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Money Laundering and Financial Instability: Exploring the Nexus in Fragile Economies

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ABSTRACT

This study investigates the intricate relation between money laundering and financial instability in fragile states, particularly the impact of underground financial networks on loss of financial governance, resource misallocation, and loss of public confidence in the financial system. **Purpose:** This study examines how money laundering fosters shadow wealth, spurs inflationary pressures and reduces the effectiveness of monetary policy. **Method:** The study adopts a mixed-methods research design, combining quantitative and qualitative approaches. The research follows an explanatory sequential design and uses both quantitative and qualitative data. **Results:** It analyses how politically exposed individuals, informal financial networks, and cross-border transactions contribute to cycles of financial opacity and economic vulnerability. The paper reveals three main channels through which money laundering directly leads to instability. First, a decrease in tax revenue and, as an outcome, rising fiscal deficits. Secondly, a destabilisation of banking sectors due to the expansion of illicit credits and bad loans. Finally, capital flight and devaluation influence. The paper also examines the issues of resource scarcity for financial intelligence units and central banks in identifying and countering irregular financial activities. **Contributions:** This study suggests policy options that include regional cooperation instruments, strengthening law enforcement capacities, and incorporating anti-money laundering measures into financial inclusion policies. Reinforcing legal and institutional capacities and using digital tools for transaction tracking seems essential to countering the destabilising impact of money laundering. The results indicate the great need for comprehensive, context-sensitive policies regarding the disruption of the money laundering process and ensuring the financial stability in vulnerable regions.

Keywords: money laundering; financial instability; fragile economies; illicit finance; anti-money laundering (AML); transactional crime; economic vulnerability

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ОРИГИНАЛЬНАЯ СТАТЬЯ

Отмывание денег и финансовая нестабильность: исследование взаимосвязи в неустойчивых экономиках

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АННОТАЦИЯ

В данном исследовании изучается сложная взаимосвязь между отмыванием денег и финансовой нестабильностью в неустойчивых государствах, в частности, влияние подпольных финансовых сетей на потерю финансового управления, нерациональное распределение ресурсов и потерю доверия населения к финансовой системе. **Цель:** исследование призвано показать, как отмывание денег способствует формированию теневого богатства, стимулирует инфляционное давление и снижает эффективность денежно-кредитной политики. **Метод:** в исследовании используется смешанный метод, сочетающий количественные и качественные подходы. Исследование построено на объяснительном последовательном дизайне и использует как количественные, так и качественные данные. **Результаты:** анализируется, как политически значимые лица, неформальные финансовые сети и трансграничные транзакции способствуют возникновению циклов финансовой непрозрачности и экономической уязвимости. В статье раскрыва-

ются три основных канала, отмывание денег через которые непосредственно приводит к нестабильности. Во-первых, снижение налоговых поступлений и, как следствие, рост бюджетного дефицита. Во-вторых, дестабилизация банковского сектора из-за расширения незаконных кредитов и проблемных займов. И наконец, отток капитала и влияние девальвации. В статье также рассматриваются проблемы дефицита ресурсов для подразделений финансовой разведки и центральных банков в выявлении и противодействии нерегулярной финансовой деятельности. **Научный вклад:** данное исследование предлагает варианты политики, включающие инструменты регионального сотрудничества, укрепление потенциала правоохранительных органов и включение мер по борьбе с отмыванием денег в политику расширения доступа к финансовым услугам. Укрепление правового и институционального потенциала и использование цифровых инструментов для отслеживания транзакций представляется необходимым для противодействия дестабилизирующему воздействию отмывания денег. Результаты указывают на острую необходимость в комплексной, учитывающей контекст политике в отношении пресечения процесса отмывания денег и обеспечения финансовой стабильности в уязвимых регионах.

Ключевые слова: отмывание денег; финансовая нестабильность; нестабильная экономика; незаконное финансирование; борьба с отмыванием денег (AML); транзакционные преступления; экономическая уязвимость

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1. Introduction

Money laundering is considered a transactional crime that negatively impacts the economy by contributing to rising societal violence and corruption, causing financial and banking upheaval, and leading to the failure of governance structures [1]. An estimation shows that money laundering (and big business corruption) results in around 2% to 5% of the damage of global gross domestic product (GDP) [2]. Money laundering is the process of concealing the origins of illicitly obtained money through complex financial transactions and poses a significant threat to the integrity and stability of financial systems worldwide. Money laundering has become a key player in the global economy to shape the development path which possibly distorts economic indicators, undermines financial integrity and continues economic instability which facilitates corruption, raises inequality and becomes an enabler for organised crime to flourish [3]. It becomes even easier in the integration of the global economy that provides free trade of capital and digital transactions that support commercial opportunities for businesses to flourish [4, 5]. One of the emerging criminal activities is money laundering, which has been supported through such innovations [6].

Money laundering is the activity of converting illegal property into regular money to preserve the property and works for the sole purpose of increasing money and legitimising, which is widely circulated through the construction business, where corporations are pumped across

the world to reach a final destination in property investment, prestige vehicles and luxury items [6, 7]. Globally, money is deemed legitimate when it originates from goods and financial markets; however, it can also emanate from detrimental sources, transferred illegally, referred to as illicit financial flows. This encompasses various unlawful activities, including illegal capital flight, tax evasion, drug and human trafficking, and terrorism financing. The circulation of trillions of dollars in international marketplaces is a consequence of the products and financial markets where capital is exchanged [8].

Money laundering poses a threat to the survival and soundness of financial sector development of any country where the banking system works as an intermediary and achieves a special position to detect and capture such crimes where a large amount of transactions (economic and financial) are made, where money laundering creates liquidity challenges and becomes a threat to financial stability [9–11]. The financial instability resulting from money laundering manifests through several channels: capital flight, currency volatility, inflationary pressures, and banking sector fragility. Laundered money typically flows through informal and shadow banking channels, undermining monetary policy effectiveness and eroding public confidence in financial institutions [12, 13]. Moreover, money laundering often fuels other illicit activities such as drug trafficking, terrorism financing, and political corruption, which exacerbate macroeconomic volatility.

1.1. Problem statement, objectives and research questions

While the literature extensively documents money laundering as a global financial crime, its direct link to financial instability in fragile economies remains underexplored. Fragile states face unique vulnerabilities such as weak regulatory oversight which allows criminal organisations to exploit financial loopholes. Besides, dollarisation and reliance on informal financial systems increase exposure to illicit capital inflows. Finally, external shocks, such as commodity price fluctuations or political unrest, interact with laundered funds, amplifying macro-financial volatility. Despite international efforts such as the Financial Action Task Force (FATF) recommendations and regional anti-money laundering (AML) initiatives, fragile economies struggle to implement robust AML frameworks. Empirical research investigating how money laundering channels destabilise financial systems in fragile contexts remains limited, resulting in a gap in evidence-based policy responses.

1. This paper aims to critically explore the nexus between money laundering and financial instability in fragile economies. The specific objectives are:

2. To analyse the theoretical and empirical mechanisms linking money laundering to financial instability (e.g., capital flight, exchange rate volatility, banking crises).

3. To identify case-specific manifestations of financial instability driven by illicit financial flows in selected fragile economies.

To evaluate existing AML policy responses and their effectiveness in mitigating financial instability.

The study is guided by the following research questions:

1. How does money laundering contribute to financial instability in fragile economies?

2. Which economic channels (capital flight, currency volatility, banking fragility) are most significantly affected?

3. What institutional and structural factors amplify the destabilising effects of money laundering in fragile economies?

4. What policy measures can effectively mitigate these risks?

1.2. Significance of the study

This study has significant theoretical and policy relevance.

1.2.1. Theoretical significance

The research extends the financial instability hypothesis [14] by incorporating the role of illicit financial flows in fragile economies. While traditional economic theories emphasise market imperfections and speculative bubbles as drivers of instability, this paper highlights how criminal financial activities act as an exogenous destabilising force.

1.2.2. Practical significance

The findings provide actionable insights for policymakers and international financial institutions. By identifying the specific channels through which money laundering destabilises fragile financial systems, governments and regulatory authorities can tailor AML measures to local contexts. This is particularly relevant for countries seeking compliance with FATF standards and access to international financial markets.

1.3. Scope of the study

The paper focuses on fragile and conflict-affected states, where institutional weaknesses heighten vulnerability to financial crimes. Case references include Nigeria, where oil-related money laundering fuels capital flight; Afghanistan, where narcotics-related laundering destabilises the banking sector; and Venezuela, where political corruption and illicit financial flows contribute to hyperinflation and currency collapse.

The study examines both domestic and transnational dimensions of money laundering, acknowledging that fragile economies are often integrated into global laundering networks through correspondent banking relationships, offshore financial centres, and digital cryptocurrencies.

At the core of this research is the assumption that money laundering exacerbates financial instability by distorting financial markets, eroding investor confidence, and undermining monetary policy effectiveness. The conceptual framework (to be presented in the Methodology section) hypothesises the following sequence:

Illicit financial inflows → Capital flight and asset price distortion → Exchange rate volatility and banking fragility → Macroeconomic instability

2. Literature review

This section synthesises existing research on the nexus between money laundering and financial instability, focusing on four major dimensions: (1) theoretical frameworks, (2) transmission channels of financial instability, (3) empirical evidence from fragile economies, and (4) research gaps.

2.1. Theoretical frameworks — nexus between money laundering and financial instability

2.1.1. Financial instability hypothesis

The financial instability hypothesis [14] posits that periods of economic stability encourage excessive risk-taking, which eventually triggers financial crises. While Minsky's framework primarily addresses speculative borrowing and asset bubbles, subsequent scholars [13] argue that illicit financial flows act as an exogenous destabilising factor, amplifying systemic vulnerabilities, particularly in fragile economies with weak regulatory oversight.

2.1.2. Black finance theory

The black finance theory [15] conceptualises money laundering as part of a “black economy” that distorts financial markets by introducing unproductive capital flows. Investing laundered funds in speculative real estate or informal markets, instead of productive sectors, exacerbates asset bubbles and exchange rate volatility.

2.1.3. Institutional economics perspective

From an institutional economics perspective, weak governance, corruption, and fragile legal systems facilitate money laundering and undermine financial stability [16]. The absence of strong anti-money laundering (AML) enforcement mechanisms allows criminal actors to manipulate financial systems, reducing investor confidence and increasing capital flight.

2.2. Transmission channels of financial instability

Money laundering destabilises financial systems through several interconnected channels.

2.2.1. Capital flight and illicit outflows

Illicit financial flows (IFFs) resulting from money laundering contribute significantly to capital flight, draining fragile economies of much-needed investment capital. IFFs arise with the misrepresenting of trade data, which occurs due to the presence of stricter capital control and high corruption in the economy during higher market uncertainty [17]. Kar and Cartwright-Smith [18] estimate that developing countries lose billions annually to illicit outflows, weakening domestic financial markets and causing chronic balance-of-payments deficits.

2.2.2. Exchange rate volatility and inflationary pressures

Money laundering significantly affects the international market due to asset price distortion and capital flows [3]. The flowing of illicit funds into the financial market in a non-transparent manner creates high uncertainty for investors, reduces capital allocation efficiency and triggers excessive volatility, which further makes the global financial market less stable and affects the economy with domino effects [3, 19]. Further, large inflows and outflows of laundered money distort exchange rate stability. Illicit funds are often converted into foreign currency or offshore assets, leading to demand-supply imbalances in foreign exchange markets. In Venezuela, politically connected laundering networks converted billions into U.S. dollars, accelerating hyperinflation and currency collapse [20].

2.2.3. Banking sector fragility

Failure of financial institutions has posed reputational damage to the banking sector, which further intensified with the loss of trust with the consumer due to their poor money laundering compliance practices [21]. The general loss could not be visible immediately, but the general loss associated with reputational risk, which has a destabilising effect, affected banks' capital and liquidity. The effect of money laundering has diverse impacts on the economy, such as higher rates of inflation, tax evasion, less sustainable and inward investment, audit risk, portfolio quality, stability, profitability, etc. [22]. Additionally, money laundering increases banking risks by introducing non-performing loans and reputational risks. Fragile banks with poor

compliance frameworks often become conduits for laundering, making them vulnerable to correspondent banking restrictions imposed by international regulators. The 2010 collapse of Kabul Bank in Afghanistan is a notable example where laundering-related fraudulent loans triggered a national banking crisis.¹

2.2.4. Distortion of monetary policy

Large volumes of unrecorded cash flows undermine monetary policy effectiveness, making it difficult for central banks to accurately estimate money supply and inflationary trends. Laundered funds circulating in the informal economy also hinder taxation and revenue mobilisation, further limiting the government's capacity to stabilise the economy [12]. Money laundering, tax evasion and tax avoidance pose a transactional threat which is addressed through international regimes of coordination and cooperation [23]. Empirical cases illustrate the action by the Hong Kong monetary policy authority of lowering interest rates after 2008, which evidences the growth of complex financial products and capital inflows from mainland China and heightened money laundering risk through shell companies and over-the-counter securities [24]. Money laundering reduces the bank's profitability and stability, poses a serious threat to the banking industry [22], leads to reputational damage and substantial financial penalties [25].

2.3. International and domestic anti-money laundering efforts

2.3.1. FATF recommendations and compliance

The Financial Action Task Force (FATF) provides global AML standards, but fragile economies struggle with compliance due to resource constraints, political interference, and corruption. Countries on the FATF "grey list" often face de-risking by global banks, further isolating them from the international financial system, which can exacerbate their economic challenges and hinder their ability to attract foreign investment.

2.3.2. Regional AML frameworks

Regional initiatives, such as the Inter-Governmental Action Group Against Money Laundering in West Africa (GIABA), have achieved limited success due to coordination challenges and lack of enforcement powers [26].

2.3.3. Domestic reforms

Some fragile economies have introduced AML reforms, but institutional weaknesses undermine their effectiveness. For instance, while Nigeria established the Economic and Financial Crimes Commission (EFCC), political interference often limits its ability to prosecute high-profile laundering cases [26].

2.4. Research gaps

Despite growing literature, significant gaps remain:

1. Limited Focus on Fragile Economies — Most empirical studies focus on developed or emerging economies, leaving fragile states under-researched.
2. Lack of Integrated Analysis — Few studies integrate macroeconomic indicators (inflation, currency volatility) with institutional quality measures to assess the laundering-instability nexus.
3. Neglect of Informal Financial Channels — Research often overlooks the role of informal systems (hawala, mobile money) in laundering within fragile economies.
4. Insufficient Longitudinal Studies — Most existing research uses cross-sectional data, limiting understanding of long-term dynamics.

The literature review confirms that money laundering contributes to financial instability through multiple economic and institutional channels. However, fragile economies present unique vulnerabilities due to their heavy reliance on informal markets, weak governance, and susceptibility to external shocks. This study addresses the identified research gaps by adopting a mixed-methods approach to examine how laundering influences financial stability indicators in fragile contexts, while incorporating institutional and structural variables.

3. Methodology

This study adopts a mixed-methods research design, combining quantitative and qualitative approaches to investigate the nexus between money laundering and financial instability in fragile

¹ International Crisis Group. 2011. The Kabul Bank crisis: Lessons for Afghanistan's financial system. ICG Asia Report. URL: <https://www.crisisgroup.org/opd/asia-pacific/afghanistan/cleaning-afghanistans-banking-system> (accessed on 18.01.2026).

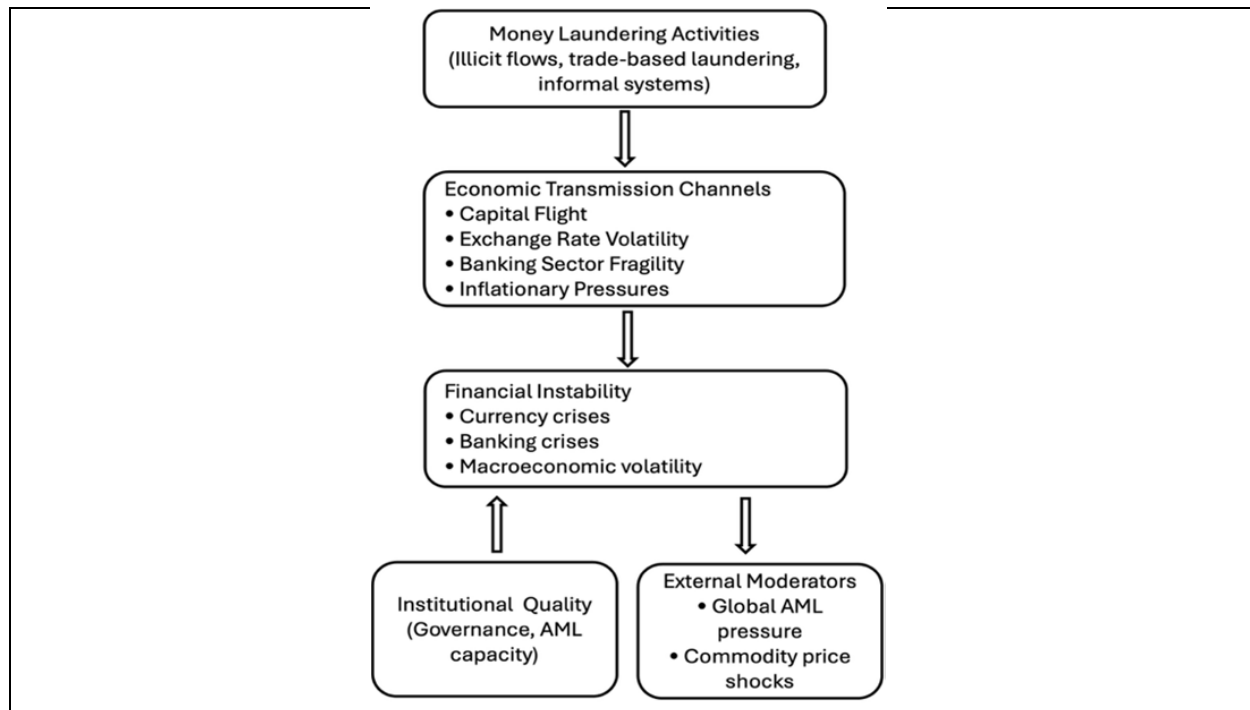


Fig. 1. Conceptual framework (the money laundering – financial instability nexus)

Source: Developed by the author based on Masciandaro et al. (2013) [13] and Minsky (1986) [14].

economies. The mixed-methods design is justified because the relationship between illicit financial flows and financial instability involves both measurable economic indicators and institutional dynamics that require qualitative interpretation.

The research follows an explanatory sequential design [27] and uses both quantitative and qualitative data. In the quantitative phase, empirical analysis of the relationship between money laundering indicators and financial instability has been measured using secondary macroeconomic data. In the qualitative phase, thematic analysis of case studies and policy documents contextualises and explains the statistical findings. This integrated approach addresses the identified research gaps by providing both statistical evidence and contextual understanding of the mechanisms at play in fragile economies.

3.1. Conceptual framework

The conceptual framework (Fig. 1) illustrates the hypothesised relationship between money laundering activities and financial instability, mediated by economic channels and moderated by institutional quality.

3.2. Population and sampling

In the quantitative phase, the study focuses on 10 fragile economies, selected based on the Fragile

States Index² and FATF grey-listing. These include Nigeria, the Democratic Republic of Congo, Sudan, Afghanistan, Yemen, Venezuela, Haiti, Myanmar, Guinea-Bissau, and Somalia. A purposive sampling strategy was used to select these countries due to the availability of macroeconomic data and their documented vulnerabilities to money laundering.

For the qualitative phase, five case studies (Nigeria, Venezuela, Afghanistan, Myanmar, and Haiti) were selected based on regional diversity and documented laundering scandals. Policy documents, investigative reports, and interviews with AML experts (as secondary sources) were reviewed.

3.3. Data

The secondary (quantitative) data were collected from multiple sources, namely, World Bank World Development Indicators (WDI) (GDP, inflation, exchange rate, banking sector indicators), Global Financial Integrity (GFI) (estimates of illicit financial flows (IFFs)) FATF and Basel AML Index (AML compliance and governance indicators), and IMF Financial Soundness Indicators (FSI) (non-performing loans, bank capital adequacy ratios). Similarly, qualitative data were also obtained

² Fragile States Index. URL: <https://fragilestatesindex.org/>

Table 1
Variables and measurements

Variables name		Measurement
Dependent variable		
Financial Instability	Exchange Rate Volatility (ERV)	Standard deviation of monthly exchange rate fluctuations (IMF data).
	Banking Sector Fragility (BSF)	Ratio of non-performing loans to total loans
	Macroeconomic Volatility (MV)	GDP growth variability and volatility
Independent variable		
Money Laundering Intensity	Proxy using Illicit Financial Flows (IFFs).	A % of GDP and AML Index Score
Control variable		
	Institutional Quality (IQ)	
	Commodity Price Shocks (CPS)	Volatility in global commodity prices for resource-dependent countries
	Foreign Direct Investment (FDI)	As a % of GDP

Source: Developed by the author.

Table 2
Descriptive statistics

Variable	Mean	SD	Min	Max
Illicit Financial Flows (% of GDP)	7.82	3.15	2.40	15.90
Exchange Rate Volatility (ERV)	12.7	6.3	3.4	28.5
Banking Sector Fragility (NPL ratio, %)	15.6	8.9	5.2	38.4
Inflation Volatility (%)	18.3	10.1	4.7	46.2
Institutional Quality (WGI, -2.5 to 2.5)	-1.33	0.72	-2.21	-0.18

Source: Developed by the author.

Note: ERV – standard deviation of monthly exchange rates; NPL – non-performing loans; WGI – World Governance Indicators.

from different sources, which include FATF mutual evaluation reports and regional AML organization publications (e.g., GIABA, APG), case-specific academic studies and policy reports, and news and investigative journalism sources (e.g., OCCRP reports for money laundering scandals). *Table 1* presents the details of variables and measurements.

Data analysis has been conducted using Stata 17. *Table 2* summarises the key variables for the 10 fragile economies over the study period (2010–2023).

Thematic analysis will follow Braun and Clarke's [28] six-step approach, which includes

familiarisation with data (policy documents, case reports), coding for key themes (AML enforcement gaps, informal channels, political interference) and identifying cross-country patterns. The findings will complement the quantitative analysis by providing contextual explanations for statistical patterns.

Although this research uses secondary data, ethical risks are minimal. However, all data sources will be appropriately cited, sensitive information from case studies handled with caution to avoid political implications and country-specific findings has contextualized to avoid stigmatization.

Table 3

Fixed-effects regression results (money laundering and financial instability)

Predictor	ERV (β)	p-value	Banking Fragility (β)	p-value	Inflation Volatility (β)	p-value
Illicit Financial Flows (IFFs)	0.39	<.001	0.28	.002	0.22	.015
Institutional Quality (WGI)	-0.31	.004	-0.26	.013	-0.19	.042
Commodity Price Shocks (CPS)	0.14	.081	0.09	.210	0.17	.064
FDI (% of GDP)	-0.11	.093	-0.08	.127	-0.12	.074
R ² (within)	0.44	—	0.38	—	0.32	—

Source: Developed by the author.

Note: All β are standardized coefficients.

Panel data regression models. A fixed-effects model will estimate the impact of laundering on financial instability:

$$FI_{it} = \alpha + \beta_1 IFF_{it} + \beta_2 IQ_{it} + \beta_3 CPS_{it} + \beta_4 FDI_{it} + \varepsilon_{it},$$

where FI_{it} is financial instability indicators for country i at time t , IFF_{it} shows illicit financial flows (% of GDP), IQ_{it} is institutional quality, CPS_{it} depicts commodity price shocks and FDI_{it} shows foreign direct investment. α is a constant term, β_1 to β_4 are the parameters and ε_i shows error term, respectively.

4. Results and discussion

This section presents the findings of the quantitative and qualitative analyses, followed by an integrated discussion. The results explore the relationship between money laundering (measured via illicit financial flows) and financial instability indicators in fragile economies, along with contextual evidence from selected case studies.

A fixed-effects panel regression was conducted to examine the impact of money laundering on financial instability indicators, and the results are shown in *Table 3*.

The findings from regression highlight that illicit financial flows (IFFs) significantly predict all three financial instability indicators, with the strongest effect on exchange rate volatility ($\beta = 0.39$, $p < .001$). Besides, institutional quality has a significant mitigating effect, supporting the argument that strong governance reduces financial instability. Additionally, commodity price shocks

and FDI are weakly significant, suggesting that laundering effects are more direct than external shocks.

4.1. Case study findings

The qualitative analysis provides contextual insights into how laundering destabilises fragile economies.

4.1.1. Afghanistan: banking sector fragility

The Kabul Bank scandal (2010) illustrates how laundering destabilises fragile banking systems. Fraudulent loans to politically linked individuals amounted to nearly \$ 900 million, triggering depositor panic, a bank run, and an IMF-led bailout.³ This supports the regression evidence linking laundering to banking fragility ($\beta = 0.28$).

4.1.2. Haiti: informal systems and AML weakness

Haiti's reliance on informal money transfer systems (e.g., hawala-like networks) enables laundering while undermining formal banking channels. Weak enforcement of AML laws allows criminal proceeds to circulate freely, contributing to chronic exchange rate volatility. *Table 4* provides a comparative summary of how laundering destabilises selected fragile economies and the existing gaps in anti-money laundering (AML)

³ International Crisis Group. 2011. The Kabul Bank crisis: Lessons for Afghanistan's financial system. ICG Asia Report. URL: <https://www.crisisgroup.org/opd/asia-pacific/afghanistan/cleaning-afghanistans-banking-system> (accessed on 18.01.2026).

Table 4

Comparative case study findings (laundering and financial instability)

Country	Key laundering channels	Financial instability effects	AML weaknesses
Afghanistan	Narcotics trade, fraudulent bank loans	Banking crisis (Kabul Bank), depositor panic	Weak central bank oversight, informal hawala networks
Haiti	Informal remittance systems (hawala-like)	Exchange rate volatility, limited monetary control	Limited AML infrastructure, reliance on informal finance

Source: Developed by the author.

Table 5

Structured recommendation

Sl. No.	Structure	Strategy	Supportive action
1	Policy oriented	Tailored AML strategies for fragile contexts	Develop context-specific AML frameworks that prioritize key laundering channels (e.g., trade misinvoicing in resource-rich fragile states)
		Regulation of informal financial systems	Introduce light-touch regulation for mobile-money platforms and hawala networks to integrate them into the formal financial system
		Regional cooperation	Strengthen regional AML organisations (e.g., GIABA, APG) to improve cross-border intelligence sharing
2	Institutional level	Capacity building	Provide training for financial intelligence units (FIUs) and enhance judicial independence to prosecute high-profile laundering cases
		Public-Private Partnerships (PPP)	Collaborate with commercial banks, fintech firms, and mobile money providers for transaction monitoring and suspicious activity reporting
		Anti-corruption measures	Integrate AML reforms with broader anti-corruption initiatives to address political interference
3	Operational-level	Targeted financial monitoring	Use AI-based trade and transaction monitoring tools to detect anomalies in fragile states with limited manpower
		Community Engagement	Involve local communities and civil society in monitoring resource-based laundering, especially in mining and oil sectors
		Incentive-Based Compliance	Offer tax and credit incentives for businesses adopting AML compliance standards

Source: Developed by the author.

responses. It shows a common pattern: resource-based laundering and political corruption interact with weak institutions to exacerbate macroeconomic volatility.

The findings confirm the financial instability hypothesis [14], extending it to show how illicit financial flows act as exogenous destabilising forces. The positive relationship between laundering and volatility supports the black finance theory

[15], which argues that illicit funds distort asset allocation and exchange markets. Further, the significant negative coefficient for institutional quality indicates that governance capacity mediates the laundering — instability nexus. Countries with better regulatory enforcement (e.g., Ghana in Sub-Saharan Africa, not included in this fragile sample) exhibit lower volatility despite similar exposure to IFFs, reinforcing the importance of institutional

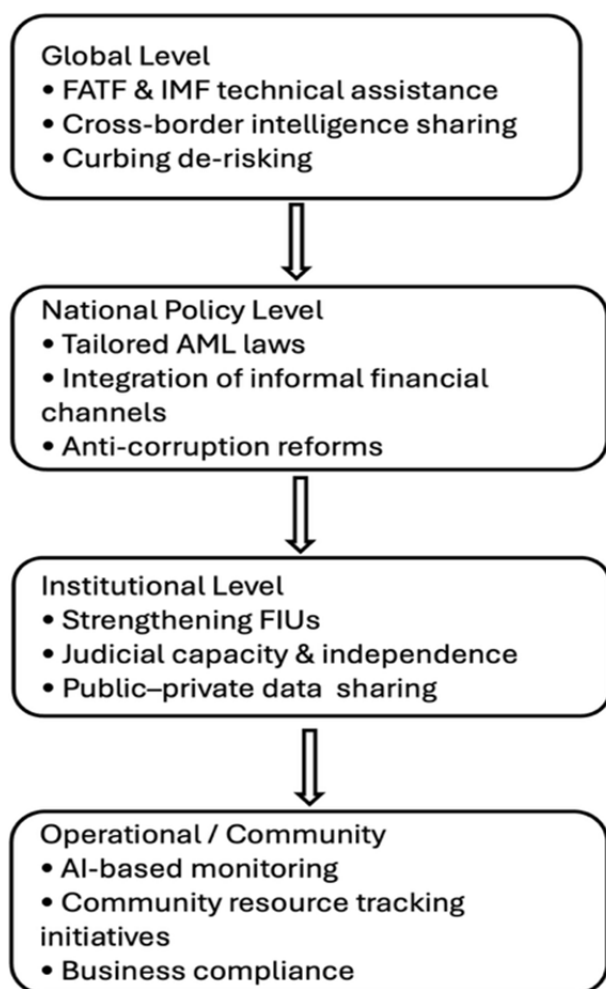


Fig. 2. Governance framework for combating money laundering in fragile economies

Source: Developed by the author.

reforms. Moreover, case study evidence highlights how informal systems (hawala, mobile money platforms) amplify laundering in fragile states, bypassing AML enforcement.

The results suggest that global AML regimes (e.g., FATF recommendations) are insufficient when local institutions are weak. Instead, context-specific interventions — such as targeting trade misinvoicing in resource-dependent economies and strengthening informal sector oversight — are required. Money laundering significantly contributes to financial instability in fragile economies, particularly through exchange rate volatility and banking sector fragility. Moreover, institutional quality moderates the relationship, with weak governance amplifying laundering's destabilising effects. Case studies confirm these patterns, showing how laundering interacts with political corruption and informal financial systems to trigger macroeconomic crises.

5. Policy implications and recommendations

The findings from this study highlight the critical nexus between money laundering and financial instability in fragile economies. This section outlines policy implications at national, regional, and global levels and provides specific recommendations for mitigating the destabilising effects of illicit financial flows (IFFs).

5.1. Policy Implications

5.1.1. Reassessing AML frameworks in fragile economies

The study underscores that FATF-compliant laws alone are insufficient in fragile contexts. Policies must account for informal financial systems, political corruption, and capacity constraints.

5.1.2. Institutional reforms as stabilizers

The strong moderating effect of institutional quality implies that building transparent regulatory institutions is a prerequisite for financial stability. Targeted institutional reforms, rather than blanket global AML pressure, are essential for fragile states.

5.1.3. Global responsibility and cooperative mechanisms

Since laundering in fragile economies is often transnational, the international community must enhance cooperation in financial intelligence sharing and provide capacity-building support. Excessive de-risking by global banks (cutting correspondent banking ties) may unintentionally push fragile economies deeper into informal channels.

Based on the study findings, the following recommendations are structured around policy, institutional, and operational levels (Table 5).

Based on the recommendation, the proposed governance framework is drawn that integrates a multi-level strategy (Fig. 2).

6. Conclusion

This study examined the complex relationship between money laundering and financial instability in fragile economies using a mixed-methods research design. The quantitative analysis, based on panel data from 10 fragile states (2010–2023), provided strong evidence that illicit financial flows (IFFs) significantly

contribute to financial instability, measured by exchange rate volatility, banking sector fragility, and inflationary pressures. Illicit financial flows were found to be the strongest predictor of exchange rate volatility ($\beta = 0.39$, $p < .001$) and also significantly influenced banking sector fragility ($\beta = 0.28$, $p = .002$) and inflation volatility ($\beta = 0.22$, $p = .015$). Institutional quality significantly moderated the laundering–instability nexus ($\beta = -0.31$, $p = .004$), confirming that strong governance frameworks reduce systemic vulnerability. The qualitative case studies of Nigeria, Venezuela, Afghanistan, Haiti, and Myanmar reinforced these statistical findings. In each case, laundering activities — whether through oil bunkering, political embezzlement, narcotics trade, or informal remittance systems — exacerbated financial crises by draining foreign reserves, destabilising currencies, and eroding confidence in banking systems. Collectively, the evidence demonstrates that money laundering acts as an exogenous destabilising force in fragile economies, amplifying existing macroeconomic and institutional vulnerabilities.

6.1. Theoretical contributions

This research contributes to the literature by extending existing economic theories:

1. Financial instability hypothesis [14] — The study expands Minsky’s framework by showing that financial crises in fragile economies are not solely the result of endogenous speculative bubbles but are also triggered by criminal financial activities that distort capital allocation and monetary policy.
2. Black finance theory [15] — The results empirically confirm the theory’s assertion that laundering fuels unproductive financial flows, particularly in speculative real estate and currency markets.
3. Institutional economics [16] — The findings underline the crucial role of institutional quality in moderating laundering-induced instability, reinforcing institutional economics’ emphasis on governance as a determinant of economic outcomes.

6.2. Practical and policy implications

The study’s findings have significant implications for policymakers, international organizations, and financial regulators:

1. Tailored AML frameworks — One-size-fits-all AML measures are ineffective in fragile economies. Context-specific strategies must prioritize

the dominant laundering channels, such as trade misinvoicing in resource-rich states or informal hawala networks in underbanked regions.

2. Institutional strengthening — Building independent financial intelligence units (FIUs), ensuring judicial independence, and combating political interference are critical to stabilizing fragile financial systems.

3. Global cooperation and technical assistance — International institutions (IMF, FATF) must move beyond punitive de-risking measures to provide capacity-building support for fragile states, helping them integrate informal systems into formal financial networks.

4. Leveraging technology — Adoption of AI-based monitoring tools and blockchain-based transaction tracking can help detect laundering patterns in resource-constrained fragile economies.

The governance framework for AML in fragile economies (presented in Section 5) provides a structured multi-level approach, linking global policy coordination, national reforms, institutional capacity building, and community-level initiatives.

Future policy directions involve the use of blockchain for AML that explores blockchain-based transaction tracking to reduce anonymity in fragile economies. Additionally, financial inclusion as an AML strategy by expanding formal financial access to reduce reliance on informal laundering-friendly systems. Finally, long-term institutional development by enabling embedded AML reforms into broader state-building and governance-strengthening efforts.

While the study offers valuable insights, it is subject to certain limitations. This limitation comes in the form of data where estimates of IFFs are based on indirect methods and may underestimate laundering flows in informal networks. The second limitation is the causality; although panel regression controls for some heterogeneity, establishing strict causal relationships remains challenging. Third, case selection bias exhibits that the focus on high-profile fragile states may over-represent extreme cases, limiting generalisability. Finally, neglect of non-financial impacts such as socio-political impacts (e.g., state legitimacy, conflict financing) is underexplored. Moreover, the methodological limitations include: data reliability — estimates of illicit financial flows are prone to measurement errors due to hidden

transactions; causality issues — while panel regression can control for some unobserved heterogeneity, establishing strict causality remains difficult and case study bias — selection of high-profile cases may overrepresent severe instances of laundering.

Future studies should address these limitations by initially employing longitudinal and time-series models to better capture dynamic interactions between laundering and macro-financial stability over extended periods. Second, expand the scope to non-financial impacts by including the political economy of laundering and its effects on state legitimacy and conflict financing. Third, exploring digital currencies and crypto-laundering was given the growing use of cryptocurrencies in fragile economies to bypass traditional AML controls. Fourth, comparative regional studies are used to identify regional variations in laundering patterns and regulatory effectiveness. Fifth, micro-level behavioural studies are used to examine how household and business actors in fragile economies interact with laundering networks.

The study confirms that money laundering is not merely a criminal justice issue but a fundamental macroeconomic risk that exacerbates financial instability in fragile economies. Unlike in developed financial systems, where regulatory institutions buffer systemic shocks, fragile states experience amplified volatility due to institutional weaknesses, political corruption, and reliance on informal financial systems. Effective mitigation requires a paradigm shift from punitive, compliance-focused AML regimes to development-orientated, capacity-building approaches. Fragile economies need multi-level governance strategies that combine global technical assistance, national policy reforms, institutional strengthening, and community-level monitoring. As fragile economies increasingly integrate into global financial networks, the international community must recognise that combating money laundering is not only a matter of financial integrity but also a prerequisite for sustainable economic stability and development.

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