized the legacy economic system. Yes, this is a simplistic model but it suits the point I will make later.

MBF is not TBML

MBF is a credit based system (again an oversimplification). Over the years, sizeable economies have grown on either sides of the Pacific Ocean. Between Beijing and Vancouver for example, there is no longer a need to remit funds across the ocean. Credit is simply applied on either end of the transaction and there would be no trace of a cross-border monetary remittance. This application dispenses with the cost of international wires. While the methodology may look like trade-based money laundering, TBML, by definition, requires that the funds be derived of ill-gotten gains, which the vast majority of these funds are not. Let's just call it capital flight. And because China's initial portal for this activity was Hong Kong, a UK territory until 1997, the greater percentage of capital flight naturally gravitated toward London, UK. Vancouver being a gateway city to the Pacific, also became a landing zone for Sino-Eastern capital initially from just Hong Kong in the late 80's, and then from the Chinese mainland shortly thereafter.

When I analyzed this legacy financial system some years ago, it became clear to me that unlike other alternative financial mechanisms utilized by organized crime groups from other ethnicities, the Chinese MBFs were used by the widest cross-section of Chinese society. And I mean everybody; my grocer, car dealer and yes, my cellphone cover seller. One of my consultants even purchased a home through MBF. It's the only way ordinary people can move their money out of China.

Extrapolative Intelligence

So let's look at the Chinese MBF another way. It is part of a superset we call the Canadian Shadow Economy. According to the Financial Post, in 2020 the size of the entire underground economy in Canada was $1.5 Trillion. The same report put the Canadian GDP at $1.6 Trillion that year. Extrapolating from a few data points from an MNP report published around 2007, the illicitly derived makeup of the combined China and Hong Kong economies based on victimization statistics was lower than the global average of 4%. I'm going to discount that last claim and conservatively accept the 4%; equal to the global average.

By the makeup of the Sino population in Canada, its economic dominance, purchasing power, share of business control of key indicator markets like real estate, I would throw a rough figure of around $1Trillion of annual commerce generated by their MBF. That's roughly 66% of Canada's entire shadow commerce. This number, though anecdotally reasonable, may be far from accurate. But I'll use it to belabour my point. Using the 4% index, I would suggest that as much as $40 billion of that MBF may be from dubious sources. But that would be staring into the hole of the doughnut. The counterpoint of the argument is that we are looking at a sizeable $960 billon of potentially clean money. Money that's already commingled in the Canadian economy, but it is not recognized as part of the Canadian GDP.

The Skinny on China's Economic Outlook

This is going to be a bone of contention. And no, this is not the 27th forecast of the demise of the Chinese economy this week. Far from it. But much in the same vein of the US subprime fiasco in 2008, China has started to show some cracks in its otherwise robust economy. Evidenced by Anbang Insurance in 2017 and then again with Evergrande in 2021, many companies are experiencing cash shortfalls and debt maintenance issues. In June of 2022, Evergrande was delisted. According to Reuters, it has been "reeling under more than $300 billion in liabilities, the firm's offshore debt (was deemed) to be in default after missing payment obligations (in late 2021)". And all indications from the Chinese government is that there will be no bailouts of the sort seen in the US economic crisis.

My financial intelligence sources are adamant that, earlier in 2021, Xi Jinping was discussing a market adjustment with his party The same sources state that Xi had intended to trigger the adjustment anticipating that the economy would regain its composure in 16 to 18 months. That recovery model was undoubtedly predicated on what was then a stable global economy. It was preferable for the Chinese government to trigger the adjustment and have some semblance of a forecast into recovery than to allow the economy to trigger its own adjustment to which the government would have no control over a recovery timeline. Here's today's problem, Putin charged off to war in early 2022 and upset the global economy. He basically threw a proverbial wrench in Xi's gearbox. I recall watching the opening and closing ceremonies of the 2022 Beijing Olympics thinking that China finally had its messaging temperature right. Intrinsically, they out-Disney'd Disney. That messaging is vital because it needed to be consistent with their reimagining of themselves and their relationships with the ASEAN community. After all, they are still conducting investment tours to ASEAN hotspots cultivating capital from political and economic elites which China then utilizes to build infrastructures in Africa and Latin America.

Why no bailouts you ask? For political reasons, Xi attributes China's past economic over-exuberance and recklessness to his predecessor Hu Jintao. And our estimates say that China can't really afford to. This is also evidenced by China's non-existent financial support for Putin's war. China had to tread carefully because backing Putin's war would also negate their well calibrated messaging during the Beijing Olympics.

There is the vast confluence of indicators that suggest Xi is cleaning house, strengthening the RMB , and relentlessly growing China's middle-income class. Just recall the fate of Jack Mah of Alibaba and his fintech AliPay. Add to that the government's intercession with WeChat and other fintechs viewed as means to transgress SAFE. Then there's Whitney Duan, formerly China's richest woman and Alvin Chau, the Macau junket kingpin, both incarcerated by the Chinese government. Xi Jinping said that he would shrink the income difference between the rich and the poor. He is certainly following up on his word, putting his money where his mouth is, whether you agree with his methods or not. Again, I point you to the messaging.

Digital RMB

Xi is driving the RMB to go digital. It will likely be the first fiat currency to do so. Digital currency imports an increased level of surveillance on the currency, the users and how the currency is used. I suspect that China will also keep digital tokens of its foreign currency holdings. They can then allow their fintechs to run at full clip with high-level algorithmic monitoring.

Prescription Instead Of Proscription

Why is any of this relevant to us? Because there is a window of opportunity to mine this untapped resource called the shadow economy. We can use this economic engine to bump up our GDP, boost consumer confidence during the post-pandemic recovery phase and ultimately destigmatize this foreign-sourced capital. It is an opportunity to educate ourselves in the legacy economic structures and instead of using proscription to make the issue go away, which doesn't work, incentivize the flow of money to the above-ground economy where it is transparent. It would make an incredible taxable resource.

Keeping one's funds in the shadow economy comes at a cost. The migration of the funds from Asia alone costs a blanket 2% of the capital. And that was during the best of times. According to recent reports from the HK region vis a'vis the growing McCarthyism against Chinese finances that money services businesses have charged as much as 7% to migrate capital. That would be downright criminal even if the origins of the money weren't. The shadow economy in many respects is like keeping your money under the proverbial mattress, the money isn't working for you, its just parked. One can invest it in the shadow economy itself, but it is not a very diversified portfolio.

This is where **opportunity cost** comes to play. Thank you Mr. Putin, the global markets all tanked. Otherwise, there was a healthy financial market which in 2020, the S&P 500 Index funds returned 18.4%. Money under the mattress would not harness such a gain.

Also, there is the issue of **credit**. Which for the most part is non-existent if the owner of the wealth has assets listed under a nominee whether a person or a corporation. Without credit in the mainstream economy, one is unable to leverage wealth above ground.

If your money was deposited in a financial institution in Canada, your money would be **protected** under the Canadian Deposit Insurance Corporation (CDIC), the MBF structure affords no such assurances.

I am not an economist and therefore could not prognosticate all the pros and cons of migrating shadow capital to the surface. There will certainly be tax implications to doing so. But I will say this, all the above indicators foretell of a revaluation of shadow assets. Yes, its coming whether Xi triggers the economic adjustment, or the economy itself does a melt-down from the cash vacancy.

Last year, Sri Lanka announced that it would be in default of its debt payments to the IMF-World Bank. China was a debtor to Sri Lanka's post civil war infrastructure rebuild. This situation further exacerbates China's cash shortfall. Chinese MBF is collateralized by real assets within China. Just like the mainstream economy, there needs to be a balance of value within and outside of China for MBF to work. Remember that it's a credit-based system, there is a financial tether that needs to be pegged down somewhere. There have been intelligence reports alluding to Xi wanting to repatriate the foreign holdings of Chinese nationals abroad to beef up China's internals. It would be easy for the CCP to identify the tether points of China's shadow economy and nationalize those assets. Even if one is bullish about the Chinese economy, a prudent move would be to hedge one's bets, and move part ones' holdings to the mainstream economy, and do it before China's economy goes into an adjustment.

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