

THE PRICE OF OFFSHORE REVISITED

APPENDIX I

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THE PRE-HISTORY OF OFFSHORE ESTIMATES

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As noted in the main text, some of the first clues to the growth of offshore havens and their role in cross-border financial wealth accumulation came from research on the size of *domestic* underground economies. It gradually became clear that much of the unexplained demand for reserve currencies like the US dollar and other financial assets came from “offshore” sources, much of it mediated

The Mysterious Demand for Big Bills

One early clue, first uncovered by this author in the late 1970s, was the unusual demand for US currency, especially \$100 bills.¹ As of 1980, for example, there was already \$137 billion of US currency and coin in circulation, including \$49 billion in \$100 bills. If this were all really located inside the US, this implied that the average American household was hoarding \$1,667 in cash, including six \$100 bills. At the time that sounded rather high – for the average household, it was almost a month of income, *in addition* to checking deposits and other liquid assets.

Over time, one would also have expected that the “velocity of currency” -- the ratio of national income to currency in circulation, outside banks – should have been *rising*, because of the increased use of checking accounts, cash machines, credit cards, and inflation, and the growth of the government and large corporate sectors, which seldom pay their bills cash.

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¹ See James S. Henry, “Calling in the Big Bills,” *WM*, May 1976, 27-33 (Cover story); James S. Henry, “Why the Underground Economy Is Booming,” *EM*, October 1978. (Study of the demand for cash.); James S. Henry, “Statement,” *The Underground Economy: Hearing Before the Joint Economic Committee*, 96 Congress, 1st Session. 38, 70 (December 1979); James S. Henry, “How to Make the Mob Miserable: The Cash Connection,” *WM*, June 1980, 54-61. U.S. currency outstanding averaged about 5 percent of GNP from 1970 to 1990, while currency turnover, the sum of currency paid out and taken in by the Federal Reserve system divided by the currency stock, increased sharply.

However, it turned out that the velocity of currency was increasing only for the smaller US bills.² From 1970 to 1980, the velocity of \$100 bills in circulation had *fallen* by more than a third, while the velocity of all other US currency in circulation had increased by over a third.³

In the next two decades, the velocity of \$100 bills continued to decline by another sixty percent, while the velocity of other bills and coin in circulation rose by 56 percent. All told, by 2005, there was almost \$750 billion of US currency in circulation, or \$6500 per US household. And more than three-quarters of the increase was accounted by \$100 bills alone, whose stock had reached \$516 billion – **45 bills per US household**. The rest of the US currency stock had fallen sharply, both relative to income and in real terms.

What accounted for this unusual demand for big dollar bills? At first it seemed that the US' own domestic "underground economy" might be responsible – especially tax evasion and drug traffic, which both grew strongly in the 1970s.⁴ But on closer inspection, there were several clues that most of the increased demand was really coming from outside the country.

For example, in 1978 the author obtained data from the US Federal Reserve which revealed that the Fed was taking in more much cash than it was paying out in several Southern border states. From 1970 to 1987, Miami's Federal Reserve Bank received \$77 billion in currency and paid out \$22 billion. The El Paso and San Antonio Federal Reserve banks also turned in multi-billion surpluses.⁵ The demand for dollars in Texas and Florida also appeared to be highly correlated with economic events in Latin America – the dollar outflow from Texas banks soared along with Mexico's devaluations in September 1976, February 1982, and August 1982, while the Federal Reserve's currency surpluses in Miami, "the capital of Venezuela," also ebbed and flowed with events in that country.

² Since the 1930s, US currency outstanding has consisted mainly of \$1, \$5, \$10, \$20, \$50, and \$100 notes, with a relatively small portion of \$2, \$500, \$1000, and \$10,000 bills. Thus the demand for \$100 bills is a good proxy for the "demand for big bills."

³ More precisely, from 1970 to 1980, the gross national income velocity of \$100 bills in circulation had declined from 84.83 to 56.28, or 34 percent, while the velocity of all other US currency and coin in circulation had increased from 22.78 to 31.52, a 38 percent increase. Data sources: US nominal \$GNI from WB-WDI (2005); December US currency and coin outstanding from the [USTB](#).

⁴ For early examples of this proposed "criminal" explanations of the unusual cash demand, see James S. Henry, *op. cit.*; Peter Gutmann, "The Underground Economy," [FAJ](#), Nov./Dec. 1977; Vito Tanzi, "The Underground Economy and Tax Evasion in the U.S.: Estimates and Implications," in Tanzi, *ed.*, [The Underground Economy in the U.S. and Abroad](#). (Lexington Press, 1982). See also James S. Henry, "How to Make the Mob Miserable," [WM](#), April 1980. Prof. Edgar L. Feige of the University of Wisconsin was also a persistent advocate of the view that most US currency demand was due to the domestic underground economy. See, for example, his "Overseas Holding of US Currency and the Underground Economy," in Susan Pozo (ed.), [Exploring the Underground Economy: Studies of Illegal and Unreported Activity](#). (Kalamazoo: W.E Upjohn Institute for Employment Research, 1996.)

⁵ From 1970 to 1987 the U.S. Federal Reserve branches in San Antonio and El Paso took in \$37 billion and paid out \$31 billion. These data are from the U.S. Senate, Joint Economic Committee, and the U.S. Board of Governors, Federal Reserve System, Washington D.C. (Special data supplied to the author.)

In the 1990s, the New York Federal Reserve, which handles most requests for US currency from foreign banks, reported that it had made very heavy currency shipments to Latin America, including \$40 billion of net shipments to Argentina alone. In 1993-94, Russia also received more than \$20 billion a year of US currency shipments from the New York Fed. Visitors to these and other developing countries reported the growth of "dollarization," with US greenbacks increasingly used as "mattress money" and a medium of exchange.

In 1995, two Federal Reserve economists estimated that by then, at least 55 to 70 percent of all US currency was held outside the US, mainly in mid-tier developing countries like Argentina, Russia, and Mexico. They estimated that increased foreign demand had accounted for over half of all the growth in US currency stocks since the 1970s.⁶ Since then, foreign demand for US bills has continued to grow. Our best estimate is that as of 2005, two-thirds of all US currency, including at least 75 percent of all \$100 bills, was held offshore - nearly \$500 billion, mainly in developing countries.⁷

Nor was the US the only First World country to experience this unusual currency demand -- so did Germany and Switzerland.⁸ By the mid-1990s, their respective currency demands per citizen were \$2,000 and \$4,000. Indeed, 30 percent of Deutschmarks were held in the form of 1000 DM notes, worth \$625 a piece. Most of this demand appeared to be coming from "weak currency" countries in the former Soviet Union and Eastern Europe.

One might have thought that the US Treasury and the European Central Bank (ECB) would have wanted to discourage this kind of subterranean demand, or even to recall their large bills occasionally, as several other countries have done.⁹ After all, the easy availability of large bills provides the global

⁶ See Richard D. Porter and Ruth A. Judson, "The Location of US Currency: How Much is Abroad?," USFRB, October 1996, 883-903. For a more conservative estimate, which still finds that 30 percent of US currency was abroad as of 1996, compared with just 5 percent in the early 1970s, see Brian M. Doyle, "Here, Dollar, Dollar...Estimating Currency Demand and Worldwide Currency Substitution," Board of Governors, US Federal Reserve, July 21, 2000.

⁷Testimony, Louise L. Roseman, Director, Division of Reserve Bank Operations and Payments Systems, Board of Governors, before the US House Subcommittee on Domestic and International Monetary Policy, Committee on Banking and Financial Services, 3/28/2000, at <http://financialservices.house.gov/banking/32800ros.htm>

⁸Venezuelan visitors to the U.S. declared more than \$2 billion of cash imports on customs declarations in 1982. U.S. Customs data, Joint Economic Committee, June 1982. As of 1987, forty percent of Switzerland's cash stock was in 1000 SF denominations, worth about \$500 -- not exactly pin money. SNB, 1987 Report, 44.

⁹ For a discussion of this curious policy, see Kenneth Rogoff, "Blessing or Curse? Foreign and Underground Demand for Euro Notes," EconP, April 1998, pp. 263-303. Eight West African CFA-zone countries implemented a cash recall in 2004, partly to curtail counterfeiting, and partly because their currency had become a carrier for disease. "African cash recall to swap dirty money," AP, 9/15/04, at http://www.sptimes.com/2004/09/15/Worldandnation/African_cash_recall_t.shtml.

This author proposed such a recall for \$100 bills in 1976. See Henry (1976), op. cit. The US Treasury and the Federal Reserve reportedly studied the proposal, but has decided to take precisely the opposite course, becoming a purveyor of currency to the global underground economy. For example, in 1996, the

underground economy with a convenient anonymous savings vehicle and a reliable transactions medium, and that just serves the interests of international criminals, tax evaders, drug traffickers, and dictators. To cite one glaring example -- when US troops reached Baghdad in April 2003, they stumbled on a pile of \$100 bills at one of Saddam's palaces that was worth \$762 million. Several of them reportedly had a hard time resisting temptation.¹⁰ It is believed that even more US cash hoards have escaped detection, and have continued to fuel the Iraqi insurgency.

However, apparently the US Treasury and the ECB preferred to reap the \$50 billion of "seignorage" -- implicit interest -- that they earned each year on these offshore cash hoards. In 2002, when it launched the Euro, the ECB even decided to compete directly with the US for the lead role as supplier of underground currency. It issued 100 Euro, 200 Euro and 500 Euro notes that are worth (at mid-2005 exchange rates) \$130, \$260, and \$650 each.¹¹ By 2005 there was E1,528 (\$2,100) per capita of Euro notes in circulation, or more than \$650 billion, 72 percent of it accounted for by these large bills. At least a third were probably held outside the EU.¹²

Growing Haven Demand for Other First World Assets

Consistent with this growing foreign demand for US currency, foreign demand for US securities, bank deposits, and other financial assets also started to take off in the late 1970s. By 2003, this offshore demand accounted for **\$4.98 trillion** of all US bonds, stocks, and other securities outstanding, about 14 percent of the total, compared with just 5 percent in 1974 and 9 percent in 1989.¹³ In 2004-05 alone, this offshore demand for US financial assets grew by \$800 billion.¹⁴ More than half of it was from anonymous sources, either in the form of bearer bonds or by way of companies based in leading havens like the Cayman Islands, Luxembourg, Switzerland, Singapore, and Hong Kong. It is not easy to trace this demand back to specific foreign countries, but it is clear that developing countries accounted for most of it.

Federal Reserve and the Treasury launched a worldwide PR campaign to communicate that there would be no recall of US currency. See US Bureau of Engraving and Printing, "Series 1996-2001 Currency Note Summary," at <http://www.moneyfactory.com/section.cfm/4/27>

¹⁰ See "Soldiers Face Jail In Cash Probe," *CBS*, 4/24/2003.

¹¹ At the 1.3 \$/Euro exchange rate that prevailed as of March 31, 2005.

¹² European Central Bank, data on Euro notes outstanding, March 31, 2005, available at <http://www.ecb.int/bc/faqbc/figures/html/index.en.html>

¹³ See "Report on Foreign Portfolio Holdings at of US Securities," Department of the Treasury, Federal Reserve Bank of New York, Board of Governors of the Federal Reserve System, August 2004.

¹⁴ See US Treasury, "International Capital System Data," 4/15/05, at <http://www.treas.gov/tic/ticpress.html#1>.

Meanwhile, the volume of US bank liabilities to offshore entities – especially deposits, and CDs owned by foreign companies, individuals, pension companies, insurance companies, and offshore banks – also took off in the late 1970s. By 2004 these offshore liabilities stood at \$2.9 trillion. More than half of them also passed through offshore havens, especially those in the Caribbean. That is consistent with a dramatic surge in unrecorded capital, pouring out of the developing world and into First World banks.

Evidence is also available from the IMF on the volume of foreign bank deposits reported by developing country residents. As of 1980s, these *reported* deposits alone were already worth up to 30 percent of the Third World debt's entire face value. But the real number for offshore assets invested by elites in developing countries by way of First World and haven banks was vastly larger, since most of it was invested in “off-balance sheet” assets, either managed or administered by the banks.¹⁵ In addition, a large share of flight capital was also invested in real estate, hedge funds, and other non-bank assets.

When we add up our best estimates of the foreign demand for currency, securities, and bank liabilities, the First World in general and the US in particular clearly became an enormous repository for anonymous foreign capital over the last three decades. By 2004, the US economy alone accounted for **more than \$8.3 trillion** of foreign-held financial assets, the majority of it in the form of anonymous cash and haven-laundered anonymous investments.

Income Missing from the World Accounts

¹⁵ These “off-balance-sheet” assets invested through banks fall into several categories. First, there are “custodial assets” held in trust and registered with banks, but not managed by them. Second, there are “assets under management,” where banks are in charge of making investment decisions. The combined sum of on-balance sheet time deposits, plus custodial assets and assets under management, yields the broadest measure of offshore assets, “assets under administration/supervision.”

The IMF reported in 1988 that \$356 billion of foreign assets were owned by “capital-importing” countries, including \$139 billion of reserves, \$83 billion of bank assets, and \$133 billion of bank deposits owned by “nonbanks.” The “big four” accounted for a quarter of these assets and half of those owned by nonbanks. Argentina, Brazil, Mexico and Venezuela had \$51 billion in deposits by “nonbanks,” out of \$133.3 billion by all capital-importing developing countries. IMF, *IFS* (1989). Another indicator of the foreign assets owned by the elites of “poor” countries is the fact that, for example, in 1988 the five leading Caribbean havens -- Panama, the Cayman Islands, the Netherlands Antilles, Bermuda, and the Bahamas -- held \$159 billion of deposits from foreign nonbanks, and owned \$515 billion of claims on foreign banks. Some of these claims involved interbank transactions. But the sum of deposits *owned in* Caribbean haven banks by foreign shell companies, plus the deposits *owned by* Caribbean shell companies in foreign haven banks, totaled \$240 billion -- in addition to \$133 billion of assets attributable to particular Latin American countries. Because of haven company “layering” this includes some double-counting. It also includes some funds from hidden activities beside flight capital, but leaves out investments like real estate, cash, gold, and securities. Non-Caribbean havens also received substantial foreign bank deposits: in 1987 U.S. banks reported \$81 billion of deposits from “nonbank” residents, while Swiss banks reported \$178 billion, the UK \$236 billion, and Luxembourg \$92 billion -- in addition to trust assets.

Yet another financial puzzle turned up in the mid-1980s, when the IMF began to notice that an increasing chunk of the world's net trade and income was simply *missing* from its global balance of payments statistics.

In principle, the exports, income payments, and transfer payments that Country X reports as having made to Country Y should be identical equal to the imports, income receipts, and transfer receipts that Country Y reports as having received from Country X. For the world as a whole, all these “current accounts” should sum to zero – as should the sum of reported exports and imports, income paid and received from abroad, and international transfer payments. Until the mid-1970s, they more or less did sum to zero. But then a growing gap appeared, which added up to nearly \$700 billion by 1986.¹⁶

The IMF was especially concerned about this discrepancy, because it played “bad cop” whenever developing countries got into debt troubles. In exchange for so-called “structural adjustment” loans, typically the IMF insisted that troubled debtor countries cut back sharply on domestic spending and imports, slashing their *reported* current account deficits in order to generate cash to service their loans. If the reported balance of payments deficits were overstated, that implied that the IMF’s prescriptions might be too harsh – as, in retrospect, we know that they often were.

In 1986 a special IMF working group took a closer look at this “current account gap,” and determined that the single most important factor was missing *investment* income, most of it consisting of unreported interest on foreign private bank deposits.¹⁷ And fully *three-quarters* of the \$230 billion of missing income that it found for 1977-83 belonged to the residents of developing countries, more than half of it to residents of leading *debtor countries*.

Combined with the currency and foreign assets evidence described earlier, this suggested a unifying explanation for all these financial puzzles: a growing share of Third World wealth was being stashed in First World assets – crossing paths

¹⁶ Data source: World Bank WDI(2005), author’s analysis. For the period 1974-1987, the cumulative global current account deficit totaled \$691.7 billion. For the period 1987 to 2003, it swelled to \$1.87 trillion. Only a small portion of this could be attributed to the fact that no estimate are available for some countries, especially low income ones. An earlier IMF study estimated that gross “underreported current account income” for 1977-87 totaled \$657 billion. IMF(1987), Report on the World Current Account Discrepancy, (Washington, DC:IMF, September 1987.) 13. For 1971 to 1977, the total world current account deficit averaged just \$2 billion a year; for 1978 to 1986 this averaged to -\$53 billion. IMF (IFS), July 1988, 136. In 1982 the net discrepancy exceeded \$100 billion.

¹⁷For the period 1977-86, of \$657 billion of total current account understatement in found in the original IMF study, \$227 billion was attributed to unreported investment income, of which \$181 billion was unreported “portfolio investment” income. IMF (BOPY), 1987 V. 38, 2, Table 2, p. 4; (\$/SDR conversion rates reported in IMF (BOPY), V. 38, 1; for 1978-79, IMF, Report, op. cit, 20, 9.) The discrepancy shrank from \$100 billion in 1982 to \$27 billion in 1986 because of the dollar's unusual strength. Measured in SDRs, the official IMF basket of currencies, the discrepancy remained huge. Another \$203 billion of the gap was due to unreported income received by the world's shipping industry, whose vessels are registered in havens like Liberia, Hong Kong, and Panama. Apparently ship owners pay very low taxes.

like ships in the night with all the loans, foreign aid, and investment that were headed for developing country governments.

Indeed, in the two decades since the 1987 IMF study, this gap in worldwide reported current account deficits has continued at an annual average of up to \$200 billion a year. All told, for 1974 to 2003, the cumulative gap totaled \$2.6 trillion, or more than \$2.9 trillion in constant \$1995. On average, about 15 percent of the gap is accounted for by a “trade gap,” the unexplained difference between reported exports and imports, after adjusting for freight and insurance.¹⁸ In most years this trade gap has been negative, a fact that is consistent with the widespread use of over-invoicing for imports and under-invoicing of exports to reduce taxes and park profits abroad. (See Figure 2.6).

However, as the original 1987 IMF study had found, by far the largest source of the discrepancy was unreported income, mainly income on offshore investments. Very little of this unreported foreign-source income accrued to ordinary people in developing countries, the vast majority of whom didn’t even have bank accounts. Part of it was been accounted for by the offshore interest earned by Third World banks, corporations, and government agencies. But most of it was received by private elites from developing countries, who held offshore bank accounts and other assets, but never reported the income that they earned to their home countries. For 1974-2003, this cumulative unreported income gap totaled **\$2.2 trillion**, in \$1995. Since a large share of this was retained and reinvested abroad, earning untaxed interest on interest, the total foreign “flight wealth” stock was even larger.

The fact that most of this capital and income avoided both Third *and* First World taxes entirely obviously did not bode well either for fiscal deficits or the global distribution of income and wealth.

¹⁸ Countries often report their exports on a “free on board” basis, excluding the costs of insurance and freight, while the imports reported by trading partners include these costs, so one has to add back an estimate of these costs before attributing the discrepancy to misinvoicing.