Economic Impacts of FATF Recommendations and Grey-listing Announcement

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Economic Impacts of FATF Recommendations and Grey-listing Announcement[1]

1. Introduction

The Financial Action Task Force (FATF), was established in 1989, and it is an intergovernmental body that promotes policies to protect the global financial system against money laundering and terrorist financing. Since the beginning of the 2000s, FATF have issued 40 recommendations on how states should combat money laundering problems. To induce the implementation of such measures, it has periodically issued lists of countries and jurisdictions that it judges to have strategic Anti-Money Laundering and/or Countering the Financing of Terrorism (AML/CFT) deficiencies. The FATF uses a mutual evaluation model. These evaluations are carried out by the FATF and nine FATF-style regional bodies and, occasionally, by the IMF or World Bank.

One of these audits happened in South Africa by the International Monetary Fund (IMF) on behalf of Financial Action Task Force (FATF) in 2020, and spurred a process of implementing various measures to avoid being "grey-listed" (Smit, 2022). FATF (2021) found various loopholes that criminals can exploit, and that prosecution is inadequate given the country's risk profile. They also refer to "state capture" (a form of corruption where businesses and politicians conspire to influence a country's decision-making process for their own gain (Arun, 2019)) and the undermining of institutions whose purpose is to prevent money laundering and the financing of terrorist activities, which they also provide an overview of. In this report, we discuss what grey-listing entails, why it is done, why South Africa might be grey-listed, the measures they have put in place (to date) and consider the potential consequences of being added to the grey-list.

FATF is a global money laundering and terrorist financing watchdog and sets international standards aimed at stopping these activities (FATF, 2003). It has 37 member jurisdictions while also relying on FATF-Style Regional Bodies, and as a result, have over 200 jurisdictions committed to implementing the standards. The "grey-list" is

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a list of jurisdictions subject to increased monitoring and have committed to addressing the identified strategic deficiencies within an agreed-upon time frame. There are currently 23 jurisdictions on the grey-list. Then, there is also a "black-list", which contains the high-risk jurisdictions, and also calls on other jurisdictions to apply the necessary due diligence when transacting with these black-listed juris- dictions. A jurisdiction is black-listed when their regimes have significant strategic deficiencies to combat money laundering and terrorist financing (FATF, 2003).

The consequences for being grey-listed are not entirely clear, and there are no formal measures that FATF members should apply. However, some opinion articles argue that this event can damage the integrity of the country's banking systems, in particular, it can compromise the international banking relations between countries (Smit, 2022; FCA, 2022). If a jurisdiction is black-listed, it could have severe consequences in the form of economic sanctions imposed by the World Bank, IMF, and African Development Bank, which are sources of low (or no) interest funding, which would be detrimental to developing countries. They could also face higher costs on cross-border transactions, rating downgrades (and the associated disinvestment due to a higher risk profile), and payment delays (and the implications it has on trade).

South Africa has until October 2022 to implement the necessary changes to avoid grey- listing (Smit, 2022). For a complete list of strategic deficiencies, see FATF (2021), but they mainly boil down to, improved risk assessment, improved prosecution, improved record keeping, and improved transparency. These were divided into policy and related legislative issues, which both take time to change. To address these, the South African government has published drafts of two bills, which currently await parliamentary approval before they can be enacted (Omarjee, 2022). These two bills collectively resolve 16 of the 20 issues, with the National Treasury of South Africa expecting to develop policy processes and mechanisms to address the remaining four issues by November 2022 (SAGNA, 2022). Their general view is that even if South Africa is grey-listed, they would have less issues to address before being removed again. However, Mavuso (2022) highlights that there is a risk that once on the grey-list, South Africa might struggle to get off of it. Pakistan, which was grey-listed in 2018, has been struggling since then to get off of the list, despite completing 26 of the 27 action items, while Botswana only managed to be removed from the list after three years, not before being included in the EU's non-cooperative list of countries and the UK's list of high-risk countries (Mavuso, 2022).

The main concern from the South African Reserve Bank (SARB) and others is about the potential impact a grey-listing will have on the South African banking sector and the economy as a whole. The SARB was reported saying that failure to avoid grey-listing could impact the stability of the financial systems in the country (Bechard, 2022; Mavuso, 2022), with SARB de- tailing the risk of a grey-listing. There is a high likelihood that the country does not sufficiently address the issues raised (SARB, 2022). Mavuso (2022) argues that grey-listing would increase the cost of capital and businesses' increased difficulty of transacting internationally. SARB (2022) also shared these concerns, with them expecting higher administrative, financing, and transaction costs; a negative impact on international trade due to more difficult cross-border transactions; the negative effect of damage to the financial system's reputation on capital and the local currency markets; and the local and regional spillover effect of a potential decline in correspondent banking relations. Paton (2022) on the other hand, reports that S&P Global Ratings expects that South Africa's grey-listing would have a 'muted' impact on the banking sector (due to the SARB's adoption of global best practices) but will raise the government's borrowing cost. S&P does not expect this to impact the country's credit rating immediately but would put the current ratings at risk. In this policy report we add to this discussion by estimating the effect of the grey-listing events on capital flows in Section 3. Differently for previous studies we find that the grey-listing did not have any detrimental effects on capital inflows for the period of time between 2010-2022.

This policy report aims to add to the public discussion on the topic. To do that, we will revise the empirical research on the countries' characteristics related to being grey-listed as well as the possible consequences of adopting the FATF recommendations and the grey-listing effects. Moreover, we also provide some evidence on the impact of being included in the grey-list on the countries' capital inflow using the information on the grey-list inclusions since 2010. By exploiting cases similar to South

Africa we are able to better understand the potential consequences of a South African grey-listing in October 2022.

2. Literature Review

The research literature on FATF grey-listing is quite limited and mostly focuses on the determinants of being listed and discusses the possible negative effects of such events without using data to backup the arguments. The research on the economic effects of such events is even more scarce due to the lack of data from the countries in the list, which tend to be small economies with limited data availability. In this section we present the summary of the research on the topic about the characteristic of the countries listed by FATF, the effectiveness of its recommendations and the FATF grey-listing economic impacts. In the next section we estimate the effects of grey-listing on capital flows up to 2 years after the event.

2.1 Countries Characteristics and FATF Compliance

We start by presenting the research that aims to understand the determinants of the grey-listing events by exploiting the relationship between countries' characteristics and inclusion in the FATF list. Mekpor and Aboagye (2018) creates a measure for AML/CFT compliance and tries to understand the main factors that affect countries' adherence to the FATF recommendations. the authors find that technology, regulatory quality, the structure of the banking sector, size of the economy, and the institution of financial intelligence centers affect AML/CFT compliance in a statistically significant manner.

Celik (2021) analyzes the mutual evaluation reports and how such reports' results correlate with financial inclusion. They find that in countries with less than 10% financial exclusion, these risks/concerns (specifically, cash, informal economy, and financial exclusion) are the lowest. Risks trend upward as financial exclusion increases, with cash risk peaking at countries with more than 50% financial exclusion and the other two risks peaking for countries with between 30% and 49% financial exclusion. As a result, a country with a high share of financial exclusion has a greater probability of being seen as a risk in these three categories. Reviewing the reports, they empirically estimate that, on average, an assessor's risk sensitivity to financial exclusion is 32% (this is essentially the point where reports start to mention financial exclusion as a concern, with some outliers, when countries are ranked according to the financial exclusion). They make various recommendations, mostly relating to assessors being aware of the potential impacts of strict rules of AML/CFT policies on financial inclusion, capacity-building support for lower-income countries, and awareness of the relationships between informal economies, financial exclusion, and AML/CFT measures.

2.2 Effectiveness of FATF Recommendations

A second strand of research aims to evaluate the effectiveness of the FATF recommendations and compliance on criminal activity and the possible unintended consequences of such recommendations on financial inclusion. On the effects of FATF on criminal activity, Ferwerda et al. (2013) uses a dataset of trade between the US and 199 other countries to analyze whether AML policies affect trade-based money laundering. This subset of money laundering is unique from a data availability perspective. The criminal proceeds are transferred worldwide using fake invoices that either undervalue or overvalue imports and exports. Given the availability of trade data, this form of money laundering is much easier to detect than traditional money laundering. Interestingly, Ferwerda et al. (2013) find no effect of strict AML/CFT policy on this type of money laundering.

Ferwerda (2009) seeks to understand the effectiveness of anti-money laundering (AML) policy on criminal behavior. They construct an indicator from mutual evaluation reports on money laundering reports compiled by FATF, IMF, and World Bank, to provide evidence on which AML compliance factors affect criminal behavior considering four key areas: legal framework, duties of the private sector, institutional framework, and international cooperation. They find that international cooperation is the only variable that relates negatively to crime.

Moreover, other papers argue that the recommendations made to the countries could have some adverse effects on countries' financial inclusion. Sykes (2007) raises some concerns about the methodology used to evaluate countries' compliance with international standards as set by FATF in AML/CFT. The main issue is the complex nature of these evaluations, the recommendations, and how countries include them in their legal framework. Another issue, which will always be present, is that some regulations compete with other national interests, particularly financial inclusion, as mentioned by Celik (2021). Sykes (2007) recommends that the evaluation process be made to give assessors guiding principals to ensure that the goal of strong AML/CFT institutions and legal frameworks are in place instead of a mechanical approach.

To this end, Bester et al. (2004, 2008) consider the implications on access to financial services/financial inclusion of implementing FATF recommendations in developing countries, specifically looking at South Africa (Bester et al. (2008) also considers four other countries: Indonesia, Kenya, Mexico, and Pakistan, each with large portions of their populations excluded from financial services). Bester et al. (2004) highlights the problem with certain implementations of the Financial Intelligence Centre Act (FICA). Namely, a third of the population lives in informal settlements, while approximately 50% of the people lack the necessary documents to verify their residential address. They, similar to Sykes (2007), recommend that the AML/CFT recommendations (and their implementation) take the circumstances of developing and middle- income countries into account. Likewise, Bester et al. (2008) recommends that countries with large under served populations implement the recommendations based on the perceived risk of money laundering rather than a blanket approach. They also highlight that financial inclusion is not solely impacted by AML/CFT policies, with affordability key among them. However, its affordability can be negatively influenced by AML/CFT policies.

2.3 Effects of Grey-listing on Economic Outcomes

Although there is a growing body of research on the effects of foreign demand on domestic assets, the literature on the impacts of grey-listing on economic outcomes is quite limited. Generally, it does not rely on the use of data to back up the arguments on the topic. Below we summarize the few exceptions.

Collin et al. (2016) examine the effect of grey-listing on cross-border payments to and from countries. Using SWIFT monthly numbers of cross-border payments between customers in every country connected to the SWIFT network between 2004 and 2014 and linking these numbers with data on the timing of grey-listing, they find that being added to the grey-list results in a 7-10 percent reduction in the number of payments sent to an affected country by the rest of the world. Morse (2019) analyzes the effect of grey-listing on bank flows (growth in cross-border liabilities) for 39 countries between 2010-2015 and finds a sizeable significant contraction on the bank flows around 15-16 percent. Kida and Paetzold (2021), which finds a negative and statistically significant effect of grey-listing on a country's capital inflows using an inferential machine learning technique in the short run.

3. Estimation of the Effects of Grey-listing on Capital In-flows

In this section, we will exploit the events of grey-listing between 2010-2018 and data on countries' total external debt to estimate the effects of the international warnings on AML/CFT domestic measures on foreign capital inflows. Using previous events similar to the possible South African grey-listing can help us evaluate the potential consequences of such an event on South African capital inflows.

3.1 Data

Our data comes from two main sources. In order to characterize the total capital inflows, we put together a quarterly panel database between 2004 and 2022, using the Quarterly External Debt Statistics (QEDS) database provided by the World Bank and the International Monetary Fund (IMF). This database has comprehensive, internationally comparable, and reliable information of external debt components. For our purpose, we use the institutional sector identification for the construction of the gross external debt position. We estimate the total effects of such events on capital inflows using the total external debt outstanding in all maturities and all instruments.

The second source of data comes form the FATF's mutual evaluation reports and grey-list.[2] The evaluations are implemented by FATF, and occasionally by the IMF or World Bank, by a small team consisting of legal, law enforcement, and financial experts. The assessment team conducts two to three on-site visits and rates the level of technical compliance of a country's legal and regulatory framework on each recommendation. If these assessments indicate that a country's performance is poor, the government has

[2] The data used here is from Kida and Paetzold (2021), see the article for more details.

one year to address its key deficiencies to avoid listing. If deficiencies are not sufficiently addressed, the FATF works with the country to develop an action plan. Once the plan is adopted by the FATF and committed to by the country, the FATF includes the country in the grey-list. If no action plan is agreed with the FATF or high-level political commitment is not given, the FATF includes the country in the black-list. The data we use here are from 10 grey-listing episodes between 2010-2017 and are listed in Table 1.

3.2 Empirical Strategy

Identification of the causal effects of grey-listing on economic conditions is difficult. The countries included in the list are developing countries with limited data availability and time span. Therefore, it is very hard to control for time-varying shocks that might be correlated to inclusion in the list and the economic conditions. For example, Mekpor and Aboagye (2018) show that countries included in the list tend to have subpar regulatory quality. Without considering such confounding factors, it is impossible to disentangle the effects of the grey-listing impacts from the countries' institutional framework, which are unobserved. These institutional features would likely affect both AML/CFT compliance measures and capital inflows.

We use the synthetic control approach proposed by Cavallo et al. (2013) to address this issue. In their approach, they overcome the identification problems outlined above by finding a group of countries that have had the same trend in capital inflows in the quarters preceding the grey-listing events and likely would have had the same behavior in the absence of the shocks studied. We then use this group to estimate the counterfactual and conduct a causal analysis. This approach is more general than the fixed-effects model commonly applied in the empirical literature, allowing confounding unobserved characteristics effects to vary over time.[3] Moreover, this method requires very limited data, which allows us to estimate the effects of grey-listing events on capital inflows for all the countries that have quarterly external debt information instead of restricting the analyzes to countries with other information on institutional quality and other economic and financial outcomes at the quarterly frequency.

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[3] For more details, see Cavallo et al. (2013)

Table 1: Grey-listing Events

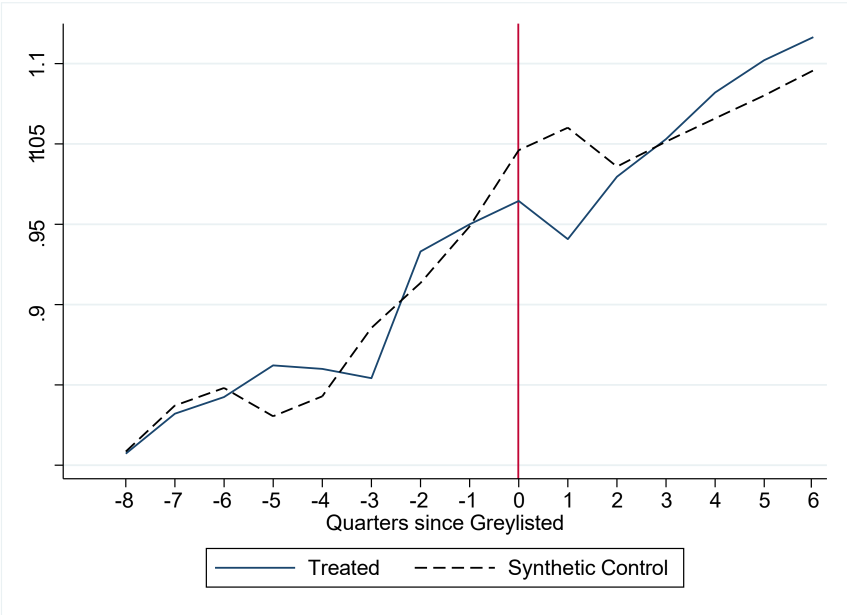
Country	Date
Greece	2010q1
Thailand	2010q1
Ecuador	2010q1
Bolivia	2010q1
Paraguay	2010q1
Ukraine	2010q1
Indonesia	2010q1
Argentina	2011q2
Albania	2012q2
Uganda	2014q1
Ethiopia	2017q1
Tunisia	2017q4
Sri Lanka	2017q4
Pakistan	2018q2

3.3 Results

We start by estimating the overall effects of the grey-listing events on countries' capital inflows. Although we cannot disentangle the effects of the reduced foreign demand from other possible indirect effects of the grey-listing, we estimate the total effects of such events on capital inflows using the total external debt outstanding in all maturities and all instruments. Figure 1 shows the actual and the counterfactual countries' external debt surrounding the grey-listing event. The results in such a figure show a good performance in the pre-treatment period, which is very important for obtaining good out-sample counterfactual predictions.

These results indicate a short-term 6,9% reduction in capital flows one quarter following the literature, allowing confounding unobserved characteristics effects to vary over time.2 Moreover, this method requires very limited data, which allows us to estimate the effects of grey-listing events on capital inflows for all the countries that have quarterly external debt information instead of restricting the analyzes to countries with other information on institutional quality and other economic and financial outcomes at the quarterly frequency.

Figure 1: Grey-listing and Capital Flows Dynamics - Synthetic Control



Notes: The specification uses four lags of the outcome variable as predictors in the synthetic control approach

However, the effects seem to dissipate quite quickly. Following the approach suggested by Cavallo et al. (2013) we compute the statistical significance of such results. The results in Table 2 suggest a short-run insignificant reduction in capital inflows which rapidly disappears after two-quarters of the events. The results indicated that the 14 events we analyzed here did not have any impact on countries' capital inflows. Our results are robust to the use of a different number of outcome lagged values as predictors as suggested by Ferman et al. (2020). In Table 3, we analyze the grey-listing events separately for each grey-listing date. One concern would be that the results in Table 2 could have significant impacts for different periods, such as high-risk periods. However, our results show that none of the grey-listing episodes had any effect on capital inflows. Moreover, some episodes can highlight some possible impacts of South African grey-list inclusion. The results of the grey-listing in African countries such as Uganda, Ethiopia, and Tunisia also do not provide any evidence of contractions in capital inflows. We also found non-significant effects for the cases which involved Pakistan and Thailand, which have a similar GDP than South Africa. Altogether, our results provide evidence that the grey-listing does not affect the capital inflows in the grey-listed countries.

4 Concluding Remarks

In this policy report, we summarized the recent developments in South Africa on the possibility of being grey-listed by FATF in October 2022. We also review the concise empirical evidence on the countries' characteristics correlated with grey-listing, as well as the effectiveness of the FATF recommendations and the possible effects on economic outcomes. We then exploit the grey-listing events between 2010-2022 to estimate their impact using a very parsimonious method to infer the causal effects of such events. Our results differ from the previous literature by showing that such events do not impact countries' capital inflows for the period analyzed.

Although the results presented here point out to a less worrisome scenario in case of a greylisting, it is very important to highlight that if the country does not address the issues raised in the mutual evaluations, it could be included in the back-list. This blacklisting would make the country face important sanctions by the IMF, World Bank, and the African Development Bank. Moreover, a vast literature shows that institutional quality matters for capital flows and long-run economic growth (Papaioannou, 2009). Therefore, even though the results in the short-term are not significant, there could be important long-run economic effects from not addressing the institutional issues raised by FATF.

We believe that this policy report can be an important tool for policymakers to better understand the causes and consequences of adopting the anti-money laundering and anti-terrorist financing measures in South Africa, especially in the short-run perspective. It would be essential to understand long-run effects of the FATF recommendations and grey-listing, which are not the focus of the current report.

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Table 2: Capital Inflows and Grey-listing

	Total External Debt			
0 Quarters post Greylisting	0.007	0.024	-0.017	-0.032
	[0.773]	[0.857]	[0.689]	[0.817]
1 Quarter post Greylisting	-0.030	-0.016	-0.052	-0.069
	[0.323]	[0.895]	[0.187]	[0.308]
2 Quarters post Greylisting	0.001	0.01	0.016	-0.006
	[0.985]	[0.919]	[0.539]	[0.801]
3 Quarters post Greylisting	0.014	0.027	0.03	0.002
	[0.685]	[0.733]	[0.33]	[0.958]
4 Quarters post Greylisting	0.025	0.035	0.041	0.016
	[0.527]	[0.576]	[0.253]	[0.651]
5 Quarters post Greylisting	0.034	0.047	0.051	0.022
	[0.388]	[0.461]	[0.192]	[0.589]
6 Quarters post Greylisting	0.023	0.034	0.04	0.021
	[0.563]	[0.552]	[0.35]	[0.648]
Number of Events	14	14	14	14
Lags	1	2	3	4

Notes: (i) Lags are the number of lags of the outcome variable used in the synthetic control as predictors, following Ferman, Pinto, and Possebom (2016).
(ii) Numbers in the brackets represent the p-values using Quistorff and Galiani (2017) approach

Table 3: Capital Inflows and Grey-listing - Date Specific Results

	Total External Debt						
0 Quarters post Greylisting	0.012	0.016	-0.044	0.028	0.049	0.028	0.049
	[0.447]	[0.389]	[0.2]	[0.227]	[0.583]	[0.227]	[0.583]
1 Quarter post Greylisting	-0.053	0.040	-0.081	-0.005	0.050	-0.005	0.050
	[0.079]	[0.315]	[0.182]	[0.883]	[0.597]	[0.883]	[0.597]
2 Quarters post Greylisting	-0.064	0.044	-0.128	0.014	0.055	0.014	0.055
	[0.068]	[0.426]	[0.164]	[0.748]	[0.431]	[0.748]	[0.431]
3 Quarters post Greylisting	-0.065	0.010	-0.206	0.005	0.123	0.005	0.123
	[0.21]	[0.944]	[0.127]	[0.922]	[0.139]	[0.922]	[0.139]
4 Quarters post Greylisting	-0.075	0.021	-0.200	0.031	0.096	0.031	0.096
	[0.161]	[0.87]	[0.127]	[0.623]	[0.236]	[0.623]	[0.236]
5 Quarters post Greylisting	-0.088	-0.030	-0.100	0.015	0.072	0.015	0.072
	[0.16]	[0.815]	[0.436]	[0.867]	[0.431]	[0.867]	[0.431]
6 Quarters post Greylisting	-0.084	-0.081	-0.126	0.018	0.107	0.018	0.107
	[0.242]	[0.463]	[0.309]	[0.845]	[0.306]	[0.845]	[0.306]
Number of Events	7	1	1	1	1	2	1
Lags	4	4	4	4	4	4	4
Date of Greylisting	2010q1	2011q2	2012q2	2014q1	2017q1	2017q4	2018q2

Notes: (i) Lags are the number of lags of the outcome variable used in the synthetic control as predictors, following Ferman, Pinto, and Possebom (2016).

(ii) Numbers in the brackets represent the p-values using Quistorff and Galiani (2017) approach.

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