

UNIVERSITY OF GHANA

COLLEGE OF HUMANITIES

**AML/CFT COMPLIANCE: DOES IT INFLUENCE
THE INFLUX OF FOREIGN DIRECT INVESTMENT?**

BY

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**THIS THESIS IS SUBMITTED TO THE UNIVERSITY OF GHANA,
LEGON, IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR
THE AWARD OF MPhil FINANCE DEGREE**

JULY, 2019

DECLARATION

I, Gifty Asantewaa Nkrumah, do hereby declare that this thesis has not been documented for presentation in this or any other university. I, therefore, declare that this thesis is my own work and all references have been recognised accordingly.

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CERTIFICATION

I hereby certify that this thesis was supervised in accordance with procedures laid down by the University.

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DATE

DEDICATION

I dedicate this work to God, who has held my hand through it all, my father of blessed memory, Prof S.A. Nkrumah, who is and will forever be my inspiration, my mother, Mrs Janet D. Nkrumah, and my brothers. You have all been very instrumental in my ability to come this far.

ACKNOWLEDGEMENT

I express my immense gratitude to the Almighty God for His unfailing grace and mercies throughout the duration of this study. In spite of all the challenges that arose, He remained faithful and His grace has brought me this far.

I am also sincerely grateful to my supervisors, Prof. A.Q.Q. Aboagye and Prof. Joshua Y. Abor for their guidance and constructive criticism. Their support went a long way to enhance the quality of this work.

I further extend my appreciation to many others whose assistance in diverse ways contributed to the successful completion of this work – Mr Emmanuel Senanu Mekpor, Mr Charles Ofori Gyamfi, Mr Emmanuel Anokye-Nkansah, Mr Sampson Boateng Anim, Mr Emmanuel Seth Konney and Mr Joseph Agyemang Mensah – as well as others I cannot enumerate. Your support is very much cherished.

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LIST OF ABBREVIATIONS

AML	Anti-Money Laundering
APG	Asia/Pacific Group on Money Laundering
BOG	Bank of Ghana
CFATF	Caribbean Financial Action Task Force
CFT	Countering the Financing of Terrorism
DNFBPs	Designated Non-Financial Businesses and Professions
EAG	Eurasian Group
ERM	Enterprise Risk Management
ESAAMLG	Eastern & Southern Africa Anti-Money Laundering Group
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FI	Financial Institution
FIC	Financial Intelligence Centre
FIU	Financial Intelligence Unit
FSRBs	FATF-Styled Regional Bodies
GABAC	Central Africa Anti-Money Laundering Group
GAFILAT	Latin America Anti-Money Laundering Group

GDP	Gross Domestic Product
GIABA	West Africa Money Laundering Group
IMF	International Monetary Fund
MENAFATF	Middle East and North Africa Financial Action Task Force
MER	Mutual Evaluation Report
ML	Money Laundering
MNE	Multinational Enterprise
MONEYVAL	Council of Europe Anti-Money Laundering Group
OECD	Organization for Economic Co-operation and Development
TF	Terrorist Financing
UNODC	United Nations Office on Drugs and Crime
VIF	Variance Inflation Factor
WDI	World Development Indicators

ABSTRACT

This study examines the relationship between countries' compliance with AML/CFT (Anti-Money Laundering and Countering the Financing of Terrorism) regulations and foreign direct investment. This study, to the best of the author's knowledge, is the first to establish a link between AML/CFT compliance and FDI, with FDI being the dependent variable and AML/CFT compliance, the independent. The research uses a sample size of 74 FATF member states and extracts data on their FDI net inflows and AML/CFT compliance ratings from the year 2004 to 2016. Furthermore, it employs a multiple regression analysis with five control variables.

The results of the analysis indicate that a country's compliance with AML/CFT regulations is a driver of the influx of foreign direct investment into its economy. This discovery is important because the costs of compliance – what seems to be the largest barrier – is not as challenging as it used to appear. Bearing this in mind, countries would be encouraged to put more effort into their compliance activities, instead of aiming for the minimum acceptable level, which seems to be the case at the moment. In addition, it is discovered that the market size, quality of infrastructure, quality of human capital and inflation rate are very instrumental in the attraction of FDI.

Keywords: Anti-money laundering, Money laundering, Terrorist financing, Foreign Direct Investment

CHAPTER ONE

INTRODUCTION

1.1 Research Background

Money laundering is a phenomenon that undoubtedly has many repercussions at various levels. As far as banks and other financial institutions are concerned, money laundering increases their risk of failure (Burbidge, 2004; Mitchell, Sikka, Arnold, Cooper, & Willmott, 2000). Local merchants are more susceptible to heavy losses due to the unfair competition that shell companies create for them (Burbidge, 2004). At the national level, there are issues such as the destabilization of the financial system (Burbidge, 2004; Mekpor, Aboagye, & Welbeck, 2018), political instability (Aluko & Bagheri, 2012; BOG/FIC, 2011) and the facilitation and strengthening of criminals (Levi, 2002; UNODC, 2014). Nketsiah (2013) also identifies, in his paper, the compromise of national security.

The above-identified repercussions, among others, necessitated the establishment of bodies in order to eliminate, or at least manage, the menace of money laundering as well as terrorist financing and the proliferation of weapons of mass destruction – both closely related crimes. In 1989, the G7 (formerly G8) created the Financial Action Task Force (FATF) initially in response to the growing concern of the global drug problem (FATF, 2014a). However, eventually, its mission grew to incorporate the development of international consensus on measures to detect and seize the proceeds from drug crime and other crimes. The FATF is currently the body responsible for the fight against money laundering and terrorist financing at the global level.

One way the FATF carries out its duties of combatting money laundering and other associated crimes is through the creation of the FATF Recommendations (FATF, 2014a). These

recommendations set out the legal and regulatory measures that countries should take in order to mitigate, if not eliminate, instances of money laundering to the barest minimum within their economies. Therefore, it is very obvious that compliance to these Recommendations are very critical to the fight. However, both literature and empirical data cast a pessimistic overview of how much work countries are actually doing with respect to compliance. According to scholars, there is generally a level of compliance among FATF member states. However, it is quite low and leaves much room for improvement (Mekpor et al., 2018; Naheem, 2018; Yeoh, 2014b; Yepes, 2011). The speculation is that the primary motive for compliance by countries is to prevent themselves from getting in trouble. In the words of Mekpor et al. (2018), “it seems as though countries are doing just enough to avoid being blacklisted by FATF giving the reputational repercussions of blacklisting.” Unger (2007) also wonders: “Countries seem to be eager to disappear from the black list. Is this compliance or only declared compliance, compliance in the books?” One suspected reason for this attitude is the high cost associated with AML/CFT compliance (Mekpor et al., 2018). Demetis & Angell (2006) also speak of the phenomenon of fear-driven compliance. Employees of banks and other financial institutions have been seen to lack faith in the legal system’s ability to convict launderers even after their suspicious transactions are flagged. This is because there is hardly ever any hard evidence to back the suspicions. However, in order to be able to be accountable to their superiors and avoid losing their jobs in instances of identified money laundering, bank employees merely go through routine procedures as expected of them. Employees now report everything unusual without using discretion. Unger & den Hertog (2012) partly confirm this assertion. As a result, many countries have increased reports of money laundering cases, however with a corresponding decline in the quality of information produced (Naheem, 2015; Takáts, 2011). Takáts (2011) refers to this as the theory of Crying Wolf.

1.2 Research Problem

It is quite apparent – and troubling, to say the least – that the highest motivation for any individual, institution or country to comply with AML/CFT directives is to avoid trouble. It also explains to an extent why compliance is not as effective as it should be. The issue is particularly worrying because the distress that financial crimes such as money laundering and terrorist financing cause cannot be overstated. According to a study by the United Nations Office on Drugs and Crime (UNODC), in 2009, of the 3.6 % of global gross domestic product that was as received as a result of criminal proceeds, 2.7% of it was laundered – an equivalence of USD 1.6 million (FATF, 2019). The 1998 statistics of the International Monetary Fund also estimated the size of money laundering to be between USD 590 billion and 1.5 trillion, which constituted between 2% and 5% of the world's GDP (FATF, 2019). However, these figures are far from precise, as the clandestine nature of the crime makes it impossible for anyone to have accurate statistics on the magnitude of financial losses. It is very apparent that any country that subjects itself to those crimes causes much damage to itself. Perhaps, it is also an indication that there is still a lot of work to do with respect to knowledge of the repercussions of money laundering and terrorist financing as well as the essence of AML/CFT procedures and compliance.

Gradually, the world is beginning to appreciate the gravity of damage by financial crimes especially money laundering and terrorist financing. At least, it appears to be the case in research and academic circles. Evidently, the attention that scholars across the globe have given to issues pertaining to these phenomena has been observed to have increased over the years. Previous research on money laundering have covered areas such as typologies and emerging trends and threats in money laundering (Simser, 2012); the role of banks in Ghana in the fight against money

laundering (Nketsiah, 2013); conditions, environments and mechanisms that facilitate or impede money laundering (Dostov & Shust, 2014; Irwin, Slay, Choo, & Liu, 2014); the link between anti-money laundering and Enterprise Risk Management (Welbeck, 2015); factors hampering the implementation of international AML laws (Keesoony, 2016); the effectiveness of existent AML/CFT measures (Kemal, 2014; Teichmann, 2017) and the determinants of AML compliance in FATF member states (Mekpor et al., 2018). However, to the best of the researcher's knowledge, little or no research has been done that links compliance to anti-money laundering/countering the financing of terrorism regulations and the inflows of foreign direct investment into a country.

It has been stated a number of times that money laundering and terrorist financing have a lot of ramifications at various levels. However, avoidance of the stated effects does not appear to be enough motivation for institutions and countries. It has also been conjectured that one major factor that has been identified as an impediment to AML/CFT compliance is the cost that is incurred. Perhaps, the perception is that the losses do not match up to the costs that are incurred in managing the menace. However, this is not the case, as the statistics indicate. Nonetheless, this research identifies the need to find a better motivation, from a financial viewpoint, for all entities to be compliant – one that would, to an extent, reduce, if not completely nullify the costs that accompany AML/CFT compliance. Foreign Direct Investment (FDI) has been seen to be very instrumental in a country. A positive relationship has generally been established between FDI and growth (Borensztein, Gregorio, & Lee, 1998; Li & Liu, 2005). Other benefits that the host country is known to receive are the transfer of knowledge and skill to domestic firms (Haddad & Harrison, 1993); provision of technology and innovation (Perez, 1997) and the maintenance of a healthy balance of payment (Kumari & Sharma, 2017). If various countries are aware that their actions pertaining to AML/CFT has an influence on the FDI they attract, they would be encouraged to be

more enthusiastic in their efforts. The purpose of this paper, therefore, is to examine the impact that AML/CFT compliance has on Foreign Direct Investment inflows.

1.3 Research Objective

The objective of this paper is to investigate the impact that compliance with AML/CFT regulations has on Foreign Direct Investment influx in FATF member states.

1.4 Research Question

The study seeks to find an answer to the following question:

“Does compliance with AML/CFT regulations have an impact on Foreign Direct Investment influx in FATF member states?”

1.5 Research Hypothesis

The following hypothesis is formulated, based on the above-stated research question:

H_0 : The level of compliance to AML/CFT regulations has an impact on the influx of Foreign Direct Investment

H_A : The level of compliance to AML/CFT regulations does not have an impact on the influx of Foreign Direct Investment

1.6 Scope of Study

The research was carried out on 74 countries that are a part of the Financial Action Task Force (FATF) – either by membership or affiliation. A purposive sampling method was applied in order

to capture only those that had at least one AML/CFT compliance rating based on the index by Mekpor et al and also had data on their FDI net inflows. Due to that necessity, all data falls within the year range 2004 and 2016. This is because mutual evaluation reports (MERs) for countries, on which the compliance ratings are based, are available for just this period. The various countries within this range cut across all continents and income brackets. The 74 countries are thus a good representation of the global AML/CFT regime.

1.7 Significance of the Research

This study promises to be a valuable addition to literature on money laundering and financial crime in general. This presents what is probably the first research establishing a direct link between AML/CFT compliance and Foreign Direct Investment. Other scholars would also be encouraged to establish links between AML/CFT compliance and other economic indicators which would go a long way to serve as an encouragement to compliant countries. Researchers can also consider a comprehensive cost-benefit analysis of AML/CFT and AML/CFT compliance in various countries. In addition, the findings of this research will hopefully make countries come to the realisation that the cost of compliance, which is probably the major reason for their minimal effort, is traded off when they reach higher levels of compliance, especially in the long run. Thus, they would be motivated to look beyond the cost of AML/CFT compliance and make a more conscious effort to combat money laundering in their respective economies. Their cause to fight money laundering and other financial crime will go beyond the mere avoidance of blacklisting. It is also expected that on new information gained, FATF and other bodies responsible for leading the fight against money laundering would have even more statistical evidence to intensify its sensitization on the essence of AML/CFT compliance.

1.8 Research Limitations

There was a major challenge that was encountered during this study. This is apparently a challenge that quite a number of scholars that work on issues pertaining to money laundering and terrorist financing face.

Money laundering and terrorist financing are under-researched topics in literature. This brought about the difficulty of getting literature on certain areas under ML/TF that needed a more detailed exposition on, especially with respect to AML/CFT and compliance with the regulations. Also, getting high-frequency statistical data on ML/TF as evidence proved to be unattainable. This is attributed to the covert nature of the activities of launderers that makes it practically impossible to keep accurate records. Due to that limitation, it was quite challenging to conduct a detailed literature review as desired. Also, it was impractical to carry out a panel data regression.

1.9 Chapter Disposition

This study comprises five chapters.

The first chapter introduces the subject matter of the study and summarises the entire research. It spells out the motivation for the study in the background and research problem, states the research objective and question, formulates the hypotheses which are grounded on the research question, mentions the scope as well as the limitations of the study and concludes with the structure of the research.

The second chapter delivers a review of previous relevant literature that pertains to Foreign Direct Investment and AML/CFT. It covers areas such as the essence of FDI and attempts to account for

the hypothesized nexus between AML/CFT compliance and Foreign Direct Investment. It also addresses themes such as the consequences of money laundering, the rule-based versus the risk-based approaches to AML and drivers of foreign direct investment.

The third chapter explains the methodology of the research. It discusses the econometric methods and techniques that are applied in order to arrive at the results as well as the diagnostic tests that are carried out on the data. It outlines the research design, population of the study, sources of the data and then specifies the econometric model.

The fourth chapter discusses the results and findings of the research. There, the objective of the study is addressed and there is a preliminary insight into whether or not the null hypothesis would be rejected. It also presents the descriptive statistics of the dataset as well as the results of the diagnostic tests.

The fifth chapter concludes the study. It summarises the findings of the research and based on the findings, a conclusion is drawn, recommendations are given and suggestions are given for further research in the subject area.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter is a review of previous literature on foreign direct investment, money laundering and the fight against it. It also attempts to establish a relationship between anti-money laundering and the inflows of foreign direct investment, based on the findings of other researchers. The chapter is divided into two: theoretical literature and empirical literature.

THEORETICAL LITERATURE

2.2 Foreign Direct Investment – an overview

The fifth edition of the IMF's Balance of Payments Manual (BPM5) defines FDI as a category of international investment that reflects the objective of a resident in one economy (the direct investor) obtaining a lasting interest in an enterprise resident in another economy (the direct investment enterprise) (International Monetary Fund, 2003). In simpler terms, it is an investment made by a firm or individual in one country into business interests located in another country. The "lasting interest" stated in the definition by IMF implies the existence of a long-term relationship between the investor and the investment enterprise (Duce, 2003; International Monetary Fund, 2003).

By all indications, Foreign Direct Investment is very beneficial to both investors and hosts alike. It is therefore not surprising that countries are taking steps to increase FDI inflows (Carkovic & Levine, 2002; Kumari & Sharma, 2017). Dunning (1980) expounds on the advantages that FDI has to investors, categorising them into three: locational advantages, internalization advantages and ownership advantages. Locational advantages refer to the country-specific advantages

investors gain from investing abroad. These may include tax benefits, sound institutionalization, low labour costs, a productive labour force and quality infrastructure. Internalization advantages are derived from the production kind of activities undertaken by the investors instead of licensing them to an external party. Ownership advantages determine which firms supply a particular foreign market. These may include the investors' superiority over their competitors in terms of marketing practices or on the technological front.

Host countries also benefit immensely from FDI inflows. However, the extent to which a host country benefits from the influxes of FDI are subject to factors such as the economic growth rate (Kumari & Sharma, 2017); the absorptive capacity (Agbloyor, Gyeke-Dako, Kuipo, & Abor, 2016; Borensztein et al., 1998; Perez, 1997); and the political, social and economic growth rate of the host country (Alam & Shah, 2013).

A positive relationship has generally been established between FDI and growth (Alam & Shah, 2013; Borensztein et al., 1998; Choe, 2003; Li & Liu, 2005). However, other studies have found either a negative or insignificant relationship between FDI and growth (Aitken & Harrison, 1999; Djankov & Hoekman, 2011; Ericsson & Irandoust, 2001). The variety in outcomes has led to a theory that FDI promotes growth only under certain conditions such as human capital development, trade openness, macroeconomic stability, infrastructural development, good governance and economic freedom (Agbloyor et al., 2016; Azman-Saini, Baharumshah, & Law, 2010; Borensztein et al., 1998; Carkovic & Levine, 2002). A study by De Mello (1999) also reveals that the growth that the host country experiences is contingent on the knowledge imparted from the investing country as well as the technology spillovers.

The other benefits that a host country derives from FDI include but are not limited to the following: contribution to the country's gross domestic product (Kumari & Sharma, 2017); economic

development (Choe, 2003; Li & Liu, 2005; Masron & Abdullah, 2010); enhancement of capital (Alam & Shah, 2013); induced increase in productivity of domestic firms (Caves, 1974; Perez, 1997); increase in employment (Alam & Shah, 2013; Kumari & Sharma, 2017; Perez, 1997); maintenance of a healthy balance of payment (Kumari & Sharma, 2017) and an improvement in technological proficiency (Borensztein et al., 1998; Haddad & Harrison, 1993; Kumari & Sharma, 2017; Perez, 1997).

2.3 Theories that support factors influencing MNEs' decisions pertaining to FDI

There are factors that are known to influence the decisions of a firm that are in connection to Foreign Direct Investment – whether or not to invest, where to invest, how much to invest, when to stop and other considerations. These factors, which would later be discussed, are based on theories that have been propounded by scholars. We look at some of these theories below.

2.3.1 Eclectic Paradigm

The Eclectic Paradigm, as introduced early on, categorises the advantages that investors derive from FDI into three – ownership advantages, locational advantages and internalization advantages (Alam & Shah, 2013). It was propounded in 1979 by John H. Dunning (Bloomenthal, 2019). It is also known as the OLI Model or OLI Framework.

Dunning states that for FDI to be beneficial, the aforementioned advantages must be evident. The ownership advantages refer to the proprietary information and various ownership rights of a company – the assets that give them a competitive advantage over other firms (Dunning, 1980; Ruhl, 2016). Alam & Shah (2013) describe them as giving firms “superiority over its competitors in terms of marketing practices or on the technological front.” These include things such as a

blueprint, a patent, reputation or managerial talent. Ownership advantages are typically considered to be intangible (Bloomenthal, 2019).

The locational advantages refer to country-specific advantages that make it worthwhile for a firm to operate in one country over another (Alam & Shah, 2013; Dunning, 1980; Ruhl, 2016). They include low labour costs, a productive labour force, transportation savings, low tax rates. They are usually helpful by reducing costs involved in production and/or exports (Ruhl, 2016). Often, these advantages are immobile.

The internalization advantage says that there must be a gain from keeping the international expansion within the firm (Ruhl, 2016). In other words, the advantages that are categorised as internalization advantages are the ones MNEs gain because of the decision to undertake activities by themselves instead of outsourcing them to third parties.

When these conditions are met, it may be most profitable to organise the firm as a multinational (Ruhl, 2016).

2.3.2 Internalization Theory

The Internalization Theory was propounded by Buckley and Casson in 1976 (Alam & Shah, 2013). This theory suggests that multinational enterprises would primarily manage and organise activities internally in order to build up their firm-specific advantages (Buckley & Casson, 1976). It also goes ahead to submit that firms indulge in internalization when the external market is imperfect or it is costly to produce through external sources. Rugman (1981) extended the theory and also posited that FDI takes place when the benefits of FDI exceed the incurred costs. The implication of the theory is that the only condition under which a firm would invest in another country is if, according to its projection, it would make a gain at the end of the day. Any contrary indications

would imply that it is actually more profitable to manage all affairs internally. It would, therefore, be an unwise decision to invest in a foreign country given those circumstances.

2.3.3 Product Life Cycle Theory

The Product Life Cycle Theory was propounded by Raymond Vernon (Shodhganda, 2019). According to Vernon, there is a pattern of FDI over time. He stated that a typical manufactured product has a life cycle (Hung, 2004). This cycle has four stages – innovation, growth, maturity and decline – and at each stage, production moves from one country to another (Hung, 2004; Shodhganda, 2019). During the introductory stage, production stays within the country for local consumption (Shodhganda, 2019). This is essential because of its research and development capabilities, human resources and the need for the site of production of a new product to be close to its market (Hung, 2004). According to Vernon (1966), it is the stage at which “communication between the market and the executives directly concerned with the new product is swift and easy, and in which a wide variety of potential types of inputs that might be needed by the production unit are easily come by”. It then moves to other industrial countries during the growth stage. At this stage, the product has attained a level of standardness and popularity in the local market and the need for flexibility falls (Hung, 2004; Kottaridi, Filippaios, & Papanastassiou, 2010). After that, during the maturity stage, the producer invests in manufacturing facilities in developing countries (Kottaridi et al., 2010; Shodhganda, 2019). These countries often offer comparative advantages in various ways, especially cheap labour (Kottaridi et al., 2010). Hence, that is the stage where FDI takes place (Shodhganda, 2019).

All the above-stated theories in diverse ways are foundational pieces to this research. However, the Internalization theory is the major underpinning of this work. It offers an intuitive explanation for the drivers of FDI that are reviewed in this paper. It is also the basis upon which a positive significant relationship between AML compliance and FDI inflows is theorised. This would be explained in detail in the next section.

2.4 The Nexus between AML/CFT Compliance and FDI

Previous literature does not clearly establish a link between AML/CFT compliance and FDI inflows. However, the internalization theory as discussed in the previous section reveals that firms' decisions to invest in a different country is heavily influenced by a cost-benefit analysis that they perform beforehand. Based on the theory, this section hypothesises some reasons for which a host country's decision to make a conscious effort to be more compliant would affect the quantity of Foreign Direct Investment that it attracts.

It must be noted, though, that due to the inadequacy of literature on the benefits of AML/CFT, these points are mainly based on some of the identified repercussions of money laundering. Those will be explained in detail in a later section.

First, FDI can be positively influenced by AML/CFT compliance because good AML/CFT regimes are an indicator of relative economic and financial stability (International Monetary Fund, 2018). Increased volatility of cash inflows in the economy of a country exposed to money laundering is known to cause the financial and economic instability of the country (Aluko & Bagheri, 2012; Burbidge, 2004; International Monetary Fund, 2018; Mekpor et al., 2018). Instability of the economic and financial sectors of a country have been seen to be a discouragement to foreign investment as investors fear the risk of less than satisfactory returns

(International Monetary Fund, 2018; Keesoony, 2016). It is, therefore, a safe conclusion to make that countries with higher compliance are more likely to attract FDI as investors are more confident.

Another reason AML/CFT compliance is expected to have a positive relationship with FDI inflows is that a compliant country is more likely to be politically stable. Money laundering is a major threat to the political development of a country (Aluko & Bagheri, 2012; BOG/FIC, 2011). This is due to the fact that organized crime uses many forms of corruption to infiltrate into the political processes of such countries. Unsurprisingly, research shows a negative relationship between political stability and FDI inflows (Asiedu, 2009; Cleeve, 2012; Root & Ahmed, 1978; Schneider & Frey, 1985). By this logic, FDI is more probable to be attracted to more compliant countries.

Also, AML/CFT compliance is likely to increase FDI inflows because it is an indicator of lower unnecessary competition. We will learn later on that money launderers create unfair competition for other firms through shell companies since these companies are actually just a front for their activities (Aluko & Bagheri, 2012; Burbidge, 2004; Watkins et al., 2003). This is bad news for foreign investors because it means they have to put in extra resources in order to catch up or risk losing market share (David, 2011). Market share and increased costs of production have a positive and negative relationship with FDI, respectively (Alam & Shah, 2013; Kumari & Sharma, 2017; Resmini, 2000). It is therefore expected that there would be a positive relationship between AML compliance and FDI inflows.

2.5 Money Laundering – basic concepts

2.5.1 Money Laundering

Many scholars and institutions have attempted to come up with an operational definition for money laundering. In their bid to do that, each of them has comprehensibly captured different aspects of the above definition. Leong (2007) puts it quite literally. She refers to the process as “dirty money” that is being “washed” and comes out in the end as “clean”. The principle of clean and dirty money is also used and explained by Fanta & Mohsin (2010). According to them, clean money is earned from legal work and dirty money, from illegal work. Simser (2012) highlights the fact that the motive behind money laundering is for culprits to enjoy their “cleansed” money without interference from predatory underworld rivals or law enforcement.

Apart from researchers, organisations have also coined definitions for money laundering. The BOG/FIC Guideline for AML/CFT (2011) defines money laundering as the process whereby criminals attempt to conceal the unlawful origin and/or ownership of property and assets that are proceeds of criminal activities. The United Nations Office on Drugs and Crime (2014) also defines money laundering as the method by which criminals disguise the illegal origins of their wealth and protect their asset bases in order to avoid the suspicion of law enforcement agencies and prevent leaving a trail of incriminating evidence. Lastly, the International Monetary Fund (2018) describes money laundering as the processing of assets generated by criminal activity to obscure the link between the funds and their illegal origins.

Throughout the various definitions, one fact is noteworthy. What makes money laundering qualify as such is the illegitimacy of the sources of funds. By implication, the term “money laundering” cannot be used to refer to a financial crime in which the funds were not illegally obtained (Kemal, 2014; Unger & den Hertog, 2012).

The Anti-Money Laundering Act, 2008 (Act 749) finds an individual guilty of money laundering if the person knows or ought to have known that property is or forms part of the proceeds of unlawful activity and the person converts, conceals, disguises or transfers the property; conceals or disguises the unlawful origin of the property or; acquires, uses or takes possession of the property. This indicates that the law requires individuals to have at least a basic knowledge of money laundering in order to identify money that is “dirty”. Ignorance of the law is not justifiable as far as the law is concerned.

2.5.2 Terrorist Financing

Terrorist financing is simply the provision of financial support to terrorists or terrorist organisations for the facilitation of terrorist acts (Ali, 2006; Weintraub, 2002).

A definition of terrorism helps to better appreciate the crime of terrorist financing. According to Sandler & Enders (2008), terrorism is the premeditated use or threat of use of violence by individuals or subnational groups to obtain a political or social objective through the intimidation of a large audience, beyond that of the immediate victim. The goals of terrorist groups include publicity, dissemination of ideology, destruction of a society or regime and simply the desire to spread terror and intimidation (Irwin, Choo, & Liu, 2011).

Ali (2006) outlines certain acts as offences of terrorist financing – using or possessing terrorist property; making terrorist or financial related services available for terrorist individuals or groups; dealing in terrorist property; facilitating a transaction on behalf of a terrorist individual or group and taking steps to conceal property owned or concealed by a terrorist individual or group.

Unlike money laundering, terrorist financing does not place as much focus on the source of the funds. That is to say that the money used to finance terrorist activities is not necessarily from an

illegitimate source (Irwin et al., 2011; Simser, 2011). On the contrary, the main concern with terrorist financing is the destination of such funds (Ali, 2006).

Another way terrorist financing differs from money laundering is in motive. The primary motivation for terrorist financing is not financial gain, but rather the use of funds to facilitate acts of terrorism (Irwin et al., 2011).

Despite the identified differences, the two crimes are closely related. They both often exploit the same vulnerabilities in financial systems that permit too much anonymity and opacity in carrying out transactions (International Monetary Fund, 2018). Also, they both pose major threats to international peace and security (BOG/FIC, 2011).

Irwin et al. (2011) identify three terrorism financing models: the traditional terrorism financing model, the reverse terrorism financial model and the alternative terrorism financing model.

2.6 The Process of Money Laundering

It is worthy of note that launderers take the route of least resistance. Money launderers would typically target countries or sectors with weak AML regimes as such places come with a low risk of detection of financial crime (FATF, 2019). It is probably based on that circumstance that Yeoh (2014a) identifies the banking system as an obvious route. He attributes it to the fact that most banks, in their enthusiastic bid to make profits, avail a range of products to the launderer to take advantage of.

The process of money laundering is generally grouped into three stages: placement, layering and integration (Buchanan, 2004; Gilmore, 1995; Ryder, 2012)

In the placement stage, the cash generated from the crime is introduced into the financial system. Thus, illegally obtained funds are moved physically to a place or into a form that disguises the

origin of the funds (Madinger & Zalopany, 1999). This is apparently the most challenging stage for the launderer as illegal money can be very easily identified (Irwin et al., 2011; Watkins et al., 2003). However, criminals can circumvent the system by breaking down large amounts of cash into less conspicuous amounts before depositing them in the bank (Watkins et al., 2003). This procedure is known as smurfing. Alternatively, launderers can purchase a series of monetary instruments such as cheques and money orders (FATF, 2019).

This is followed by the layering stage. Launderers, at this phase, attempt to ensure that dirty money cannot be distinguished from clean money by exploiting the frequency, volume or complexity of transactions (Watkins et al., 2003). In other words, complex layers of financial transactions are created (Irwin et al., 2011). Funds are disguised or concealed through a myriad of transactions through banks and other financial institutions, bank cheques, collective accounts, payable-through accounts, loans at low or no interest rates, back-to-back loans, fake invoices and insurances, fictitious sales and purchases, shell companies, trust offices or special purposes entities, wire transfers and monetary instruments (Welbeck, 2015). Another method launderers use is to wire the funds through a series of accounts at various banks across the globe (FATF, 2019). This is especially prevalent and useful to launderers in jurisdictions that do not cooperate in anti-money laundering investigations.

Integration is the final stage of the process. During this stage, criminals attempt to integrate the funds into legitimate businesses (Watkins et al., 2003). Finally, “the launderer is reconciled with their laundered funds which are clothed with legitimacy” (Keesoony, 2016). This is when it becomes extremely difficult to differentiate between legal and illegal money (Irwin et al., 2011).

2.7 Predicate Offences under Money Laundering

Money laundering is described as a derivative crime (BOG/FIC, 2011). The term refers to a crime that is the result of another crime. This presupposes that for money laundering to occur, there must be prior occurrence of some unlawful activity.

The crimes that underlie money laundering are referred to as predicate offences (USLegal, 2016). The offences that make this list are not definite – they vary and are ranked depending on the vulnerability of the country in question (Jayasuriya, 2003). Crimes typically flagged as predicate offences include but are not limited to terrorist financing; arms smuggling; prostitution; participation in an organized criminal group and racketeering; illicit trafficking in narcotic drugs and psychotropic substances; gambling; sale of pornographic material; fraud; tax evasion; sexual exploitation; corruption and bribery; counterfeiting currency; environmental crime; extortion; murder and grievous body injury; insider trading and market manipulation; counterfeiting and piracy of products; trafficking in human being and migrant smuggling; and illegal restraint and hostage-taking (BOG/FIC, 2011; Jayasuriya, 2003; Unger & den Hertog, 2012).

2.8 Repercussions of Money Laundering

It cannot be stated enough that the menace of money laundering has so many consequences to various entities. Boister (2012) remarks that “it constitutes a harmful criminal activity separate from the predicate offences”. Some of these repercussions are outlined by numerous scholars, though the list is definitely not exhaustive.

Financial institutions that accept illegal funds expose themselves to increased volatility in their cash flows (Burbidge, 2004; Mekpor et al., 2018). This is due to the fact that these institutions merely serve as a conduit for laundering activities (Yeoh, 2014a). Large amounts of money that

flow into the system are therefore likely to flow out just as suddenly. Consequently, their risks of liquidity, solvency and eventually, reputation rise as well (Burbidge, 2004). These increase the likelihood of their failure (Mitchell et al., 2000).

The activities of money launderers also put other merchants at a disadvantage. Launderers sometimes use shell companies to hide their activities – companies that are not set up to actually make profit but as a disguise to be able to be accountable for cash flows (Aluko & Bagheri, 2012; Standberg, 1997; Watkins et al., 2003). Thus, they can afford to sell at unusually low prices that genuine competitors must either beat or run the risk of not selling (Aluko & Bagheri, 2012; Burbidge, 2004). Either way, this usually makes them run at a loss or, in the best-case scenario, cuts into their profit.

Money laundering also causes financial and economic instability of the country involved (Aluko & Bagheri, 2012; Burbidge, 2004; International Monetary Fund, 2018; Mekpor et al., 2018). This is also due to the increased volatility of cash flows, attributing to the fact that sectors in the economy serve merely as channels for illegal activities. Correspondingly, currency and interest rates are also distorted (Aluko & Bagheri, 2012; Burbidge, 2004).

Another key aspect that is dealt a heavy blow by the activities of money laundering is the reputation of the host nation. Being a country associated with money laundering creates a bad name and investors eventually lose confidence in the said country. It becomes even more severe when the nation is blacklisted by regulatory bodies (Unger, 2007). Unfortunately, it is not always possible to repair a damaged reputation (Burbidge, 2004).

Other hazards that accompany money laundering are the compromise of the criminal justice system (Gilmour, 2016; Levi, 2002; Mekpor et al., 2018; UNODC, 2014); loss of revenue (Aluko & Bagheri, 2012); political instability (Aluko & Bagheri, 2012; BOG/FIC, 2011); compromise of

national security (Nketsiah, 2013); decline of the integrity of the private sector (Unger & den Hertog, 2012); disruption of international trade (Wright, 2013); undermining of integrity and loss of confidence in the international financial system (Aluko & Bagheri, 2012; Livescu, 2017; Ryder, 2012; Wright, 2013); and undermining of democracy and the rule of law (Diamond, 2016; FATF, 2019; Gilmour, 2016).

2.9 Anti-Money Laundering

The aftermaths of money laundering activities as outlined in the previous section are enough evidence of the necessity of the fight against money laundering. It therefore comes as no surprise that the international community has stepped up in the effort to deter this menace. Thankfully, literature records an appreciable level of advancement, even more so due to the strengthening of AML/CFT regimes and an increase in cooperation and support among agencies (Irwin et al., 2011; Yikona, Slot, Geller, Hansen, & el Kadiri, 2011).

The initiation of policies against laundering policies go as far back as the 1980s (Gill & Taylor, 2004; Verhage, 2011). The council of Europe was then strongly fighting for the government of its member states to ratify the measures put in place against money laundering, especially through banks (Gill & Taylor, 2004). In 1988, the UN and the Basel Committee also established measures to combat money laundering – the former did this through a convention in Vienna and the latter, through the commissioning of the Basel Committee on Banking Supervision (Viritha, Marriapan, & Venkatachalapathy, 2015). The aim of this committee was to protect the banking system from being used as a channel for launderers.

At the global level, the Financial Action Task Force (FATF) is the principal body tasked with the mandate to fight money laundering and terrorist financing. However, other international bodies

like the International Monetary Fund (IMF), the World Bank, the United Nations Office on Drugs and Crime (UNODC) and the FATF-style regional bodies (FSRBs) are also steadily involved in the fight, hand-in-hand with FATF (Burbidge, 2004; Mekpor et al., 2018).

The FATF-style regional bodies are smaller bodies that work closely in conjunction with the FATF in order to achieve global implementation of the AML/CFT regulation (FATF, 2019). Nine in number, they are distributed across the globe and supervise over approximately 160 countries in addition to the 36 countries directly under FATF. The main task of these bodies is to devise systems for combatting money laundering and terrorist financing in their respective regions. The FSRBs conduct mutual evaluation reports of the member states and make recommendations for their improvement (EAG, 2019). In addition, they are involved in the study of typologies (EAG, 2019). The FSRBs are as follows: Asia/Pacific Group on Money Laundering (APG) based in Sydney, Australia; Caribbean Financial Action Task Force (CFATF) in Port of Spain, Trinidad and Tobago; Eurasian Group (EAG) based in Moscow, Russia; Eastern & Southern Africa Anti-Money Laundering Group (ESAAMLG) in Dar es Salaam, Tanzania; Central Africa Anti-Money Laundering (GABAC) based in Libreville, Gabon; Latin America Anti-Money Group (GAFILAT) based in Buenos Aires, Argentina; West Africa Money Laundering Group (GIABA) based in Dakar, Senegal; Middle East and North Africa Financial Action Task Force (MENAFATF) based in Manama, Bahrain; and Council of Europe Anti-Money Laundering Group (MONEYVAL) based in Strasbourg, France (APG, 2019). The jurisdictions that fall under the FSRBs have Financial Intelligence Units (FIUs) that oversee affairs with respect to AML/CFT within the country.

The universally recognised international standard for AML/CFT is the 40 Recommendations created by FATF (FATF, 2014a, 2018). Other countries and institutions, on their own, have also

passed rigorous laws for the same cause. Noteworthy among them is the US Patriot Act (Costanzo, 2013). It gives a detailed account of a shift of the United States' approach of AML from rule-based to risk-based (Mekpor et al., 2018). The United Nations has also put in place initiatives such as The United Nations Convention against Transnational Organized Crime, the Terrorist Financing Convention, the United Nations Global Programme against Money Laundering and The Global Programme against Terrorism (Shehu, 2005).

Some challenges to the enforcement of AML have been identified by scholars though. It has been observed that criminals consistently find new ways to circumvent the measures that have been put in place to combat money laundering and terrorist financing (FATF, 2014a; Mekpor et al., 2018). Keesoony (2016) also notices that difficulty in achieving uniformity of laws as well as inconsistencies regarding the extent to which certain laws are binding in different jurisdictions are both barriers to the implementation of international AML laws. In addition, Kemal (2014) points out a limit to the FATF Recommendations. As they are not legally binding, they do not have a strong impact, leading to weak compliance among nations. A proffered solution is the infusion of these recommendations into every country's constitution (Kemal, 2014).

2.10 Rule-based vs. Risk-based Approaches to AML

The early days of AML policy experienced what was known as the rule-based approach. This system was characterised by hard and fast rules. Based on rigid rubrics, accountable institutions were required to report suspicious activities to financial intelligence units. However, this approach was accompanied by two main challenges. There was primarily the issue of the extremely large number of transactions that the financial institutions were dealing with. Secondly, launderers easily evaded the system through smurfing. (Mekpor et al., 2018). This is the process where criminals

break down laundered money into smaller amounts in order to pass it through the financial system. This was successful because the rule-based system often defined a threshold amount of which amounts above were flagged for investigation. Therefore, so long as monies that went through the system were below the threshold, they were very likely to evade the risk of being flagged.

The risk-based method was introduced to mitigate the challenges presented by the rule-based approach. It placed an obligation on not only financial institutions but also on other agencies such as law firms, real estate agencies and notaries – collectively known as Designated Non-Financial Businesses and Professions (DNFBPs). They were required to document transactions they considered as high-risk relating to their unique professions, giving particular attention to contextual factors such as their size, composition and structure (Jayasekara, 2018; Mekpor et al., 2018). Thus, instead of rules, risk was placed at the centre-stage (Yeoh, 2014a). The risk-based approach improves upon the rule-based approach in terms of quality, time consumption, resource allocation and cost (FATF, 2007; Jayasekara, 2018; Yeoh, 2014a). Consequently, supervisors are better enabled to strengthen the AML/CFT regime of their respective countries (Jayasekara, 2018; Yeoh, 2014a).

A few challenges, however, have been identified as well. Firstly, the risk-based approach is accompanied by high costs, especially in the short term (Costanzo, 2013; FATF, 2007). Nevertheless, Costanzo (2013) optimistically posits that in the long term, the rewards from a more effective AML regime compensate for the high costs. Also, the adoption of the risk-based system comes with a greater need for more expert staff capable of making sound judgements (FATF, 2007).

2.11 The Financial Action Task Force

The Financial Action Task Force (FATF) is an independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction (FATF, 2009, 2014b, 2018). It was established in 1989 by the G7 and the President of the European Commission (Burbidge, 2004). The constituents of this entity were then from the G7 member states, the European Commission and eight other countries (Burbidge, 2004). The FATF was tasked to examine money laundering threats and trends, review actions that had already been taken at a national or international level and set out measures needed to combat money laundering (Burbidge, 2004).

The Financial Action Task Force currently comprises 36 member jurisdictions, 2 regional organisations and several other observer organisations. FATF also works closely with nine FATF-style regional bodies (FSRBs) which encourage the effective implementation of the FATF Recommendations in their respective territories. The global network of FSRBs and FATF memberships brings the jurisdictions of FATF to a total of over 200. (FATF, 2019)

The Financial Action Task Force sets criteria for the adequacy of AML/CFT programs for its member countries (Axelrod, 2017).

2.12 The FATF Recommendations

The FATF Recommendations are at the crux of FATF's work (FATF, 2014a). A year after FATF was created, it presented the first set of Recommendations to provide measures for the detection, prevention and punishment of the abuse of the international financial system for money laundering (Burbidge, 2004; FATF, 2014a; Mekpor et al., 2018). The Recommendations have undergone a

number of refinements since. For instance, in 2001, eight special recommendations (later expanded to nine) were added in order to deal with the issue of terrorist financing (FATF, 2014a, 2018). They were revised for a second time in 2003 to incorporate stronger standards for predicate offences and stronger customer due diligence requirements (FATF, 2014a, 2018). The latest revision of the FATF Recommendations was in 2012. It addresses new and emerging threats such as the proliferation of weapons of mass destruction (FATF, 2014a, 2018). In addition, the 40 Recommendations were restructured to fully integrate the 9 Special Recommendations that made provision for terrorist financing (FATF, 2018).

The FATF Recommendations provide an extensive and detailed list of measures that countries should have in place to combat money laundering and terrorist financing (Yikona et al., 2011). Based on these recommendations, many countries institute their AML/CFT regime. For instance, in most countries, financial institutions are required by law to report suspicious transactions – or suspicious activities, as referred to in some jurisdictions – to law enforcement, typically their financial intelligence units (Axelrod, 2017; Demetis & Angell, 2006; Unger & den Hertog, 2012). This is in line with the recommendation that countries should criminalize money laundering, establish a Financial Intelligence Unit and have the widest possible range of tools and procedures that facilitate the work of law enforcement agencies (Yikona et al., 2011).

Apart from the setting of the recommendations, FATF also assesses how well countries have implemented them and identifies those that have weaknesses in their AML/CFT measures (FATF, 2014a).

EMPIRICAL LITERATURE

2.13 Anti-Money Laundering Compliance

The compliance of countries – the FATF member states, members of the FATF-styled regional bodies and other constituents – to the international AML/CFT regulations set by the Financial Action Task Force (FATF) are assessed by Mutual Evaluation Reports (MERs) presented by the countries at the end of the year (FATF, 2009; Mekpor et al., 2018). The FATF describes an effective AML/CFT system as one that has an adequate legal and institutional framework, with competent authorities ensuring the effective implementation of the set system and certain structural elements, not covered by the assessment criteria, being put in place (FATF, 2009). In the deficiency of the aforementioned structural elements or the presence of significant shortcomings in the general framework, the implementation of an effective AML/CFT framework is very likely to be drastically impaired (FATF, 2009).

The countries are assessed based on the individual recommendations. Each recommendation has four possible levels of compliance: compliant, largely compliant, partially compliant and non-compliant. The reports do not only assess formal compliance with the Recommendations, but also the effectiveness of its implementation (FATF, 2009). Another noteworthy point is that the degree of risk of money laundering or terrorist financing is taken into consideration when assessing compliance of an institution – whether it is categorised as a financial institution (FI) or a designated non-financial business or profession (DNFBP).

A majority of the mutual evaluation reports divulge that the supervision of FIs and DNFBPs in terms of AML/CFT is less effective under the 2013 FATF Methodology (Jayasekara, 2018). According to the fourth round of mutual evaluation reports, no jurisdiction had achieved a high level of effectiveness for AML/CFT supervision and only five out of thirty-six had reached a

substantial level of effectiveness (Jayasekara, 2018). Undoubtedly, this raises a red flag – there is the need for the jurisdictions to reinforce their supervision regime.

Previous research has established a positive significant relationship between income levels of a country and the level of effectiveness of the AML/CFT supervision (Jayasekara, 2018). That implies that countries with lower income, due to fundamental deficiencies in AML/CFT supervision, are more susceptible to issues pertaining to money laundering or terrorist financing.

Demetis (2010) also confirms the essence of financing in the fight against money laundering and terrorist financing. He identifies that the persistent increase in the scale of money laundering has correspondingly led to the constant increase in compliance costs. This proves to be a challenge as a lot of work is still needed with respect to compliance (Yepes, 2011). It is acknowledged, though, that a lot of money is currently being invested in order to improve on activities pertaining to anti-money laundering and countering the financing of terrorism (Mekpor et al., 2018; Yepes, 2011).

2.14 Drivers of Foreign Direct Investment

2.14.1 Market size

The market size refers to the number of individuals in a certain market segment who are potential buyers. Typically, companies try to estimate the market share before they launch a new product or service (David, 2011). Foreign countries prefer a larger market size for investment as it is an indication of a higher degree of development and higher per capita income (Cuyvers, Soeng, Plasmans, & Van Den Bulcke, 2011). Also, such countries are apparently more appealing because they provide the avenue for MNEs to exploit their ownership advantages and benefit from economies of scale (Cuyvers et al., 2011). Davidson (1980) does point out, though, that FDI is economically prudent only when the volume of production exceeds a level at which the average

cost of serving the market by exporting is larger than the average cost of production within the market.

Several other empirical studies have supported the hypothesis of a positive relationship between FDI inflows and the market size of the host country (Alam & Shah, 2013; Asiedu, 2009; Kumari & Sharma, 2017; Resmini, 2000).

2.14.2 Quality of infrastructure

Host countries with good infrastructure have been known to attract more FDI inflows (Alam & Shah, 2013; Cheng & Kwan, 2000; Coughlin, Terza, & Arromdee, 1991; Resmini, 2000). According to Tsen (2005), good infrastructure is a priority for foreign investors because it signifies efficient business operations in the host country. This assertion is confirmed by Asiedu (2002). Her study reveals infrastructure to be so important a component to the extent that, in the absence of good infrastructure, some other factors that drive FDI into a country become insignificant.

In spite of the general recognition of the necessity of infrastructure, other studies prove otherwise. Wheeler & Mody (1992) find infrastructure to be an insignificant component and construe that infrastructure does not matter as much for developed countries as it does for developing countries. A negative, significant impact of infrastructure on FDI inflows is also discovered by Kumari & Sharma (2017) and Liu, Daly & Varua (2014).

2.14.3 Human capital

The investment a host country makes in its human capital is very necessary to foreign investors because it is instrumental in the development of skilled trainers, employers and employees

(Globerman & Shapiro, 2002). Investment in human capital can be categorised into three: education, health and employment (Kumari & Sharma, 2017).

It has been discovered that human capital encourages FDI inflows and a lack of it, on the other hand, is a discouragement to investors (Kumari & Sharma, 2017; Rodriguez & Pallas, 2008; Tsen, 2005). However, other researchers discovered human capital to be insignificant, specifically in developing countries (Root & Ahmed, 1978; Schneider & Frey, 1985). This is probably a confirmation to the assertion made by Asiedu (2002) that in the absence of quality infrastructure, other drivers of FDI may be rendered insignificant.

2.14.4 Research and development

Research and development (R&D) within a nation is another factor that has been proven to have an influence on FDI inflows. This is because it is representative of scientific and technological progress in the host country (Kumari & Sharma, 2017). Advancement in those areas is vital to any firm because it has the ability to dramatically affect its products, services, markets, suppliers, distributors, competitors, customers, manufacturing processes, marketing practices, and competitive position (David, 2011). Scientific and technological advancement can also drastically reduce production costs. It is therefore not surprising that scholars establish a positive relationship between R&D and FDI inflows (Hubler & Keller, 2010; Kumari & Sharma, 2017; Tomiura, 2003).

2.14.5 Interest rate

The interest rate is another factor that is considered by foreign investors. This is necessary to them because it helps them to compare the cost of borrowing in the host country relative to that of their home country. A higher cost of borrowing in the host country relative to the home country's gives

foreign investors a cost advantage over rivals in the host economy because it affords them the opportunity to borrow money locally at a lower rate and invest it in the host country for higher returns (Cuyvers et al., 2011; Farrell, Gaston, & Sturm, 2000; Pan, 2003). Consequently, a high interest rate generally attracts foreign investment into the host country (Cevis & Çamurdan, 2007; Cuyvers et al., 2011).

However, some research to determine the relationship has produced contrary results. Khan & Zahra (2016), as well as Kumari & Sharma (2017), establish a negative significant relationship between the interest rate and FDI inflows. Certain studies also reveal that interest rate has an insignificant impact on the influx of FDI (Faroh & Shen, 2015; Fornah & Yuehua, 2017; Kiptanui, 2017; Singhania & Gupta, 2011).

2.14.6 Inflation rate

The inflation rate in a country is representative of the economic tension of its economy and the failure of the central bank and government to restrict the money supply and balance the budget (Buchanan, 2011). Consequently, low inflation rates are an indication of positive economic growth and stability and are preferable to foreign investors (Balasubramanyam, 2002; Kumari & Sharma, 2017). On the other hand, high levels of inflation signify macroeconomic instability (Buckley et al., 2007), making it undesirable for foreign investors (Asiedu, 2009; Schneider & Frey, 1985).

2.14.7 Labour cost

Another factor that foreign investors consider when making a decision is the cost of labour in the host country. Lower labour costs are known to make a country more competitive and attractive (Cuyvers et al., 2011). This is even more essential to firms for which labour costs constitute a

large proportion of their total costs as it provides a cost advantage over competitors in their home country (Dunning & Lundan, 2008; Navaretti, Venables, & Barry, 2006). This is consistent with the eclectic paradigm as presented by Dunning (1980). He states that among other advantages that multinational firms derive from FDI, low labour costs form part of locational advantages – the country-specific advantages that these firms gain when investing abroad. As a result, host countries with lower labour costs are more likely to attract more FDI into the country (Alam & Shah, 2013; Bevan & Estrin, 2004; Wei & Liu, 2001).

CHAPTER THREE

METHODOLOGY

3.1 Introduction

This chapter discusses the steps, processes and techniques used to determine the relationship between AML/CFT compliance and FDI inflows. This covers sections such as the research design that is employed, the population of the study, the sources of the data used and the model specifications. All methods as applied in this study have been carefully chosen on the basis of the literature that has been reviewed in the previous chapter.

3.2 Research Design

A research design is a basic plan that guides the data collection and analysis phases of the research. Based on set objectives, the design provides a framework that specifies the type of information to be collected, the sources of the data and the process of collection (Kinnear & Taylor, 1996). A study typically employs a qualitative, quantitative or mixed design.

Boateng (2016) states that while a qualitative design seeks to describe and explain variations, relationships and experiences, a quantitative design is intended to quantify variations and predict causal relationships. This is evident in the methods that are used to collect and analyse data under each design. He also identifies that a quantitative design, unlike its qualitative counterpart, does not permit the researcher's personal orientations, biases and/or experiences to influence his collection and analysis of data. The mixed method is a hybrid of the two, employing characteristics of both ends that are relevant to the study in question.

This study used a quantitative approach. An econometric model was formulated in order to determine the relationship between AML/CFT compliance and FDI inflows.

3.3 Population of Study

The study set out to test the hypothesis that the extent of countries' compliance with AML/CFT regulations significantly influences the inflows of Foreign Direct Investment. Based on the objective of this study, a purposive sampling technique was applied. All the countries used in the research are countries that are under the jurisdiction of the Financial Action Task Force and also have data on both AML/CFT compliance ratings as computed by Mekpor et al. (2018) and FDI inflows between the years 2004 and 2016. For countries that had more than one compliance rating, the most recent value was used. Based on the criteria, there was a total number of 74 countries used for the analysis.

3.4 Data

All data used in this study is secondary. Data on AML/CFT compliance, the main independent variable, was sourced from the AML/CFT compliance index generated by Mekpor et al. (2018). This index was generated based on the ratings from 207 Mutual Evaluation Reports on 155 countries as provided by the FATF.

Data on FDI and all other country-specific control variables was extracted from the World Development Indicators catalogue, an online database of the World Bank. In section 4 of this chapter, all variables used in the study will be further broken down to reveal their individual sources and proxies.

3.5 Variables

This study regressed Foreign Direct Investment inflows on the following independent variables: AMLCFT compliance – the main independent variable – and market size, infrastructural quality, quality of human capital, interest rate and inflation rate – the control variables.

3.5.1 Foreign Direct Investment (FDI)

Foreign direct investment is the dependent variable of the model. It refers to the direct investment equity flows in the reporting economy. It is the sum of equity capital, reinvestment of earnings, and other capital, according to the WDI data catalogue. A higher FDI suggests that a country appears as more attractive to foreign investors. In line with the works of Kumari & Sharma (2017) and Alam & Shah (2013), FDI is proxied by the log of foreign direct investment, net inflows (current US\$).

3.5.2 AML/CFT compliance

AML/CFT compliance is the main regressor of the study. It is a measure of how compliant a country is with the FATF Recommendations. AML/CFT compliance was proxied by the AML/CFT Compliance Index generated by Mekpor et al. (2018). The higher the figure, the more compliant a country is with the Recommendations.

It must be noted, though, that the figures as used in this research are expressed as percentages. This is due to the presence of a data split between the periods 2004 to 2011 and 2012 to 2016. As at 2004, 9 more recommendations had been added the original 40 to address issues of terrorist financing after the events of the historic 9/11. In 2012, the 40+9 Recommendations were once again revised, incorporating the 9 additional recommendations into the 40 (FATF, 2014a). The conversion into percentages was done in order to even out any disparities in scores.

It was expected that the more compliant a country is, the more FDI it attracts from investors because of relatively better economic and financial stability (International Monetary Fund, 2018), political stability (Cleeve, 2012; Schneider & Frey, 1985), less competition (David, 2011; Kumari & Sharma, 2017) and reputational reasons (Keesoony, 2016; Unger, 2007). Therefore, the expected relationship between AML/CFT compliance and FDI inflows was positive.

3.5.3 Market size

Market size is the first control variable used in this study. It was proxied in this study by GDP at purchaser's prices – the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. This proxy was used because it reflects two important components to investors – the number of people within the host country as well as their purchasing power (Tintin, 2003). In other words, it is a good representation of market size because it indicates not only how large a pool of potential consumers is – it also shows in monetary terms, the capability of these potential customers to actually acquire what they need. Data is in current US dollars.

A larger market size is more attractive to foreign investors. Therefore, a positive relationship was expected between market size and FDI inflows (Alam & Shah, 2013; Asiedu, 2009; Kumari & Sharma, 2017; Resmini, 2000).

3.5.4 Infrastructural quality

Quality of infrastructure, the second control variable, measures the efficiency of business operations in the country. It was proxied by the number of fixed broadband subscriptions per 100 people. This refers to subscriptions to high-speed access to the public Internet (a transmission

control protocol or an internet protocol connection), at downstream speeds equal to, or greater than, 256 Kbit/s. It includes both residential subscriptions and subscriptions for organizations.

While some studies have found a positive, significant relationship between infrastructural quality and FDI inflows (Asiedu, 2002; Tsen, 2005), other research came up with contrary results. Scholars such as Kumari & Sharma (2017) and Liu et al. (2014) found a negative relationship. Additionally, others such as Wheeler & Mody (1992) have empirically proven that under certain conditions, there is the absence of a significant relationship between the two variables under discussion. Consequently, we expected either a positive or negative coefficient for infrastructural quality.

3.5.5 Quality of human capital

The third control variable used in this study is the value of human capital. It was proxied by the secondary school gross enrolment ratio. This is the ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to secondary school education. Secondary education completes the provision of basic education that began at the primary level and aims at laying the foundations for lifelong learning and human development. This is achieved by offering more subject- or skill-oriented instruction using more specialized teachers. It, therefore, serves as a good measure of the potential quality of a country's human capital.

Since high quality of human capital in a host country has been discovered to encourage FDI inflows and its lack, an obstruction (Kumari & Sharma, 2017; Rodriguez & Pallas, 2008; Tsen, 2005), it was expected that there would be a positive relationship between quality of human capital and foreign direct investment inflows.

3.5.6 Interest rate

The fourth control variable used in the study is the interest rate. In our model, this was represented by the real interest rate. The real interest rate, as defined by the World Development Indicators data catalogue, is the lending interest rate adjusted for inflation as measured by the GDP deflator. There have generally been mixed results concerning the impact of interest rate on FDI inflows. Though there is largely a positive relationship between interest rate and FDI inflows (Cevis & Çamurdan, 2007; Cuyvers et al., 2011; Farrell et al., 2000; Pan, 2003), literature reveals that some studies have been able to empirically prove the existence of a negative relationship (Khan & Zahra, 2016; Kumari & Sharma, 2017). Therefore, we expected that the sign for interest rate could either be positive or negative.

3.5.7 Inflation rate

The final control variable used in the model is the inflation rate. As stated early on, this is representative of the economic tension of a country's economy and the failure of the central bank and the government to regulate money supply (Buchanan, 2011). This study proxies a country's inflation rate with its consumer price index. The consumer price index reflects changes in the cost to the average consumer of acquiring a basket of goods and services that may be fixed or changed at specified intervals. With our data, all prices are compared to prices in the year 2000, which is the base year and the change expressed as a percentage.

In concord with all identified previous literature (Asiedu, 2009; Balasubramanyam, 2002; Buckley et al., 2007; Kumari & Sharma, 2017; Schneider & Frey, 1985), an inverse relationship was expected between inflation rate and inflows of foreign direct investment. There would, therefore, be a negative sign for the coefficient of inflation rate.

The table below summarises the variables used, their proxies, sources of data, expected signs and literary justifications.

Table 3.1: List of Dependent and Independent Variables

Variable	Abbreviation	Proxy	Source	Expected sign	Justification
Foreign Direct Investment	FDI	Log of FDI net inflows (%)	World Development Indicators		Alam & Shah (2013) Kumari & Sharma (2017)
AML/CFT Compliance	AML.CFTComp	AML/CFT compliance index	Mekpor et al. (2018)	+	Cleeve (2012) David (2011) Kumari & Sharma (2017) Keesoony (2016) IMF (2018)
Market Size	Mkt	Log of GDP (current US\$)	World Development Indicators	+	Tintin (2003) Alam & Shah (2013) Asiedu (2009) Kumari & Sharma (2017) Resmini (2000)
Infrastructural Quality	Infr	Fixed broadband subscriptions (per 100 people)	World Development Indicators	+ -	Asiedu (2002) Tsen (2005) Kumari & Sharma (2017) Liu et al. (2014)
Quality of Human Capital	HC	School enrolment, secondary (% gross)	World Development Indicators	+	Kumari & Sharma (2017) Rodriguez & Pallas (2008) Tsen (2005)

Interest Rate	IR	Real interest rate (%)	World Development Indicators	+	Cevis & Çamurdan, (2007) Cuyvers et al. (2011) Farrell et al. (2000) Pan (2003) Khan & Zahra (2016) Kumari & Sharma (2017)
Inflation Rate	Infl	Consumer price index (2000=100)	World Development Indicators	-	Asiedu (2009) Balasubramanyam (2002) Buckley et al. (2007) Kumari & Sharma (2017) Schneider & Frey (1985)

3.6 Model Specifications

The econometric model used in this study was cross-sectional. This was ideal because despite the fact that the data points range from the period 2004 to 2016, there is lack of consistency with respect to the data on AML/CFT compliance – which happens to be the main regressor – and that is evident in the index that is generated by Mekpor et al. (2018). The dependent variable in the regression was FDI inflows and the independent variable, as earlier indicated, was AML compliance. Other country-specific variables were added to the model to control for economically realistic conditions.

The relationship between FDI and its influencing variables is expressed as:

$$FDI = f(AML, CFTComp, Mkt, Infr, HC, IR, Infl)$$

Based on this relationship, the following model was derived:

$$FDI_i = \beta_0 + \beta_1 AML.CFTComp_i + \beta_2 Mkt_i + \beta_3 Infr_i + \beta_4 HC_i + \beta_5 IR_i + \beta_6 Infl_i + \varepsilon_i \quad (1)$$

The pairwise correlation matrix was used as a tool to detect the existence and degree of multicollinearity among the independent variables. The rule of thumb as applied in this study was to eliminate one of two variables which had an absolute correlation coefficient of above 0.5. This gave rise to two additional models as follows:

$$FDI_i = \beta_0 + \beta_1 AML.CFTComp_i + \beta_2 Mkt_i + \beta_3 HC_i + \beta_4 IR_i + \beta_5 Infl_i + \varepsilon_i \quad (2)$$

$$FDI_i = \beta_0 + \beta_1 AML.CFTComp_i + \beta_2 Mkt_i + \beta_3 Infr_i + \beta_4 IR_i + \beta_5 Infl_i + \varepsilon_i \quad (3)$$

CHAPTER FOUR

RESULTS AND DISCUSSION

4.1 Introduction

The objective of this study is to determine whether AML/CFT compliance has a significant impact on the influx of Foreign Direct Investment. In order to achieve the set objective, with a sample of 74 FATF member states, the study formulated a model that regresses FDI inflows on AML/CFT compliance. Based on empirical literature, other economic indicators that have been proven to be determinants of FDI inflows – market size, infrastructural quality, quality of human capital, interest rate and inflation rate – were added to the model as control variables. All analysis was done using StataSE14. This chapter presents the results of the regression analysis that was conducted. It also discusses the descriptive statistics of the sample and the results of the diagnostic tests on the dataset.

4.2 Descriptive Statistics

Descriptive statistics deal with measures of different aspects of a population or a distribution of population values (Bickel & Lehmann, 2012). This section looks at the mean, standard deviation, minimum, maximum and the number of observations per variable, as computed by StataSE 14, the software used for the analysis of the data.

Table 4.1: Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Minimum	Maximum
Foreign Direct Inv.	74	2.14×10^{10}	5.89×10^{10}	4.66×10^6	3.32×10^{11}
AML/CFT Compliance	74	56.44	13.59	28.06	83.13
Market Size	74	5.55×10^{11}	1.79×10^{12}	3.69×10^8	1.39×10^{13}
Infrastructural Quality	74	9.10	10.57	0.00	38.82
Quality of Human Capital	74	84.34	24.61	20.29	158.14
Interest Rate	74	2.32	6.21	-17.16	16.18
Inflation Rate	74	26.77	41.70	-4.67	152.54

Source: StataSE 14

The table above condenses the descriptive statistics of the dependent variable, Foreign Direct Investment inflows, and the variables that explain it.

The mean figure for FDI, proxied by FDI net inflows, is \$21,404,345,173.06, which represents the average annual amount of FDI that a country attracts. The standard deviation of \$58,916,183,619.27 indicates the spread of figures around the mean. The minimum annual inflow of FDI is recorded by Tonga, a total of \$4,661,006.00. On the other hand, the Netherlands records the highest inflow of \$331,838,461,860.78.

Averagely, the percentage level of AML compliance among the 74 countries used in the study is 56.44% and it has a corresponding standard deviation of 13.59%. These figures are an indication that quite a substantial number of countries have their levels of compliance clustered around the mean. The countries which measure the lowest and highest level of compliance are Tajikistan and Malaysia with values of 28.06% and 88.13% respectively.

The market size, which was measured by the GDP, reveals an average of \$554,783,748,315.77 and a standard deviation of \$1,785,812,557,185.98. The country known to have the highest GDP, per

the data, is the United States of America with a total annual figure of \$13,855,888,000,000.00. Tonga, on the other hand, records a total annual GDP of \$ 369,485,198.80, the lowest within the range.

The number of fixed broadband subscriptions per 100 people was used to proxy the quality of infrastructure in the country. The average figure in that category is 9.10 and the standard deviation is 10.57. The country with the least quality of infrastructure, given the established premise, is Cameroon, with a figure of 0.005. Conversely, the Netherlands, with 38.82 subscriptions per 100 people, is represented as the country with the most developed infrastructure.

The next variable used in this study is the quality of human capital. This was represented by the ratio of total enrolment, regardless of age, to the total number of people within the age bracket that officially corresponds to secondary school education. An average of 84.34% and a standard deviation of 24.61% are recorded. Burkina Faso documents the lowest quality of human capital, a value of 20.29% and Belgium, the highest. The country has a whopping figure of 158.15%.

The interest rate records an average value of 2.33% and a standard deviation of 6.22%. The minimum interest rate recorded is -17.16% by the Seychelles. The negative value reveals that the inflation rate exceeded the interest rate. Armenia had the highest interest rate – 16.18 percent.

The final variable accounting for FDI in our study is the inflation rate. This was proxied by the consumer price index with the year 2000 as the base year. The mean value and standard deviation were 25.37% and 42.23% respectively. The lowest level of inflation – which is, in principle, a deflation – is -4.68% in St. Lucia. Bhutan, on the other hand, records the highest level of inflation, 152.54%.

4.3 Diagnostic Tests for Robustness

4.3.1 Tests for Multicollinearity

Multicollinearity is the instance of independent variables being very highly correlated. The measure of correlation between any two variables is the correlation coefficient. This can be determined by the use of the Pearson Correlation Matrix, which is applied in this study. The absolute value of the coefficient indicates the strength of the correlation and the sign attached specifies the direction. The correlation coefficient always falls within a range of -1 and +1, where -1 signifies perfect negative correlation and +1 signifies perfect positive correlation. A correlation of 0 means that the variables are not correlated. Thus, the closer the absolute value of the coefficient is to 0, the weaker the correlation between the two variables in question. On the other hand, the closer the absolute value is to 1, the stronger the correlation. A positive correlation coefficient means that the two variables either increase together or decrease together. A negative correlation coefficient shows that when one variable increases in value, the other decreases, and vice versa.

Multicollinearity is usually problematic because it makes some of the data redundant and it increases the possibility of a Type II error due to the fact that the standard errors of the affected coefficients tend to be large. To avoid that, one of the variables must be dropped. The rule of thumb used in this study was to drop one of the pair of variables that had a correlation coefficient of above 0.5 in absolute terms.

From the table below, we see that there is a high correlation between AML compliance and infrastructural quality (0.571) and also between infrastructural quality and human capital (0.622).

Table 4.2: Pairwise Correlation Matrix

	FDI	AML/CFT Comp.	Market Size	Infr. Quality	Human Capital	Interest Rate	Inflation Rate
FDI	1.000						
AML/CFT Comp.	0.5706	1					
Market Size	0.8236	0.4999	1				
Infr. Quality	0.5857	0.5786	0.4789	1			
Human Capital	0.4304	0.459	0.2972	0.6318	1		
Interest Rate	-0.1298	0.1622	-0.1893	0.1244	-0.0162	1	
Inflation Rate	-0.0035	0.3469	0.0513	0.1736	0.1767	0.1399	1

Source: StataSE 14

The Variance Inflation Factor is an alternative measure of multicollinearity between variables. It is used to determine the extent to which the variance of a regression coefficient is exaggerated due to multicollinearity. VIF figures are interpreted as follows:

Table 4.3: Variance Inflation Factor

Variance Inflation Factor	Indication
1	No correlation
Between 1 and 5	Moderately correlated
Above 5	Highly correlated

Source: Mekpor et al. (2018)

From Appendix C, all the variables have a VIF within the 1 to 5 range, meaning that they are all moderately correlated.

The VIF is also used to determine which of the pairs of variables with the correlation coefficient above 0.5 should be dropped to avoid the issue of multicollinearity. In each set, the variable with the higher VIF should ordinarily be dropped. With the first set, between AML compliance and

infrastructural quality, infrastructural quality has a higher VIF of 2.18. Thus, it is dropped in order to get the second model. Between infrastructural quality and quality of human capital, infrastructural quality still has a higher VIF. However, since infrastructural quality is already eliminated in the second model, the quality of human capital is removed to get the third model.

4.3.2 Test for Normality

A test for normality is verification that the sample data used for the research is drawn from a normally distributed population. A normal distribution means that the data values are symmetrical around the mean, where most of the observations tend to cluster. This is important because it helps to decide the appropriate tests to run – whether parametric or non-parametric. In this study, the Shapiro-Wilk Test is used to ensure the normality of the sample. With this test, the null hypothesis was that the data is normally distributed. The results that were obtained indicated that the dataset exhibits normality. The results of the test are presented in Appendix D.

4.3.3 Test for Heteroskedasticity

An instance of heteroskedasticity means that the error term does not have a constant variance. This would be problematic because it compromises the efficiency of the OLS estimator due to the underestimation of the variance and covariance.

The Breusch-Pagan/Cook Weisberg Test is used to detect heteroskedasticity of a dataset in a linear regression model. Given the null hypothesis of a constant variance, the results of the test indicate that there was the data was heteroskedastic. This issue was corrected for by applying the Newey-West standard error technique. This helps to obtain unbiased standard errors under

heteroskedasticity. The results for the Breusch-Pagan/Cook-Weisberg Test are presented in Appendix E.

4.3.4 Test for Autocorrelation

Autocorrelation simply means that there are patterns in the residuals from the OLS model. This is not supposed to be the case. Like the issue of heteroskedasticity, autocorrelation has the effect of making the OLS estimator no longer efficient.

The Breusch-Godfrey LM Test is applied to discover the presence of autocorrelation in the errors of a regression. The test had a null hypothesis of no autocorrelation. However, the results required that the null hypothesis be rejected. Regression with the Newey-West standard errors corrected for this shortcoming as well. The results of this test can be found in Appendix F.

4.4 Influence of AML Compliance on FDI Inflows

This section tackles the findings of the main objective – the hypothesis of a significant positive relationship between AML compliance and FDI inflows. Using an ordinary least squares model, Foreign Direct Investment (FDI) was regressed on AML/CFT compliance (AML.CFTComp), market share (Mkt), quality of infrastructure (Infr), quality of human capital (HC), interest rate (IR) and inflation rate (Infl). As discussed earlier, after the original model (Model 1), the pairwise correlation matrix and the variance inflation factors were jointly used as a yardstick to drop two different variables, giving rise to Models 2 and 3. The highlights of the regression results follow shortly. The full regression output as provided by Stata is under Appendices G, H and I.

Table 4.4: Determinants of Foreign Direct Investment

INDEPENDENT VARIABLES	DEPENDENT VARIABLE		
	FDI (model 1)	FDI (model 2)	FDI (model 3)
AML/CFT Compliance	0.0324* (0.0177)	0.0384** (0.0180)	0.0353* (0.0181)
Market Size	0.6331*** (0.0903)	0.6723*** (0.0956)	0.6983*** (0.0909)
Infrastructural Quality	0.0354* (0.0179)		0.0476** (0.0147)
Human Capital	0.0089 (0.0081)	0.0158** (0.069)	
Interest Rate	-0.0146 (0.0248)	-0.0057 (0.0270)	-0.0197*** (0.0252)
Inflation Rate	-0.0080* (0.0046)	-0.0082* (0.0047)	-0.0078** (0.0047)
Constant	3.2501* (1.6299)	1.6634 (1.7728)	3.9530* (1.6759)
Observations	74	74	74
R-squared	75.67%	74.67%	75.24%
Adjusted R-squared	73.50%	72.81%	73.42%

*p<0.1; **p<0.05; ***p<0.01

Source: StataSE 14

The results from the three models reveal in each case that the independent variables explained approximately 73 percent of the variations in foreign direct investment. It is also observed that a substantial number of entries are dropped in the course of the analysis.

The figures on the table inform us that for all the three models, there was a significant positive relationship between AML/CFT compliance, our main regressor, and FDI, the dependent variable.

The first model, which captured all the independent variables, exhibited significance at a 10% significance level. The second model, which dropped the infrastructural quality component, had AML/CFT compliance significantly impacting FDI at 5%. Model 3, the final model which dropped the human capital component, indicated an impact at a significance level of 10%

Apart from AML/CFT compliance, the other independent variables are seen to have variations in levels of significance for the different models. For model 1, three out of the five control variables had a significant impact on FDI. The second model had three out of four exhibiting significance and in the third model, all independent variables were seen to be significant.

The first control variable, the market size, is observed to consistently have a positive significant impact on FDI at a 1% significance level. This is consistent with all identified literature (Alam & Shah, 2013; Asiedu, 2009; Kumari & Sharma, 2017; Resmini, 2000). It is also probably evidence of the indispensability of adequate market share to MNEs when taking decisions concerning FDI.

The second variable, infrastructural quality, is also found to be positively statistically significant, though at different levels. In model 1, infrastructural quality was statistically significant at 10%. However, after the variable human capital was dropped, the level of significance changed from 10% to 5%, which depicts a higher likelihood of accuracy. The positive significant relationship found in our model is in line with the findings of scholars like Alam & Shah (2013) Asiedu (2002) Cheng & Kwan (2000) and Coughlin et al. (1991).

The third variable, human capital, is seen to be statistically insignificant in the original model. Nevertheless, in the second model, after the infrastructural quality component is dropped, a positive significant relationship is identified at the 5% level of significance.

With interest rate, although a negative relationship is identified throughout the models, it is only in the last model that the relationship is actually significant. In model 3, we see that interest rate negatively impacted FDI at the 1% level of significance. These findings tally with those of Khan & Zahra (2016) and Kumari & Sharma (2017).

Finally, the inflation rate, in consistency with all identified literature, also exhibited a negative significant impact throughout. In models 1 and 2, the impact was at a 10% significance level and in model 3, the negative impact was at a 5% significance level.

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CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The final chapter encapsulates the results that were obtained from the research, based on the objective to test the hypothesis that compliance of FATF states to the recommendations set out by the organisation to combat money laundering and the financing of terrorism influences the influx of Foreign Direct Investment to the said countries. The findings were obtained from an Ordinary Least Squares regression model. After the findings are presented, recommendations are offered, the topic is concluded on and suggestions are given for further research.

5.2 Summary of Findings

The study sought to ascertain whether the decision of a firm to invest in another country was in any way influenced by the host's country's compliance with AML/CFT regulations, particularly the FATF Recommendations. Previous literature revealed that among other theories, the internalization theory suggested that an MNE would only undertake FDI if any perceived costs were outweighed by the perceived benefits. Based on that and identified repercussions of ML and TF, a positive relationship between AML/CFT compliance and FDI was hypothesized. This theory, if proven right, would be priceless information as in the past, literature had indicated that generally, the compliance levels of FATF countries had been lower than optimum.

According to the results of this study, there is a significant positive relationship between AML/CFT compliance and FDI inflows. In other words, the more compliant a country is to the FATF recommendations, the more likely it is to draw investment from foreign firms. In addition,

we learn from the reported value of the R-square that the independent variables explain approximately 76% of the variability in FDI. Of the control variables that were added, we also see that market size, infrastructural quality and inflation rate also have a significant impact on FDI. The other two variables, interest rate and quality of human capital are only significant under certain conditions.

5.3 Conclusion

The introduction of this study established that despite the numerous indisputable consequences of money laundering and terrorist financing, previous literature pessimistically states that FATF member states still have a lot of work to do as far as compliance with AML/CFT regulations was concerned. This was mainly attributed to the high costs that were associated with the establishment of an effective regime. This paper, therefore, sought to prove that though there are indeed high costs involved, when things are properly done, those costs are offset by the rewards that are obtained. In this paper, FDI was the reward. At the end of this study, the hypothesis is successfully confirmed – that AML/CFT compliance is actually a significant driver of Foreign Direct Investment.

This discovery is revolutionary because it informs countries that the cost is not as big a barrier as they might have expected. We now know of at least one of the rewards – among many others that are yet to be discovered – that compensate for the costs of compliance, borrowing the words of Costanzo (2013). Therefore, hopefully, they are encouraged to put more effort into being more compliant with the AML/CFT regulations.

5.4 Recommendations

The findings of this research could be considered an affirmation to the claim of Costanzo (2013) that the high costs incurred in setting up an effective AML/CFT regime are eventually compensated for. This is very reassuring, considering that expenses were identified as one of the major reasons for the substandard compliance levels of a lot of the countries. Bearing this information in mind, the Financial Action Task Force, in collaboration with the FATF-styled Regional Bodies and other institutions that are a part of the cause to eliminate money laundering and terrorist financing, should take the initiative to intensify the sensitization on the essence of AML and CFT to its member states, as well as the FIs and DNFPBs within these countries. It should be emphasized that though it may be expensive to comply with AML and CFT directives, there is also a lot to gain in return. Therefore, they do not have cause to worry too much about the costs. This knowledge goes a long way to encourage states to make strides at becoming compliant with the little income that they have.

It has also been established that FDI is heavily influenced by the market size, quality of infrastructure and the rate of inflation. Countries should make an effort to improve on the state of the above-mentioned indicators. An increase in GDP – which translates into a larger market size – can be achieved by the cutting of tax and offering tax rebates by the government. This works because it puts more money back into the pockets of consumers, which encourages spending. The government should also put more effort into improving the infrastructure in the country. Considering the possibility of the limitation of public resources, private companies should be encouraged to get involved in this exercise. Finally, the inflation rate can be kept low by adopting a contractionary monetary policy. This involves the decrease in bond prices and increase in interest

rates, thus making it more appealing for more people to invest. Consequently, the amount of money in circulation is reduced, minimizing the possibility of demand-pull inflation.

5.5 Suggestions for further study

Previous literature has made it very obvious that money laundering and terrorist financing should not be tolerated. It has also established very clearly that contrary to what a substantial number of countries are currently doing, it is not enough to just aim at a level of compliance that saves them from getting into trouble. Since it has been proven that the high cost of compliance is one of the outstanding reasons for many countries' willingness and/or ability to reach higher levels of compliance, scholars can work towards finding other financially-inclined evidence that in the long run, AML compliance is actually beneficial to the countries as well. A cost-benefit analysis can be carried out in order to weigh the advantages against the supposed challenges. Also, research can be carried out to determine more cost-effective ways for countries to be compliant. The Financial Action Task Force can spearhead such an initiative.

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APPENDICES

Appendix A: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
country	0				
amlcftorg	74	56.43774	13.59982	28.06122	83.125
gdp	74	5.55e+11	1.79e+12	3.69e+08	1.39e+13
broadband	74	9.099499	10.56731	.0045486	38.8242
secschenr	74	84.34442	24.60873	20.29426	158.1472
realir	74	2.328545	6.218043	-17.15803	16.18001
cpi2000100	74	26.77464	41.70049	-4.67738	152.5454
fdiinflows	74	2.14e+10	5.89e+10	4661006	3.32e+11

Appendix B: Pairwise Correlation Matrix

	logfdi	amlcft~g	loggdp	broadb~d	secsch~r	realir	cpi200~0
logfdi	1.0000						
amlcftorg	0.5706	1.0000					
loggdp	0.8236	0.4999	1.0000				
broadband	0.5857	0.5786	0.4789	1.0000			
secschenr	0.4304	0.4590	0.2972	0.6318	1.0000		
realir	-0.1298	0.1622	-0.1893	0.1244	-0.0162	1.0000	
cpi2000100	-0.0035	0.3469	0.0513	0.1736	0.1767	0.1399	1.0000

Appendix C: Variance Inflation Factor

Variable	VIF	1/VIF
broadband	2.26	0.442456
amlcftorg	2.01	0.498537
secschenr	1.76	0.567231
loggdp	1.67	0.599746
realir	1.20	0.832616
cpi2000100	1.17	0.856194
Mean VIF	1.68	

Appendix D: Shapiro-Wilk Test Results

Shapiro-Wilk W test for normal data

Variable	Obs	W	V	z	Prob>z
fdiinflows	74	0.38987	39.292	8.008	0.00000
amlcftorg	74	0.98549	0.934	-0.148	0.55898
gdp	74	0.31989	43.798	8.245	0.00000
broadband	74	0.81305	12.039	5.428	0.00000
secschenr	74	0.94352	3.637	2.817	0.00243
realir	74	0.95263	3.050	2.433	0.00749
cpi2000100	74	0.62093	24.411	6.970	0.00000

Appendix E: Breusch-Pagan/Cook-Weisberg Test Results

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity

Ho: Constant variance

Variables: fitted values of logfdi

chi2(1) = 10.59

Prob > chi2 = 0.0011

Appendix F: Breusch-Godfrey Test Results

Breusch-Godfrey LM test for autocorrelation

lags (p)	chi2	df	Prob > chi2
1	1.374	1	0.2411

H0: no serial correlation

Appendix G: Results for Model 1Regression with Newey-West standard errors
maximum lag: 0

Number of obs = **74**
 F(6, 67) = **37.15**
 Prob > F = **0.0000**

logfdi	Newey-West		t	P> t	[95% Conf. Interval]	
	Coef.	Std. Err.				
amlcftorg	.032428	.0177297	1.83	0.072	-.0029607	.0678167
loggdp	.6330538	.0902691	7.01	0.000	.4528759	.8132318
broadband	.0354099	.0178872	1.98	0.052	-.0002931	.0711128
secschenr	.008862	.0081169	1.09	0.279	-.0073394	.0250635
realir	-.0146202	.0248404	-0.59	0.558	-.0642019	.0349614
cpi2000100	-.0079997	.0046466	-1.72	0.090	-.0172743	.0012749
_cons	3.25012	1.629944	1.99	0.050	-.0032616	6.503501

Appendix H: Results for Model 2

Regression with Newey-West standard errors
maximum lag: 0

Number of obs = 74
F(5, 68) = 42.93
Prob > F = 0.0000

logfdi	Coef.	Newey-West Std. Err.	t	P> t	[95% Conf. Interval]	
amlcftorg	.0384575	.0179769	2.14	0.036	.0025851	.0743299
loggdp	.6722711	.0956011	7.03	0.000	.4815021	.86304
secschenr	.0158402	.0068827	2.30	0.024	.002106	.0295745
realir	-.005692	.0270143	-0.21	0.834	-.0595982	.0482142
cpi2000100	-.0081588	.0047203	-1.73	0.088	-.0175781	.0012605
_cons	1.663464	1.772842	0.94	0.351	-1.874187	5.201116

Appendix I: Results for Model 3

Regression with Newey-West standard errors
maximum lag: 0

Number of obs = 74
F(5, 68) = 42.04
Prob > F = 0.0000

logfdi	Coef.	Newey-West Std. Err.	t	P> t	[95% Conf. Interval]	
amlcftorg	.0353296	.0181328	1.95	0.055	-.0008539	.0715132
loggdp	.6239716	.0908686	6.87	0.000	.4426462	.805297
broadband	.0475519	.0146981	3.24	0.002	.0182223	.0768815
realir	-.0196603	.0251902	-0.78	0.438	-.0699266	.0306059
cpi2000100	-.0078047	.0047145	-1.66	0.102	-.0172123	.0016029
_cons	3.952975	1.675874	2.36	0.021	.6088199	7.297131