Chapter III

International finance for development

Significant vulnerabilities remain in the global financial system...

The global financial crisis demonstrated the substantial risks that the international financial system can pose to the real economy and global development. Yet, despite efforts by the international community to implement reforms (particularly in the area of financial regulations), significant risks in the financial system remain, more than five years after the crisis. Risks include vulnerabilities in the banking and shadow banking systems, as well as in short-term volatile capital flows, global imbalances, weakening fiscal positions and sovereign debt overhangs.

...a system that failed to adequately allocate savings to investment in sustainable development

At the same time, discussions on the post-2015 development agenda have highlighted the enormous needs for financing the social, economic and environmental dimensions of sustainable development. Long-term financing will be essential for raising the resources required for a transition to a green economy and for promoting sustainable development. Yet, to date, the international financial system has failed to adequately allocate resources for long-term sustainable development needs. There has been insufficient investment in a number of critical areas: infrastructure; health, education and sanitation services for the world's poor, small- and medium-sized enterprises (SMEs); financial services for all; and the green technologies necessary to address climate change in both developed and developing countries.[1]

Nonetheless, estimated financing needs still represent a relatively small portion of global savings. Annual global savings are estimated to be about $17 trillion as of 2012, with global financial assets at about $218 trillion as of 2011.[2] Furthermore, despite turbulent markets and deleveraging across the developed world, global financial assets have grown at least 10 per cent since the end of 2007. [3] Although reallocating the pool of global financial assets would be challenging, reinvesting a small percentage in sustainable development could have an enormous impact. The challenge lies in promoting a global financial system that incentivizes such a reallocation in a sustainable manner, while also building stable domestic capital markets for long-term investment in developing countries.

1 UN/DESA, "Financing for sustainable development: review of global investment requirement estimates", Report of the UNTT Working Group on Sustainable Development Financing, chap. 1 (New York, 2013); Peer Stein, Tony Goland and Robert Schiff, "Two trillion and counting: assessing the credit gap for micro, small, and medium-size enterprises in the developing world" (World Bank International Finance Corporation and McKinsey & Company, October 2010).

2 International Monetary Fund (IMF), *World Economic Outlook 2012* (Washington, D.C.); TheCityUK, *Fund Management Report 2012* (London, November 2012).

3 McKinsey & Company, "The Hunt for Elusive Growth: Asset Management in 2012: Will the goose keep laying golden eggs?", McKinsey's annual perspective on the global asset management industry (June 2012).

Trade-offs exist between reducing risks in the international financial system and enhancing access to credit for achieving sustainable development

Ultimately, stability, sustainability and inclusiveness are mutually reinforcing: stable and inclusive markets encourage greater investment, while long-term investment can play a stabilizing, countercyclical role in financial markets and the real economy.[4] Nonetheless, there are also trade-offs between lowering risk and enhancing access to the credit necessary for achieving sustainable development.

Global imbalances and international reserves accumulation

Global imbalances have narrowed but remain an issue in the long run

As discussed in Chapter 1, global imbalances on the current accounts of major countries narrowed in 2013, continuing a general trend since the financial crisis, with only a temporary reversal in 2010. In the medium term, global imbalances are projected to decrease modestly, helped by lower surpluses among energy exporters.[5] To an extent, the reduction in global imbalances reflects a cyclical downturn and weak external demand in deficit countries. In addition, it reflects some structural improvements in several major economies. For example, the narrowing in the external surplus of China reflects in part a more flexible exchange rate. Global imbalances are not expected to widen by a significant margin in the coming two years. Nonetheless, much of the structural issues underlying global imbalances remain, which continue to pose a risk to long-term economic stability.

Global imbalances have been interlinked with the increase in global foreign-exchange reserves in the last decade, which increased more than fivefold from $2.1 trillion to $11.7 trillion between 2000 and 2012. Although reserves fell across regions following the crisis, reserves have stabilized since 2010, but this is mainly owing to a large increase in reserve accumulation in Western Asia. For example, over the past year, reserves increased slightly across developing countries and economies in transition, although the situation varied significantly across regions (figure III.1). Western Asia sharply increased its level of international reserves to gross domestic product (GDP), from 33 per cent in 2011 to 40 per cent in 2013. By contrast, reserves to GDP fell in Indonesia and Ukraine, mirroring the decline in capital inflows. Emerging and developing countries held an estimated $ 7.5 trillion in the second quarter in 2013, accounting for 67 per cent of the total.[6] Accumulated reserve holdings are particularly significant in East and South Asia, where they amount to almost 38 per cent of GDP, largely because of China, compared to 31 per cent for developing and emerging market countries overall (figure III.1).

Countries have been accumulating large international reserves for a variety of reasons...

The accumulation of international reserves is influenced by a range of motivations.[7] In the aftermath of the emerging market crises of the 1990s, reserve accumulation came to be seen by a number of emerging economies as protection—or "self-insurance"—against risks associated with volatile private capital flows. Reserve accumulation can also be a by-product of interventions of central banks on foreign-exchange markets, especially during episodes of surges in capital inflows. As such, reserve accumulation has been highly correlated with global liquidity and changes in international investor sentiment. Finally, reserves can be a

4 UN/DESA, "Challenges in raising private sector resources for financing sustainable development", Report of the UNTT Working Group on Sustainable Development Financing, chap. 3 (New York, 2013).

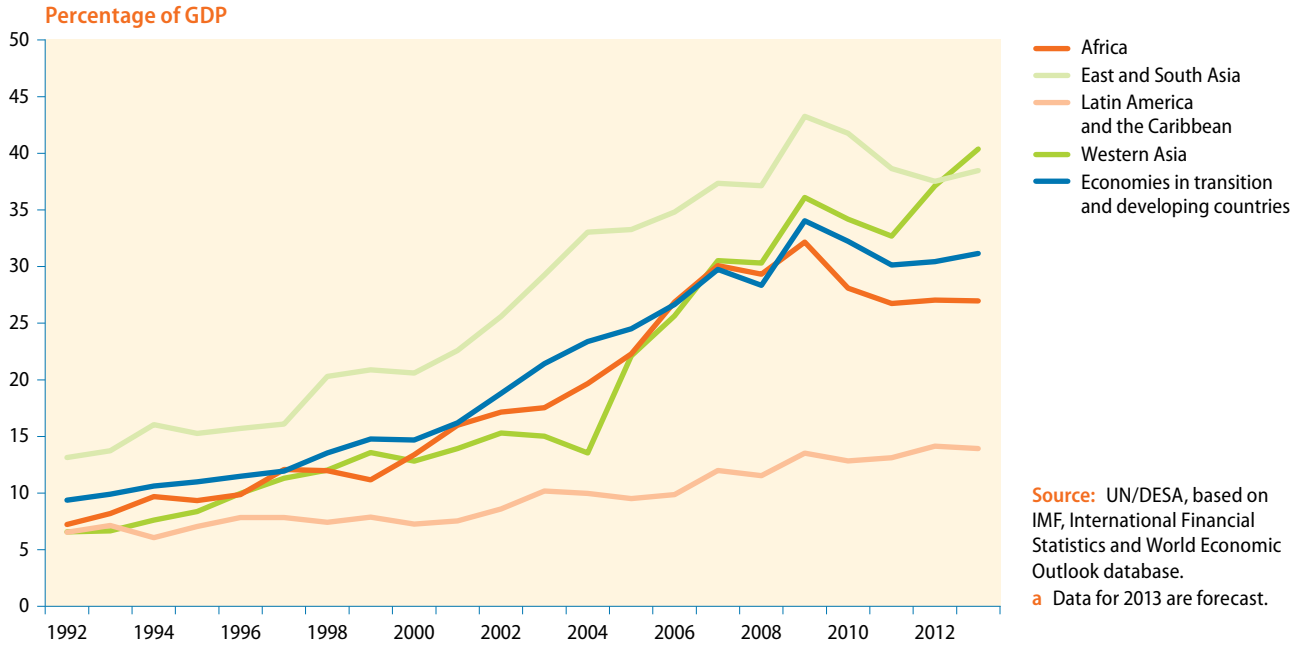
5 IMF, *World Economic Outlook 2013: Transitions and Tensions* (Washington, D.C., October 2013).

6 UN/DESA calculations based on IMF COFER database, second quarter 2013.

7 United Nations, *World Economic Situation and Prospects 2013* (United Nations publication, Sales No. E.13.II.C.2).

by-product of export-led growth strategies that maintain an undervalued currency through direct interventions in the currency market. Overall, empirical studies suggest that no single explanation for reserves accumulation can account for the behavior of all countries at all times. Precautionary demand and self-insurance motives provided prominent roles for the increase in international reserves following the East Asian crisis, although mercantilism in the form of an undervalued real exchange rate also appears to have contributed in some cases.[8]

Figure III.1
Foreign-exchange reserves, 1992-2013[a]



Source: UN/DESA, based on IMF, International Financial Statistics and World Economic Outlook database.
a Data for 2013 are forecast.

…but there are costs to accumulation, including diverting resources from sustainable development

Nonetheless, there are costs associated with the buildup of reserves. Most international reserves are held in United States treasuries, which are considered safe, but are low-yielding. Foreign-exchange reserves thus represent a form of "constrained saving" since national savings allocated to reserves withhold funds that could be invested elsewhere, possibly with greater social benefit. Second, accumulation of foreign-exchange reserves tends to increase the domestic money supply (since the central bank buys foreign currency and sells local currency).[9] In addition, that a large share of international reserves is invested in assets abroad implies a net transfer of resources from poorer countries to wealthier ones. Overall, net transfers from developing economies and economies in transition were $622 billion in 2013, down from $740 billion 2012. Net transfers of resources are negative for most developing and emerging economies, with the exception of least developed countries (LDCs), which continue to receive net positive transfers (figure III.2). In addition, Latin American

8 Atish R. Ghosh, Jonathan D. Ostry, Charalambos G. Tsangarides, "Shifting motives: explaining the build-up in official reserves in emerging markets since the 1980s", IMF Working Paper, No. WP/12/34 (Washington, D.C., January 2012).

9 On occasion, to minimize expansion in the money supply, authorities may choose to sterilize the monetary effect of foreign-reserve accumulation through off-setting intervention that involves selling government bonds to the general public (thereby reducing the amount of money in circulation).

economies recorded positive transfers of $23 billion in 2013, for the first time since 2001, due primarily to a fall in reserve accumulation in Brazil, in response to falling portfolio inflows. Finally, precautionary reserve accumulation, while sensible at the national level, adds to global imbalances and a less stable financial architecture at the global level.

Several proposals have been put forth to address global imbalances. A sustained reduction in global imbalances is an important objective of the Group of Twenty (G20), although there are challenges in arriving at politically agreed upon solutions, given the divergent interests of deficit and surplus countries. The Commission of Experts of the President of the United Nations General Assembly recommended that the international reserve system make greater use of International Monetary Fund (IMF) Special Drawing Rights as a way to reduce systemic risks associated with global imbalances, and as a low-cost alternative to accumulation of international reserves. However, this idea has not gained sufficient political support in policy discussions.[10]

To reduce developing countries' self-insurance, it is necessary to address the risks associated with the global financial system

The lack of political agreement underscores the importance of reducing risks embedded in the international financial system in order to lessen the perceived need for self-insurance, and to free up reserves for productive investment. Such risk reduction can be achieved, in part, through better management of the risks associated with volatility of cross-border private capital flows, excessive leveraging in the financial system, too-big-to-fail institutions, shadow banking and sovereign debt distress.

Trends in international private capital flows

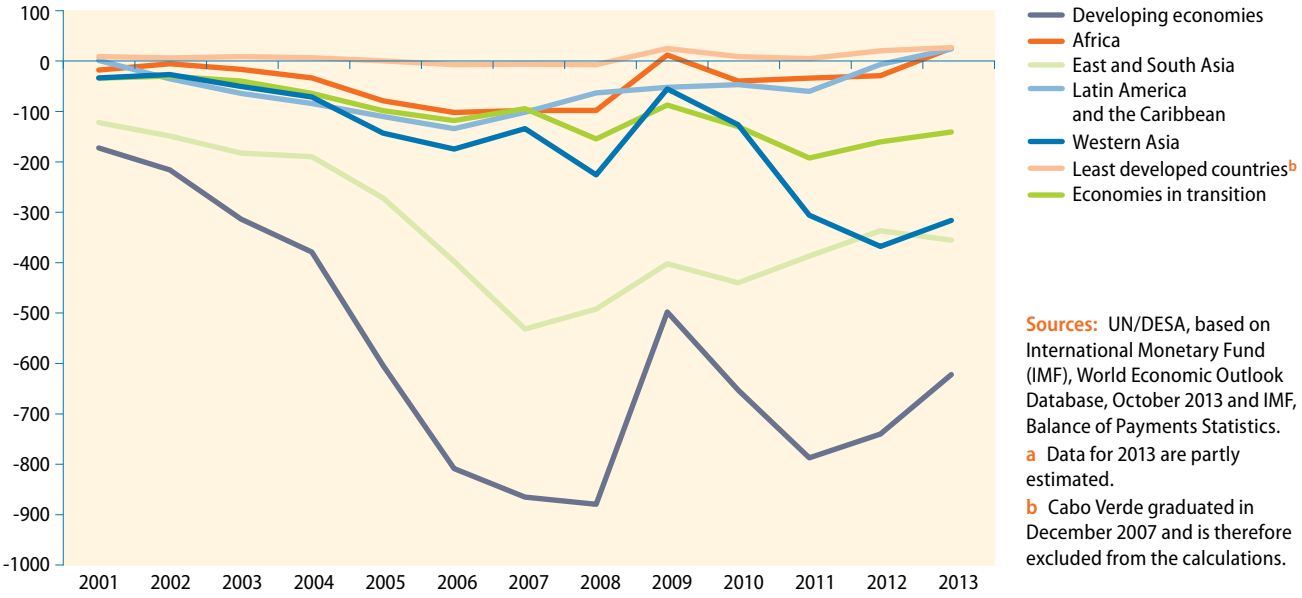
A significant proportion of private capital flows remains short-term oriented and volatile

Attracting stable and long-term private investment into development-enhancing sectors, human resources, and critical infrastructure sectors—including transport, energy, and communications and information technology—is of increasing importance for developing countries to accomplish sustainable development objectives. Yet, today, a significant share of private capital flows to developing countries remains short-term oriented, which is inappropriate for long-term investment needs.

Financial investors, particularly institutional investors, have been considered a potentially significant source of financing for sustainable development. Institutional investors, for example, are estimated to hold between $75 trillion and $85 trillion in assets. However, many of them fit the profile for long-term investors. For example, pension funds distribute about 40 per cent of their assets within 10 years, and 60 per cent within 20 years, so that, to match liabilities, they could hold 60 per cent of their assets in relatively long duration instruments. Similarly, life insurers need to distribute about 60 per cent of their assets to beneficiaries within 10 years, and 40 per cent of their assets within 20 years. Moreover, many sovereign wealth funds are meant to preserve and transfer wealth to future generations, with few short-term liabilities. However, despite their long-term liabilities, most institutional investors have traditionally held relatively liquid portfolios. As a result, investment by institutional investors in many sectors necessary for long-term sustainable development remains limited in both developed and developing countries. For example, direct investment in infrastructure globally, represents less than 1 per cent of pension fund assets, with lower allocations to infrastructure in developing countries and low-carbon infrastructure. At the same time, many developing countries lack a domestic long-term institutional investor base for long-term investment.

10 United Nations, Report of the Secretary-General on international financial system and development, (A/68/221).

Figure III.2
Net transfer of resources to developing economies and economies in transition, 2001-2013[a]



Sources: UN/DESA, based on International Monetary Fund (IMF), World Economic Outlook Database, October 2013 and IMF, Balance of Payments Statistics.

a Data for 2013 are partly estimated.

b Cabo Verde graduated in December 2007 and is therefore excluded from the calculations.

There is also evidence that since the crisis, institutional investors shifted their asset allocations toward more liquid assets and shorter-term investments.[11] In particular, during the financial crisis, institutional investors experienced difficulties in refinancing liabilities, which led them to reduce their exposure to long-term investments in favor of more liquid assets.[12] This, in combination with other factors—such as a move towards mark-to-market accounting (requiring long-term illiquid portfolios to be evaluated relative to a public market benchmark for some investors), stricter capital requirements, and the structure of staff evaluation/compensation schemes and internal decision-making/governance—is argued to have restricted the proportion of assets employed by these institutional investors for long-term investing.

There has recently been a renewed focus on corporate responsibility and sustainable finance. Yet, despite some significant achievements and major breakthroughs, sustainable finance practices are still far from the mainstream. In 2009, for example, 7 per cent—or $6.8 trillion of investments in the $121 trillion global capital markets—was subject to environmental, social and governance (ESG) considerations.[13] Sustainable finance implies a shift in the financial sector to make sustainable development, including the three pillars of economic, social and environmental stewardship, a central concern for the global financial sector. While the financial industries have traditionally focused on creating economic value, their short-term investment horizon has meant that they have often overlooked the long-term value of sustainable ESG practices, and may have not given adequate attention to the long-term risks associated with neglecting them.

11 Ibid.

12 World Economic Forum (WEF), "The future of long-term investing", WEF report in collaboration with Oliver Wyman (New York, 2011).

13 United Nations Environment Programme, *Towards a Green Economy: Pathways to Sustainable Development and Poverty Eradication* (Nairobi, 2011).

The short-term outlook of most investors has manifested in both developed-country capital markets, as well as in the volatility of international capital flows to developing countries. In the United States of America, for example, the average holding period for stocks fell from about eight years in the 1960s to approximately six months in 2010. Recent studies also show that the sensitivity of cross-border capital flows—especially portfolio flows—to risk aversion, interest rate differentials and other global factors has increased since the financial crisis, leading to greater volatility of flows.

Trends in cross-border capital flows

In 2013, net international private flows to developing countries are expected to increase to $284 billion, up from $137 billion in 2012 (table III.1). Nonetheless, total cross-border capital flows are still significantly below the $439 billion reached in 2010.

Different types of capital inflows have exhibited heterogeneous behavior, driven by diverse underlying forces. In 2013, net portfolio flows to developing countries underwent a sharp decline accompanied by extremely high volatility, amid shifting expectations on the tapering of the large-scale asset purchases programme by the United States Federal Reserve (Fed). There was some revival in cross-border bank lending to developing countries, although this continues to be subdued, with banks in the euro area still facing deleveraging pressures. On the other hand, foreign direct investment (FDI) has remained relatively strong and stable (table III.1).

Foreign direct investment

FDI inflows to developing and transition economies have been growing strongly

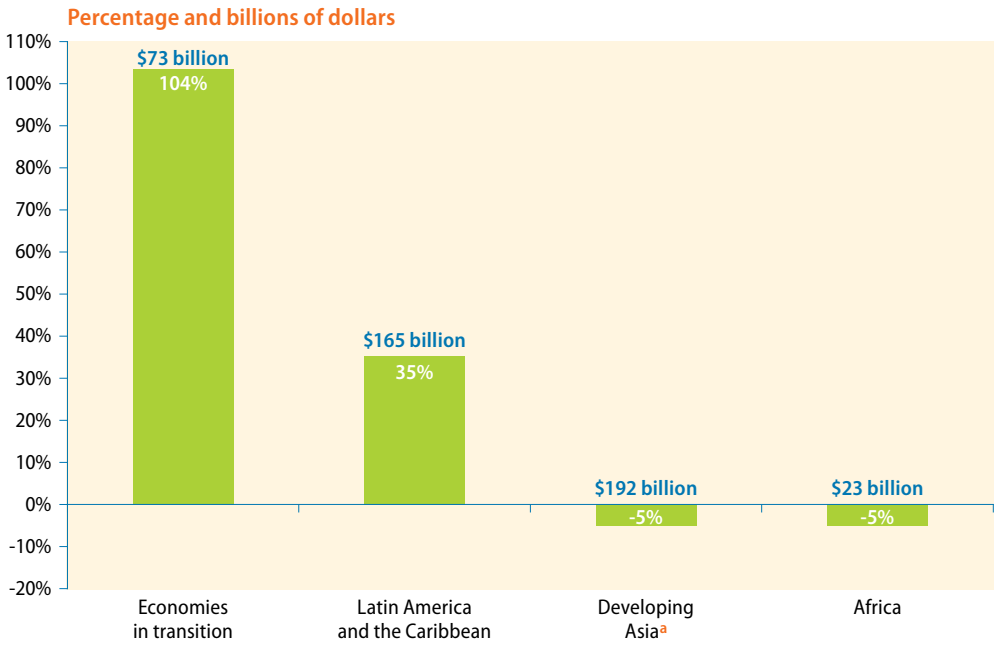
While net FDI flows to developing countries fell somewhat from 2012 to 2013, this was mostly owing to an increase in outward FDI, rather than a fall in inflows. Overall, the contribution of developing and transition economies to FDI outflows has grown from 17 per cent in 2007 to about 31 per cent in 2012. In terms of inflows, FDI flows to developing and transition economies rose by 18 per cent in the first half of 2013, absorbing about 60 per cent of global capital inflows—a record share.[14] This increase was driven by acquisitions in Latin America and the Caribbean and record inflows into the Russian Federation. Although flows to developing Asia fell slightly, the region continues to absorb more than half of the FDI directed to developing economies as a group, and one quarter of global FDI flows (figure III.3).

After a slight decline in 2012, FDI flows to Latin America and the Caribbean jumped by 35 per cent in the first half of 2013, to $165 billion. Belgian brewer Anheuser-Busch Inbev's $18 billion acquisition of a 44 per cent share of Grupo Modelo explains most of the increase in FDI for Mexico and Central America. However, FDI to Chile, South America's second largest recipient in 2012, fell by almost 50 per cent. FDI flows to Brazil remained stable at $30 billion in the first half of 2013, while those to Colombia increased by 6 per cent, driven by investment in the mining and manufacturing sectors.

In developing Asia, the recovery of FDI inflows was weak. In the first half of 2013, total inflows to the region amounted to $192 billion, slightly lower than for the same period in 2012. Inflows to China resumed growth after a slight drop in late 2012, thanks to increasing FDI in services, such as real estate and distribution trade. At the same time, FDI fell to a

14 UNCTAD, Global Investment Trend Monitor, No. 13, 31 October 2013.

Figure III.3
Growth rate and amount of FDI inflows to groups of economies, first half of 2012 to first half of 2013



Source: UNCTAD.
Note: Dollar figures are the inflow amounts for the first half of 2013.
a Includes East Asia, South Asia and Western Asia.

number of the region's major recipients, such as Hong Kong Special Administrative Region of China, Singapore and Thailand. In Western Asia, FDI flows dropped by 19 per cent in the first half of 2013 compared to the first half of 2012; this continued the downward trend that began in 2009 due to the regional political instability and a near absence of large deals in Turkey, a major destination for FDI in this subregion. FDI to transition economies in South-Eastern Europe, the Commonwealth of Independent States (CIS) and Georgia more than doubled in the first half of 2013 compared with the same period in 2012, reaching $73 billion, primarily owing to FDI inflows to the Russian Federation involving British Petroleum (United Kingdom) and Rosneft (Russian Federation). At the same time, FDI to Africa decreased slightly over the period. While flows to North Africa and Southern Africa recorded positive growth rates, flows to other regions fell, although several countries (e.g., Ghana and Nigeria) are expecting to see a rise in industrial and manufacturing investment, particularly in the automotive industry, which would help diversify investments away from the oil and mining sectors.

Overall, FDI can play an important role in development, particularly when it contributes to promoting employment, new sectors, linkages, technology transfer and capabilities accumulation. However, the evidence on the impact of FDI on the domestic economy remains mixed.[15] In countries that experienced positive spillovers, there is evidence that government policies played an important role in facilitating the spillovers. For example, explicit policies—such as local content requirements, training requirements and mandated joint research and development programmes—helped to promote positive

15 Xiaolan Fu, Carlo Pietrobelli and Luc Soete, "The role of foreign technology and indigenous innovation in emerging economies: technological change and catching up", Inter-American Development Bank Technical Notes, No. IDB-TN-166 (Washington, D.C., September 2010).

spillovers in countries such as China, Costa Rica and Singapore.[16] This underscores the importance of the public sector role in ensuring that private flows, such as FDI, contribute to public goals.

At a global level, and in terms of flows to developing countries, the composition of FDI (between equity, reinvested capital and other capital representing intracompany loans) has remained relatively stable during the past eight years. However, for transition economies, the share of intracompany loans has increased, which may suggest that FDI may also be becoming more volatile in this region.[17] In addition, databases that exclude intracompany transfers show a much smaller increase in FDI—only about 7 per cent for emerging economies versus 18 per cent for net FDI inflows overall.[18]

Portfolio flows

Portfolio flows remain extremely volatile

Net portfolio capital flows to developing countries turned negative in 2013 (table III.1). The decline in net flows represented a 50 per cent fall in portfolio inflows, along with a slight increase in portfolio outflows. The 2013 drop in capital flows has been most pronounced in East and South Asia, particularly in portfolio equity inflows to India and the Republic of Korea and non-bank credit flows to Indonesia. Portfolio outflows have resulted in declines in equity markets, albeit to varying degrees, and sharp depreciations in the currencies of many emerging economies, such as Brazil, India, Indonesia, Mexico, South Africa and Turkey, as discussed in chapter I.

Quantitative easing (QE) in the developed economies in 2009 and 2010 led to a surge in portfolio flows into developing economies, which tapered in 2011. The third round of easing led to another surge in flows in 2012. In mid-2013, however, expectations of an end of the QE in the United States led to a sell-off of financial assets in emerging economies. This pattern of expansion and retrenchment in portfolio flows in recent years underscores the volatility in international capital flows, as well as the spillover effects of advanced-economy policies on developing countries.[19] In addition, the current economic weakness of some large emerging economies—Brazil, India, Indonesia, the Russian Federation and South Africa, for example—has also contributed to capital outflows.

While the recent expectations of an end to QE proved to be premature, the likely normalization of monetary conditions in developed countries over the coming years may lead to a continued retrenchment in portfolio flows to developing countries. The most vulnerable countries are those with large current-account deficits who recently received large short-term inflows, such as Brazil, India, Indonesia, South Africa and Turkey.

16 United Nations, *World Economic and Social Survey 2011: The Great Green Technological Transformation* (United Nations publication, Sales No. E.11.II.C.1); Rajneesh Narula and Sanjaya Lall, eds., *Understanding FDI-Assisted Economic Development* (London and New York: Routledge, 2006); Sunil Mani, *Government, Innovation and Technology Policy: An International Comparative Analysis* (Cheltenham, United Kingdom: Edward Elgar, 2002).

17 Database from UNCTAD on FDI components.

18 Institute of International Finance (IIF) database.

19 Shaghil Ahmed and Andrei Zlate, "Capital flows to emerging market economies: a brave new world?", International Finance Discussion Papers, Board of Governors of the Federal Reserve System (June, 2013); IMF, *Global Financial Stability Report: Old Risks, New Challenges* (Washington, D.C., April 2013).

Table III.1
Net financial flows to developing countries and economies in transition, 2000-2014 (*Billions of United States dollars*)

	Average annual flow						
	2000-2003	2004-2009	2010	2011	2012	2013[a]	2014[b]
Developing countries							
Net private capital flows	67.5	206.1	439.1	360.8	137.1	284.7	206.1
Net direct investment	146.4	264.9	343.8	479.6	427.0	378.1	375.1
Net portfolio investment[c]	-44.7	-59.1	11.2	-19.5	84.3	-21.1	-58.4
Other net investment[d]	-34.1	0.4	84.1	-99.2	-374.2	-72.2	-110.5
Net official flows	-31.1	-61.3	45.6	-31.4	-38.0	-108.9	-79.1
Total net flows	36.5	144.8	484.7	329.4	99.0	175.9	127.1
Change in reserves[e]	-148.3	-660.0	-875.5	-732.5	-445.5	-614.0	-544.8
Africa							
Net private capital flows	6.6	20.3	-7.7	-6.2	7.6	35.2	41.8
Net direct investment	17.6	36.3	34.7	44.0	42.0	51.7	53.5
Net portfolio investment[c]	-4.0	-6.8	-0.4	-16.3	-10.2	-12.4	-2.7
Other net investment[d]	-7.0	-9.3	-42.0	-33.9	-24.2	-4.0	-9.0
Net official flows	-1.1	2.1	31.4	21.6	27.9	25.2	35.9
Total net flows	5.5	22.4	23.8	15.4	35.5	60.4	77.7
Change in reserves[e]	-12.2	-54.7	-25.8	-30.1	-29.0	-18.0	-26.5
East and South Asia							
Net private capital flows	27.5	110.1	327.7	251.5	9.4	133.9	52.7
Net direct investment	63.5	122.4	193.5	276.1	228.0	171.3	163.8
Net portfolio investment[c]	-33.6	-42.1	9.2	15.0	26.5	-65.4	-79.4
Other net investment[d]	-2.5	29.8	125.0	-39.5	-245.1	28.0	-31.8
Net official flows	-9.6	-11.2	9.0	-25.2	-13.1	-21.0	-17.0
Total net flows	17.9	98.9	336.7	226.3	-3.8	112.9	35.7
Change in reserves[e]	-142.0	-492.9	-690.7	-514.8	-213.5	-465.3	-419.9
Western Asia							
Net private capital flows	-0.3	45.5	51.3	-47.2	-3.4	19.6	14.2
Net direct investment	7.9	41.2	38.0	28.4	29.7	24.5	30.4
Net portfolio investment[c]	0.3	2.4	4.6	-30.2	45.3	37.3	25.6
Other net investment[d]	-8.5	1.9	8.7	-45.4	-78.4	-42.2	-41.8
Net official flows	-26.0	-53.7	-37.4	-57.5	-108.6	-156.9	-135.6
Total net flows	-26.2	-8.1	13.8	-104.7	-112.0	-137.3	-121.4
Change in reserves[e]	-4.7	-89.5	-93.0	-101.6	-172.5	-131.4	-105.2
Latin America and the Caribbean							
Net private capital flows	33.8	30.3	67.8	162.6	123.5	96.1	97.4
Net direct investment	57.3	64.9	77.6	131.1	127.3	130.7	127.3
Net portfolio investment[c]	-7.5	-12.6	-2.2	11.9	22.7	19.4	-2.0
Other net investment[d]	-16.1	-22.1	-7.5	19.7	-26.5	-54.0	-27.9
Net official flows	5.6	1.4	42.6	29.7	55.8	43.8	37.6
Total net flows	39.3	31.7	110.4	192.3	179.4	139.9	135.1
Change in reserves[e]	10.7	-22.9	-66.0	-86.0	-30.5	0.7	6.7

Table III.1
Net financial flows to developing countries and economies in transition, 2000-2014 (*Billions of United States dollars*) (*continued*)

	Average annual flow						
	2000-2003	2004-2009	2010	2011	2012	2013[a]	2014[b]
Economies in Transition							
Net private capital flows	2.5	19.7	-20.1	-52.3	-28.0	-52.2	-16.1
Net direct investment	4.3	27.6	11.7	17.2	18.5	21.2	25.9
Net portfolio investment[c]	1.5	-1.0	8.7	-25.9	-3.3	-3.8	0.1
Other net investment[d]	-3.3	-6.9	-40.6	-43.6	-43.1	-69.6	-42.1
Net official flows	-5.7	-3.1	11.4	-10.0	4.7	-3.8	-5.9
Total net flows	-3.2	16.6	-8.7	-62.2	-23.4	-56.1	-21.9
Change in reserves[e]	-21.6	-69.3	-50.1	-22.1	-31.5	13.4	-11.5

Source: IMF World Economic Outlook database, October 2013.
Note: The composition of developing countries above is based on the country classification located in the statistical annex, which differs from the classification used in the IMF World Economic Outlook.
a Partly estimated.
b Forecasts.
c Including portfolio debt and equity investment.
d Including short- and long-term bank lending, and possibly including some official flows due to data limitations.
e Negative values denote increases in reserves.

Cross-border bank lending

Cross-border bank lending to developing countries remains subdued and volatile

Short-term commercial bank flows to many developing countries have been the most volatile form of capital inflows, experiencing more surge and reversal cycles than any other types of flows. Lending to large countries with open capital accounts, such as Brazil and South Africa, has been particularly volatile.[20] Net commercial bank flows to developing countries remain subdued as a number of international banks—particularly in Europe—have continued to face significant deleveraging pressures. The reduction in cross-border lending activity has been most severe in emerging economies that were more dependent on banks from the euro area (emerging European economies, for example).

Despite the aggregate situation, there were some positive developments in early 2013, as cross-border loans to some emerging economies increased noticeably in the first quarter—mainly to larger economies in Asia-Pacific and Latin America, but also to emerging economies in Europe[21] (with large economies, such as Brazil, China, and the Russian Federation accounting for 85 per cent of the increase). In addition, loans to emerging economies by banks from the euro area, notably by France and the Netherlands, rose for the first time since 2011. Still, it is not clear whether these emerging recovery signs will persist, especially considering the slowdown in many emerging economies.

One key concern is that long-term financing from banks has been constrained during the past few years.[22] In particular, long-term financing from banks to developing countries

20 Susan Lund and others, "Financial globalization: retreat or reset?", Global capital markets 2013 report of McKinsey Global Institute (March, 2013).

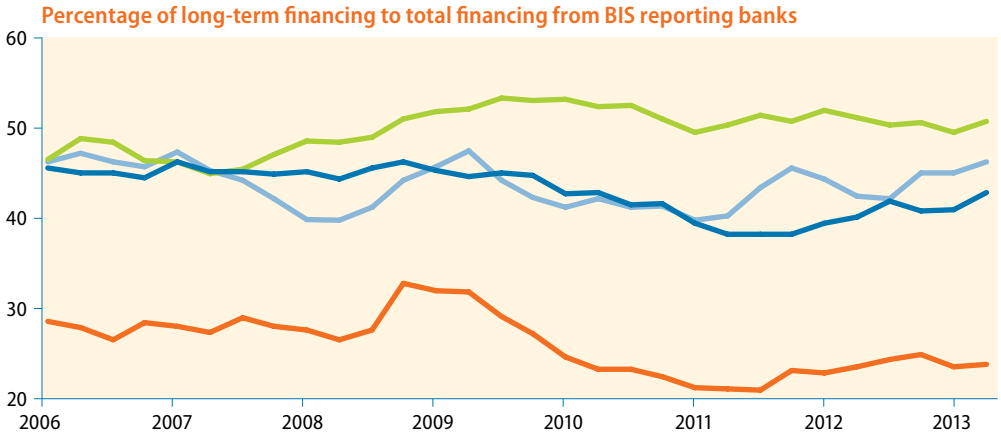
21 Bank for International Settlements (BIS), "International banking and financial market developments", BIS Quarterly Review (September, 2013).

22 United Nations, Report of the Secretary-General on international financial system and development, op. cit.

in the Asia-Pacific region has increased at a slower pace than short-term financing, causing the proportion of long-term financing to the region to decrease (figure III.4). In addition, total international claims of European banks, including all cross-border and local claims in foreign currency with a maturity of over two years, have decreased.[23]

Historically, commercial banks have played an important role in financing long-term projects in developing countries. This is especially the case for infrastructure investment in countries where corporate bond markets are relatively undeveloped and unable to raise the required levels of long-term finance. In 2012, however, deal volumes were at a historical low and global project financing fell by 6 per cent from the previous year.

Figure III.4
Shares of long-term financing for developing regions,[a] first quarter 2006-second quarter 2013



Source: UN/DESA, based on data from the Bank for International Settlements (BIS).
a Regions are based on the BIS classification.

Nonetheless, on average, commercial bank loan maturities average 4.2 years in developed economies and 2.8 years in emerging economies, which is shorter than other forms of borrowing, such as through bond markets. In particular, given the increasing share of short-term deposits, banks are not in a position to provide longer-term financing. This is further reinforced in regulatory systems for banks, such as Basel III, which make long-term financing more expensive in terms of capital requirements, as discussed below.

Remittances

As emphasized by the Monterrey Consensus and the Doha Declaration, remittances have become a significant source of cross-border financing. However, remittances are of a different nature than the capital flows discussed above. Remittances are private flows related to personal transactions from migrants to friends and families that are recorded in the income balance of the current account. Remittances flow directly to households, thereby having an effective role in reducing poverty and financing imports, but with limited direct effect on investments at the microeconomic level.[24] However, the effects of remittances on aggregate

23 "Long-term investment financing for growth and development: umbrella paper". Prepared by World Bank staff based on input from the staffs of the OECD, IMF, UNCTAD, UN/DESA, World Bank Group, and the Financial Stability Board. Presented at the meeting of the G20 Ministers of Finance and Central Bank Governors, February 2013, Moscow.

24 Dilip Ratha, "Leveraging remittances for development", Migration Policy Institute Policy Brief (Washington, D.C.: World Bank, June 2007).

investment in the economy are determined by macroeconomic investment behavior, not by how remittances are used by the individual households that receive them.

In the last decade, remittances to developing countries have become increasingly relevant as a form of cross-border finance. Remittances are larger than private debt and portfolio equity flows, and are more than twice the level of official development assistance (ODA) for developing countries. In some countries, such as Haiti, the Kyrgyz Republic, Lesotho, Nepal and Tajikistan, officially recorded remittances represent more than 25 per cent of GDP. Moreover, some estimates suggest that the inclusion of informal transfer channels would increase total remittances flows by almost 50 per cent.[25] Remittances have been more stable than capital flows; they can be a countercyclical source of balance-of-payment financing, thus playing a macroeconomic stabilizing role as their level is more dependent on the economic situation in the host country than in the recipient country.[26]

Remittance flows continue to increase, but the costs of sending remittances must be reduced

In 2013, remittance flows to developing countries are expected to increase by 6.3 per cent to $414 billion, continuing the upward trend observed in the last decade that was only temporarily reversed during the financial crisis.[27] Remittances to developing countries are expected to increase further in the coming years, surpassing $500 billion in 2016. One of the key challenges is to reduce the costs of sending remittances. While remittances costs are falling in high-volume corridors, the global average cost has remained relatively stable in recent years at just under 9 per cent. Furthermore, in some small-volume corridors, such as in Africa and the Pacific Islands, remittances costs remain exorbitant.

Management of volatile capital flows and other policy measures

Short-term volatile capital flows complicate macroeconomic management, and have been a major concern for many emerging economies. Surges in capital inflows generally expand credit in an unsustainable manner, while the sudden stops and withdrawals caused by heightened global risk aversion can contribute to spreading financial crises and to a decline in long-term investments.[28] This has led to a renewed interest in capital-account management, including capital controls.

As discussed above, during the past decade, some emerging economies have accumulated large levels of international reserves, which have placed those countries in a better position than in the past to respond to sudden outflows. Nevertheless, excessive reserve accumulation has costs. Greater attention is therefore being given to other tools to manage volatile capital flows. Traditional approaches to managing cross-border capital flows focused on macroeconomic policies. However, fiscal and monetary policies may not be enough to stabilize large volatile financial flows and may have undesired side effects. In this context, macroprudential policies as well as more direct controls have gained recognition among experts and policymakers as important tools to complement traditional policy approaches.

25 Dilip Ratha and Xu Zhimei, *Migration and Remittances Factbook 2008* (Washington, D.C.: World Bank, 2008).

26 Jeffrey A. Frankel, "Are bilateral remittances counter cyclical?", NBER Working Paper, No. 15419 (Cambridge, Massachusetts: National Bureau of Economic Research, October 2009).

27 World Bank, "Migration and remittance flows: recent trends and outlook, 2013-2016", Migration and Development Brief, No. 21 (Washington, D.C., 2 October, 2013).

28 Joseph E. Stiglitz and others, *Stability with Growth: Macroeconomics, Liberalization and Development*, (Oxford, United Kingdom: Oxford University Press, 2006).

For example, in 2012, the IMF changed its earlier position of opposing the use of capital-account management techniques in all cases, to acknowledging that there are circumstances where such measures may be useful—particularly when the room for macroeconomic policy adjustment is limited, when necessary policy steps or macroeconomic adjustments require time, and when surging capital inflows raise risks of financial system instability.[29]

Effectiveness of macroprudential measures in managing cross-border inflows is mixed

Over the past few years a range of countries, including Brazil, Indonesia, Malaysia, Peru, Philippines, the Republic of Korea, Taiwan Province of China and Thailand, have implemented different direct and indirect capital-account regulations. The majority of the new initiatives were aimed at limiting the build-up of systemic risks, such as currency mismatches and credit bubbles, using macroprudential tools through the banking system[30] (for example, balance-sheet restrictions that limit the foreign-exchange mismatches of banks). The evidence on the effectiveness of macroprudential measures in managing cross-border inflows remains mixed: while they appear to have lengthened the maturity composition of capital inflows in some countries—particularly those where a large degree of financial intermediation occurs through the banking system, such as Croatia and Peru—the effect on total capital flows was limited.[31] In some cases, it has been important to address mismatches in the corporate sector as well.

Some countries, such as Brazil, India and Indonesia, have implemented direct controls on capital inflows. These direct controls can be price based, in the form of levies or taxes on capital inflows, or quantity based, in the form of direct limits. For example, Brazil increased its tax on fixed-income foreign investment in 2010 to raise the cost of speculation (although the tax has since been cut), while Indonesia imposed a six-month holding period for Bank of Indonesia certificates to limit short-term hot money inflows. More recently, during the latter half of 2013, the Reserve Bank of India implemented measures to discourage capital outflows by banning private firms from spending more than their book value on direct investment abroad, unless given specific approval from the central bank. In addition, the Reserve Bank of India outlined a plan to provide concessional swaps for banks' foreign-currency deposits.[32]

Capital-account regulations need to be adapted to country-specific circumstances

Empirical evidence suggests that price-based capital controls have also been effective in changing the composition of inflows away from short-term debt.[33] For example, between 1991 and 1998, price-based controls on inflows in Chile appeared to have been effective in altering the composition of inflows, with short-term debt declining as a proportion of total liabilities while the stock of FDI increased from about 34 per cent to about 53 per cent. The impact on the volume of flows is, however, more ambiguous, with regulations appearing to have been more successful in some cases than in others. The varying results of similar mechanisms across countries and times suggest that there is no one-size-fits-all solution.

29 IMF, "The liberalization and management of capital flows: an institutional view" (Washington, D.C., 14 November 2012).

30 United Nations, Report of the Secretary-General on international financial system and development, op. cit.

31 Jonathan D. Ostry and others, "Managing capital inflows: what tools to use?", IMF Staff Discussion Note, No. SDN/11/06 (Washington, D.C., 5 April 2011); Mahmood Pradhan and others, "Policy responses to capital flows in emerging markets", IMF Staff Discussion Note, No. SDN/11/10 (Washington, D.C., 21 April 2011).

32 The Reserve Bank of India, "RBI to open a swap window to attract FCNR(B) dollar funds", Press release No. 2013-2014/494, 4 September 2013; and "RBI announces measures to rationalise foreign exchange outflows by resident Indians", Press release No. 2013-2014/323, 14 August 2013.

33 United Nations, *World Economic Situation and Prospects 2012* (United Nations publication, Sales No. E.12.II.C.2).

The design of regulations thus needs to take into account the specific circumstances of individual countries, including the economic situation, existing institutions and regulatory framework, and the structure and persistence of inflows.[34]

One reason often cited for why controls might not be effective is the risk of evasion.[35] In particular, capital-account regulations may be particularly difficult to implement in countries where there is a large derivatives market, since speculators can often circumvent the restrictions through this market. For this reason, some countries, such as Brazil and the Republic of Korea, implemented restrictions directly into the derivatives market, albeit at relatively low initial rates.[36] However, both countries also adjusted these and other controls countercyclically in response to changes in investor sentiment. For example, the Republic of Korea tightened limits on domestic and foreign banks' exposure to foreign-exchange derivatives towards the end of 2012 in an attempt to stem volatility in the rapidly appreciating won.[37] On the other hand, by mid-2013, Brazil reversed some of the capital controls implemented in previous years, when the real was under strong appreciation pressures. In particular, the central bank eliminated reserve requirements on short-dollar positions held by local banks, and the Government removed taxes on currency derivatives and foreign purchases of bonds.[38] Although some observers, such as the IMF in its institutional view on capital controls, have called for such mechanisms to be temporary, the flexibility of this approach argues for permanent regimes, which can be adjusted countercyclically.

The short-term, volatile character of private capital flows is also influenced by the compensation incentives for financial managers

In addition to managing capital flows to reduce volatility, policymakers should consider policies to incentivize longer-term and more stable investment. Many fund managers are compensated on the basis of annual performance, in packages that reward risk-taking on the upside but don't penalize losses on the downside. This incentivizes excessive short-term risk-taking, and makes it unlikely that the private sector will invest sufficiently in long-term sustainable development on its own. Indeed, according to the Financial Stability Board (FSB) surveys of market participants, more than 80 per cent of respondents believe that compensation packages contributed to the accumulation of risks that led to the crisis, with general agreement that without changes in such incentives, other reforms are likely to be less effective.[39]

Changes could include both top-down public and bottom-up private sector responses, at the international and national level. Public pension funds, sovereign wealth funds,[40] and endowments represent enormous pools of capital that ultimately report to the pension-

34 United Nations, Report of the Secretary-General on international financial system and development, op. cit.

35 Shari Spiegel, "How to evade capital controls, and why they can still be effective", in *Regulating Global Capital Flows for Long-Run Development*, Pardee Center Task Force Report (Boston, Massachusetts: Boston University, March 2012).

36 In the case of Brazil, in particular, these were initial measures to assess the reactions of financial markets as well as difficulties with implementation. However, evaluating their effectiveness is a difficult task given the low initial rate and the many factors that drive investors' behavior.

37 Simon Mundy and Song Jung-a, "South Korea tightens derivatives limits", *Financial Times*, 27 November 2012.

38 David Biller and Maria Luiza Rabello, "Brazil scraps tax on currency derivatives to stem real drop", *Bloomberg News*, 12 June 2013.

39 Financial Stability Board, "FSB principles for sound compensation practices: implementation standards", (Basel, 25 September 2009).

40 Some sovereign wealth funds are mandated to focus on financial stabilization. These types of funds are not providers of long-term finance. However, a larger set of sovereign wealth funds are investing

ers or to citizens who could put pressure on the industry to alter compensation structures. It remains an open question, however, whether the market on its own can develop changes to better align intermediaries with the goals of their long-term providers of capital. This implies a role for government through improved regulations.

Overall, capital market volatility needs to be better managed in both developed and developing countries. Developing countries have an imperative to develop local capital markets to provide long-term investment in productive sectors, but to do so in ways that minimize volatility. This includes managing volatility associated with inflows from international investors, while at the same time promoting the development of domestic investor bases that incorporate incentives for long-term investment in a stable manner. Developed countries have a responsibility to improve international coordination and better regulate international capital and financial markets to reduce global volatility, with a focus on longer-term stable investment.

Strengthening international financial regulation

The 2008 financial crisis prompted Governments and the intergovernmental community to undertake a number of important reforms in financial sector regulation. To date, these reforms have focused on ensuring the safety and soundness of the financial system, primarily by adhering to the banking sector regulations in Basel III, supplemented by a series of recommendations from the FSB.

Financial regulation should strike a balance between reducing risks and promoting access to finance

The ultimate goal of the financial system is to facilitate the flow of funds from savers to borrowers[41] and to effectively allocate funds throughout the economy. Safety and soundness (of both individual institutions and the financial system more broadly) is crucial for this effort. However, the financial system also needs to address the broader goal of access to credit if it is to effectively contribute to sustainable development. Reducing risks while promoting access to credit presents a complex challenge for policymakers since there can be trade-offs between the two. For example, in the extreme, a completely safe financial system would only lend to AAA or other highly rated borrowers, such as sovereigns, but that clearly would not be an effective allocation of resources for long-term growth. The regulatory and policy framework thus needs to strike a balance between stability, particularly in reducing systemic risks, and access, especially for long-term investments, in order to ensure that the financial system works in the interest of sustainable global development.

Reforms to the banking system

The main regulatory instrument, Basel III, is designed to increase the capacity of banks to withstand future shocks. Reforms include higher minimum capital requirements[42] and an improved quality of capital. In particular, core capital, which includes common equity, was

national wealth for future generations. A majority of their investments are in long-term finance, either through equities, real estate, private equity, or direct stakes in infrastructure or other projects.

41 A second function is to facilitate payments.

42 The original Basel III rule from 2010 was supposed to require banks to hold 4.5 per cent of common equity (up from 2 per cent in Basel II) and 6 per cent of Tier I capital (up from 4 per cent in Basel II) of risk-weighted assets. Basel III introduced additional capital buffers: (i) a mandatory capital conservation buffer of 2.5 per cent and (ii) a discretionary counter-cyclical buffer, which would allow national regulators to require up to another 2.5 per cent of capital during periods of high credit growth.

strengthened to exclude some hybrid instruments, such as subordinated debt, that were included in core capital as part of Basel II. Moreover, a new leverage ratio[43] and larger liquidity buffers[44] have been added. The new rules[45] require banks to have sufficient high-quality liquid assets to withstand a thirty-day stressed funding scenario specified by supervisors. One of the important innovations is to include off-balance-sheet obligations of the banks.

Basel III also introduces a countercyclical capital buffer, although it is unclear whether this will achieve its purpose

Along with the traditional microprudential approaches, which focus on reducing risks of individual banks, Basel III also attempts to strengthen the macroprudential policy framework through a countercyclical capital buffer that is introduced when authorities consider credit growth to be creating an unacceptable build-up of systemic risk. Thus, during periods of strong growth, capital requirements can be raised up to 2.5 per cent, whereas during slowdowns the buffer can be reduced to zero. The purpose is to mitigate the pressures on banks to reduce lending during an economic slowdown—a time when access to finance is particularly needed for economic growth (and vice versa during periods of economic booms). However, it is unclear whether this countercyclical capital buffer will be strong enough to achieve its intended purpose.

During the global financial crisis, large financial institutions in particular were found to have spread systemic risks. Such global systemically important financial institutions (G-SIFIs) carry an implicit government guarantee, which has lowered their borrowing costs while shifting the risk of covering the cost of a potential bailout to taxpayers. The IMF has estimated that the implicit subsidy to big banks in terms of lower borrowing costs to be about 0.8 percentage points.[46] In response, the FSB has suggested that G-SIFIs should have a loss-absorbing capacity beyond the general standards of Basel III, that G-SIFIs develop recovery and resolution plans (also known as living wills), and that countries prioritize this in national regulatory frameworks. The FSB also called for the adoption of cross-border cooperation agreements, pointing out that national jurisdictions need to put in place the powers and arrangements for cross-border cooperation, and that separate jurisdictions must be able to share firm-specific information.

Progress in implementing reforms of the banking system

While efforts to formulate the regulatory framework have been carried out mainly in international forums, such as the FSB and the Bank for International Settlements, their implementation takes place at the national level. To date however, implementation has been slow,

43 Basel III introduced a minimum leverage ratio, which is calculated by dividing Tier 1 capital by the bank's average total consolidated assets; banks are expected to maintain a leverage ratio in excess of 3 per cent under Basel III. In July 2013, the Fed announced that, in the United States, the minimum Basel III leverage ratio would be 6 per cent for 8 systemically important financial institution (SIFI) banks and 5 per cent for their bank holding companies.

44 Basel III introduced two required liquidity ratios: the Liquidity Coverage Ratio was supposed to require a bank to hold sufficient high-quality liquid assets to cover its total net cash outflows over 30 days; the Net Stable Funding Ratio was to require the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress.

45 Stephany Griffith-Jones, Shari Spiegel and Matthias Thiemann, "Recent developments in regulation in light of the global financial crisis: implications for developing countries", Background note prepared for the Conference on "Managing the Capital Account and Regulating the Financial Sector" in Rio de Janeiro on the 23-24 August 2011.

46 Christine Lagarde, "The global financial sector: transforming the landscape", speech delivered at the Frankfurt Finance Summit on 19 March 2013.

owing to a variety of factors, including political obstacles, limited national capacities and challenges in adapting global principles to the diversity of national-level specificities—especially in the light of the reluctance of national authorities to adopt regulatory standards that could place their financial industry at an internationally competitive disadvantage.

Implementation of banking reforms has been slow and uneven across countries

The implementation of Basel III was originally planned for 1 January 2013, but delays have caused this deadline to be extended in many jurisdictions.[47] On the other hand, the agreed start date for banks to begin disclosing their leverage ratios and for the phase-in of Basel III liquidity requirements is 1 January 2015, but many members have already made steps towards introducing these new requirements, including Canada, China, India, the Russian Federation and the United States.

Concerning global systemically important banks (G-SIBs), by 2013, their common equity capital increased by about $500 billion, or close to 3 per cent of their risk-weighted assets, as compared to 2009,[48] while two jurisdictions—Canada and Switzerland—have begun to enforce final regulatory rules, with an internationally agreed start date of 1 January 2016.[49] However, apart from these new capital requirements, examples of translation of these recommendations into national legislations have been limited. Two exceptions are the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States, which incorporates living wills into its framework, and the European Union (EU) Bank Recovery and Resolution Directive. However, there is the risk of a delay in the implementation of these legislations and, moreover, additional legislative measures would be necessary to implement all requirements and ensure the creation of arrangements for cross-border cooperation on resolution measures.

Overall, there are significant differences between countries in the extent of their implementation of banking regulatory frameworks.[50] Similarly, many differences exist in the interpretation of the legislation into national guidelines. For example, countries have very different requirements on risk weightings used in calculating risk-weighted assets[51] as part of capital requirements. Figure III.5 shows risk-weightings for corporate lending across regions and countries. As shown, these weightings can vary substantially. For example, weightings on average for corporate loans vary from 85 per cent in North America to 50 per cent in Europe. There are some who argue that these differences can lead to a watering down of standards, while others argue that differences are necessary given different institutional country frameworks.

47 By August 2013, out of the 27 jurisdictions of the Basel Committee members, 11 had issued final Basel III capital rules that were legally in force. Fourteen jurisdictions had issued final rules but not yet brought them into force (Argentina, Brazil, the Republic of Korea, the Russian Federation, the United States and the nine EU member States that are members of the Basel Committee on Banking Supervision), while the remaining two – Indonesia and Turkey – were at the stage of issuing draft rules. See Basel Committee on Banking Supervision, "Report to G20 leaders on monitoring implementation of Basel III regulatory reforms" (Basel: Bank for International Settlements, August 2013).

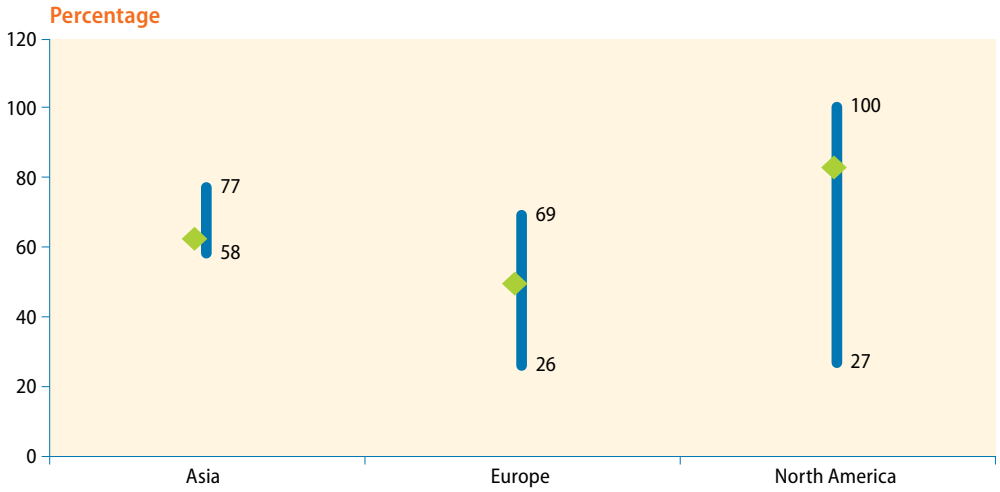
48 Financial Stability Board, "Progress and next steps towards ending 'too big to fail': report of the Financial Stability Board to the G20" (Basel, 2 September 2013).

49 Basel Committee on Banking Supervision 2013, "Report to G20 leaders on monitoring implementation", op. cit.

50 Christine Lagarde, "The global financial sector: transforming the landscape", op. cit.

51 A risk-weighted asset is a bank's assets or off-balance sheet exposures, weighted according to risk. This way of calculating assets is generally used in determining the capital requirement or Capital Adequacy Ratio (CAR) for a financial institution.

Figure III.5
Minimum, maximum and average risk-weights for corporate lending by region



Source: Vanessa Le Leslé and Sofiya Avramova, "Revisiting risk-weighted assets: why do RWAs differ across countries and what can be done about it?", IMF Working Paper, No. WP/12/90 (March 2012), p. 22.
Note: Diamond indicates the average risk-weight.

The Basel III framework may not be fully suitable for developing countries

There are also some debates on the extent to which Basel regulations should be implemented in emerging market and developing economies, many of which fall outside of the Basel Committee on Banking Supervision member jurisdictions. The FSB has pointed out that some countries are hampered in implementing the Basel III framework as a result of inadequate resources and lack of capacity.[52] Outreach activities by international financial institutions and the Basel Committee, as well at the Basel Committee's increased emphasis on emerging markets are aimed at addressing these issues.[53] However, the actual relevance of these rules to developing and emerging countries has been questioned as Basel III was designed for financial institutions in developed countries, and is not necessarily fully appropriate for the rest of the world. For instance, as required by the Liquidity Coverage Ratio, banks need to hold corporate and government bonds, which can be in shorter supply and not particularly liquid, in countries with thinner, less liquid capital markets. In this respect, it has been argued that Basel III should not necessarily aim to cover all jurisdictions in all aspects because of major differences in national institutional arrangements.[54] This does not imply that developing and emerging countries should not be regulated, but rather that regulatory frameworks could be more effective when adapted to national circumstances.

Implications of new regulations for financing sustainable development

Basel III may have the effect of limiting long-term lending and SME financing

While Basel III is in the early stages of implementation and its full impact is not yet clear, there has been some concern that the Basel capital adequacy rules might have the effect of limiting riskier lending by raising the cost of lending. In particular, Basel III imposes higher

52 Financial Stability Board, "Monitoring the effects of agreed regulatory reforms on emerging market and developing economies (EMDEs)", 12 September 2013.

53 Ibid., p. 6.

54 Stephany Griffith-Jones, Shari Spiegel and Matthias Thiemann, "Recent developments in regulation in light of the global financial crisis", op. cit.

costs on risky activities of banks to internalize the costs of risky behavior and incentivize banks to reduce risky activities. Indeed, this is considered an implicit goal of the Basel Accord.[55] In other words, by construction, the regulatory framework incentivizes a reduction in areas of high-risk investment. Yet, some of these higher-risk sectors are precisely those that need investment for achieving sustainable development. In the light of this trade-off, regulation needs to strike a balance between limiting risky lending while at the same time ensuring that investments in sustainable development enhancing activities are not unduly stifled. For example, as mentioned earlier, a key aspect of the Basel III regulations concerns the capital requirement ratio (ratio of capital to risk-weighted assets). This ratio incorporates higher risk weights for longer-term and/or higher-risk lending. It also implies higher risk weightings for areas without sufficient data on default histories, such as trade finance and green investments. As a result, there has been particular concern regarding the impact of Basel rules on long-term lending, including infrastructure lending, trade finance, innovation, and SME financing.

Recognizing the risk of lower SME lending, as shown in table III.2, the EU has allowed small companies to be incorporated into the retail category, which has a lower risk weighting (75 per cent) than unrated corporates. In addition, the Capital Requirement Directive IV reduced the risk weights for SMEs by further reducing the weights by a factor of 0.7169, bringing the risk weighting down to 57 per cent, in line with higher-rated corporate loans.

There are similar questions regarding trade financing, which is a particularly important form of credit for the developing world. Trade finance could be constrained in some cases by the leverage rule, which incorporates off-balance sheet items, such as letters of credit used in trade finance, at what many consider to be a high risk factor.

Table III.2
Summary of Basel corporate risk weights for banks using the standardized approach in the European Union

Loan Type		Risk Weight
Retail portfolios	These are exposures to individuals or small businesses. Includes revolving credits, loans and leases	75%
Mortgages on residential property—owner occupied or rented	National regulators should ensure that strict prudential criteria are applied to residential mortgage lending, such as substantial margin of additional security over the amount of the loan based on strict valuation rules	35%
Commercial real estate	50% risk weighting may be granted in well-developed and long-established markets for mortgages on office and/or multi-purpose commercial premises where the loan does not exceed 50% of the market value	100%
Past due loans	May be less than 50% if bank holds specific provisions > 20% of the loan amount	150%
Corporate Loans	Use external (Moody's, S&P) or mapped internal ratings	
	AAA to AA-	20%
	A+ to A-	50%
	BBB+ to BB-	100%
	B+ and below	150%
	not rated	100%

Source: Financing for Development Office, UN/DESA.

55 IMF, *Global Financial Stability Report: Restoring Confidence and Progressing on Reforms* (Washington, D.C., October 2012).

The different requirements of the Basel III rules create incentives that can potentially impact investment across sectors

More broadly, the different requirements of the Basel III rules (such as capital, leverage and liquidity requirements) create implicit incentives for investment, which differ across different types of banks as well as across jurisdictions. This is illustrated by the Global Financial Markets Association's Basel III leverage ratio survey, which covers 26 banks across Canada, Japan, United States and Europe (including 18 out of 28 G-SIBs).[56] For more than half the banks surveyed, the leverage ratio was cited as the binding constraint rather than the risk-based capital requirement ratio. Indeed, for larger banks, the leverage requirement is likely to constrain their lending before the capital requirement takes effect. By contrast, smaller banks are likely to be less constrained by leverage rules in comparison with the capital requirement rules. The interplay of these different requirements may have stronger consequences in regions that are most reliant on bank financing, such as Asia and Europe.

Despite these concerns, not all jurisdictions are focusing sufficiently on the extent of the incentive implications of the new regulations across sectors. One argument often made is that regulations should focus on reducing risks while other policy measures should focus on incentivizing investment. In this regard, the broader discussion on financing sustainable development includes other policy measures, including direct investment through development banks, low-interest loans, subsidies, and different forms of private public partnerships. Yet, in the current economic context, in many countries public funds for such measures are limited. Furthermore, it can be argued that there is a need to view economic policymaking outside of a silo approach, including appreciating the underlying incentives implicit in policies, including in the regulatory structure.

Overall, the goal should be to maintain strong capital buffers, while at the same time reducing negative incentives or even promoting positive incentives for investment. There are two potential approaches. First, rules can be adjusted as necessary when access to credit in important sectors is seen as restricted. This can be cumbersome and slow, but is likely the preferred route for countries already implementing Basel III. Alternatively, a regulatory framework could be based on broad-based simple regulations, such as high capital ratios and low leverage ratios, with simple countercyclical rules built in.[57] This could encourage safety and stability while allowing banks intermediate credit in ways that are conducive to sustainable development.

Progress in regulating shadow banking

Risky activities could shift from the regulated banking system to the shadow banking sector

In the wake of the new banking regulations, there is concern that risky activities that require higher capital could shift from the regulated banking system to shadow banking practices, representing a form of regulatory arbitrage. Shadow banking is defined as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system",[58] and includes derivatives, money market funds, hedge funds, structured finance vehicles and other investment funds. Despite this wide range, these entities have two common elements: they are not subject to the banking sector regulatory framework

56 Global Financial Markets Association and others, "Comments in response to the consultative document on the revised Basel III leverage ratio framework and disclosure requirements", 20 September 2013, available from http://gfma.org/correspondence/item.aspx?id=536.

57 It may still be appropriate to have some specific regulations in particular areas, but only when they are areas that are relatively self-contained and for which regulators have access to full information.

58 For a more detailed discussion and critique of these measures and policy implications for emerging market countries, see Stephany Griffith-Jones, Shari Spiegel and Matthias Thiemann, "Recent developments in regulation in light of the global financial crisis", op. cit.

and they lack direct access to a liquidity backstop through a public lender of last resort, which makes them riskier than banks. Moreover, most of these entities are subject to mark-to-market accounting, thus amplifying procyclicality—an effect exacerbated by both a lack of transparency and the complexity of many shadow banking products. This in turn leads to mispricing of securities, potentially worsening boom and bust cycles.

In the past decade, the value of shadow banking has increased substantially, from an estimated $26 trillion in 2002 to $67 trillion in 2011 (the most recent estimate to date), while its share of total financial intermediation decreased since the onset of the crisis from 27 per cent in 2007 to 25 per cent in 2009-2011. According to the FSB, the aggregate size of the shadow banking system is about half the size of banking system assets.[59] The FSB has spearheaded the process of designing a framework for managing systemic risks in the shadow banking system. The latest policy recommendations issued in September 2013 focus on five thematic areas: (i) mitigating the spillover effect to the regulated banking system; (ii) reducing the susceptibility of money market funds to "runs"; (iii) assessing and aligning incentives associated with securitization; (iv) mitigating risks and procyclical incentives associated with specific securities; and (v) assessing and mitigating systemic risks posed by other shadow banking entities and activities.

The FSB has established an annual monitoring exercise to assess the global trends and risks of the shadow banking system; this system now includes jurisdictions covering 90 per cent of global financial system assets, and has put forward a calendar for national implementation of these new regulations with a peer review set for 2015.[60] In September 2013, the G20 endorsed both this exercise and the bid to identify global systemically important non-bank non-insurance financial institutions by end-2013.[61] The recognition of the need to regulate shadow banking is an important step forward. However, without implementation of regulatory measures at the national level, recommendations made by the FSB are unlikely to prevent the systemic risks of shadow banking from impacting the regulated banking sector.

Derivatives

The regulation of the derivatives market remains behind schedule

In 2008, the crisis exposed several risks associated with unregulated derivatives, which dramatically increased leverage in the system. Risks were noted particularly in the over-the-counter derivatives market, including a lack of transparency regarding counterparty exposures, insufficient collateralization, uncoordinated default management, and concerns about market misconduct. The G20 responded by agreeing to improve transparency, mitigate systemic risk and prevent market abuse, with several measures to be taken by the end of 2012.[62] Overall, the FSB reported some progress on this agenda, with three quarters of FSB member jurisdictions intending to have relevant legislation by the start of 2014, and the creation of central clearing requirements in most derivatives markets. However, at the

59 Financial Stability Board, "Global shadow banking monitoring report 2012", 18 November 2012.

60 Financial Stability Board, "Strengthening oversight and regulation of shadow banking: an integrated overview of policy recommendations", 18 November 2012.

61 See the G20 Leaders' Declaration at the St. Petersburg Summit, September 2013, p. 17.

62 All over-the-counter derivatives contracts should be reported to trade repositories; all standardised contracts should be traded on exchanges or electronic trading platforms; and non-centrally cleared contracts should be subject to higher capital requirements with the establishment of minimum margining requirements. See Financial Stability Board, "OTC derivatives reforms progress: report from the FSB Chairman for the G20 Leaders' Summit", 2 September 2013.

time of writing, the FSB had not reported on any legislative reform actually implemented at the national level to regulate the derivatives market, implying that derivatives are not necessarily regulated more effectively than in 2008.

Regulating the credit rating agency industry

Credit ratings play an important role in financial markets by reducing informational asymmetries between lenders and borrowers. In theory, credit ratings should support economic and development activities by lowering the cost of intermediation. However, the rating agencies were strongly criticized for failing to correctly rate the risks of securitized products prior to the financial crisis.

In particular, ratings on certain structured products have proven to be highly inaccurate. Indeed, the failure of credit rating agencies (CRAs) to properly assess the inherent risk of collateralized debt obligations and related products contributed to the subprime mortgage crisis and the ensuing world financial and economic crisis. There have also been questions of the accuracy of sovereign debt ratings, particularly in ratings prior to recent sovereign debt problems in some European countries. In general, the current process for sovereign ratings tends to incorporate more of the analysts' judgement on political and other issues than other rating sectors. On the other hand, evidence appears to indicate that ratings on corporate debt, for which there is a significant amount of historical data, have been relatively accurate.

Lack of competition in the ratings industry contributed to the failings of CRAs

There are several underlying issues that have been identified with regard to the failings of CRAs, both with regard to the structure of the industry and the business model and the ratings methodologies. First, there is a high level of concentration in the industry, which is dominated by the three main CRAs (Standard and Poor's, Moody's and Fitch). This has resulted in a lack of competition in the industry. In addition, there are significant conflicts of interest since it is the borrowers who pay the agencies to obtain their ratings. Ratings have also exhibited considerable procyclicality, with many ratings being raised during boom periods and lowered during slowdowns when financing is most needed, as discussed below. This has exacerbated volatility in credit flows.

There are also issues of transparency, which make it difficult for investors to assess the accuracy of ratings. This is particularly the case with sovereign ratings, which often involve qualitative and quantitative analysis, and should be seen as more of a tool for evaluation than a standard. At the same time, sovereign debt ratings can wield considerable influence on the ability of countries to borrow and finance development.

In addition, there has been an over-reliance on many ratings on the part of some market participants. First, ratings have been built into regulatory frameworks, such as Basel capital requirements. Many investors also rely on credit ratings in a mechanistic fashion, without doing internal credit screening. To that extent, investors should perform their own research and risk management, while regulators need to reduce reliance of ratings in regulations.

In response to these problems, policymakers have begun to develop new regulations for CRAs. The FSB has published "Principles for reducing reliance on credit rating agencies" along with a road map for their implementation, which were approved by the G20. These principles aim to reduce the "hard wiring" of credit ratings in standards, laws and regulations, and to provide incentives for financial institutions to develop their own capacity to assess credit risk.[63] The International Organization of Securities Commis-

63 Financial Stability Board, "Roadmap and workshop for reducing reliance on CRA ratings", FSB report to G20 Finance Ministers and Central Bank Governors, 5 November 2012.

sions, a trade group, has also established a code of conduct for credit rating agencies and is carrying out a peer review.

The response of Governments has been varied. A number of countries have implemented reforms, such as Argentina, China and the United States, and the EU.[64] In the United States, the implementation of the Dodd-Frank Act (2010) requires the complete removal of references to CRA ratings from the Securities and Exchange Commission (SEC) regulations and empowers the SEC with an Office for Credit Ratings to oversee credit ratings agencies. As a result, the new capital rules for banks eliminate ratings from the standardized approach, as discussed above. In the EU, the latest CRA III regulation approved in June 2013 requires the relevant regulatory agency—the European Securities and Markets Authority—to draft regulatory technical standards on the European Rating Platform, on the disclosure of requirements for structured finance instruments, and on the periodic reporting on fees charged by CRAs.

Consideration should be given to proposals for addressing underlying weaknesses in the structure, business models and methodologies of the ratings industry

Potential proposals to further address weaknesses in the rating system include: the establishment of a global rating platform, based on a uniform rating scale, to compile information and give investors access to ratings; increased transparency in ratings methodologies and assumptions; mechanisms to increase competition, notably the creation of domestic rating agencies, whether public or private; and, to reduce conflicts of interest, the creation of alternative structures (such as investor organizations that collectively request ratings) under new business models where the investors would pay for the rating, or whereby investors maintain the power to choose which CRA is hired.

In addition, there have been calls for mechanisms to reduce the procyclicality of ratings. For example, rating agencies often describe their process as being "forward looking". This can imply that ratings are based on analysts' predictions. However, based on private sector performance, analysts are rarely correct more than 40 per cent of the time.[65] Rather than tying ratings to specific predictions based on macroeconomic cycles, an alternative approach would be to assess ratings throughout a cycle, so that the rating would reflect how well different borrowers could withstand different degrees of economic slowdown, as well as liquidity crises. Such steps could be taken by CRAs themselves, but given the role of ratings in the financial system, there is an important role for Governments in working with the industry to strengthen the ratings process.

Financial inclusion

One of the primary goals of an effective financial system, which has not been fully incorporated into the reform agenda, is the importance of access to finance and financial services for all. Most recently, the Basel Committee on Banking Supervision, the Financial Action Task Force, and the International Association of Insurance Supervisors have revised their normative standards to strengthen financial inclusion through the proportionality principle—that is, the balancing of risks and benefits against costs of regulation and supervision. Further guidance is required on how to apply proportionality in the design of regulatory and supervisory frameworks to promote responsible financial inclusion at the country level. At the same time, there is no one-size-fits-all approach for building an inclusive financial system. Some countries have placed priority on building a nationwide electronic payment

64 Financial Stability Board, "Credit rating agencies: reducing reliance and strengthening oversight", Progress report to the St. Petersburg G20 Summit, 29 August 2013.

65 United Nations, *World Economic and Social Survey 2011*, op. cit.

system, while others have focused on access to credit for SMEs, and still others have focused on the need to improve the quality of usage, financial education and consumer protection. In all cases, coordination among a wide array of public and private actors is vital in order to arrive at a regulatory framework conducive to inclusive finance.

International development cooperation and official flows

Official development assistance

In addition to private flows, public resources play an important role in the international financial system. Public and private flows should be viewed as complements, not as substitutes for each other, as each has very different objectives. Despite small (but growing) pockets of socially conscious investors, most private capital remains driven by the profit motive. As a result, the private sector will under-invest in public goals when the expected return is lower than the expected return on other investment opportunities (on a risk-adjusted basis). Hence, it is important to recognize that public financing and public sector policies will remain essential.

International public financing is indispensable in two key areas. First, it remains essential for countries that do not have sufficient resources to fulfil development goals, such as the LDCs, where ODA accounts for approximately half of all external financing.[66] In addition, international public finance is needed for areas that the private sector does not finance sufficiently, such as global public goods, including climate change mitigation and adaptation. International public finance thus mirrors the main purposes of public finance more broadly—first, for equity (the distributive function of public finance, motivated by ethical concerns), and second, for allocative efficiency (addressing market failures and the provision of national and global public goods).[67]

ODA has been falling for two years owing to economic difficulties in donor countries

Nonetheless, despite increasing needs, the most recent ODA figures published by the Organization for Economic Cooperation and Development (OECD) indicate that ODA has now been dropping for two years. Following a sustained increase in ODA from 2000 to 2010, ODA fell by 4 per cent in real terms in 2012, after a 2 per cent drop the previous year. ODA dropped particularly sharply in the poorest countries. Bilateral ODA to East, West, Central and Southern Africa fell by 7.9 per cent between 2011 and 2012 to $26.2 billion, while ODA to the African continent as a whole fell by 9.9 per cent. Likewise, bilateral ODA to LDCs fell by 12.8 per cent to $26 billion.[68]

Excluding 2007, which saw the end of exceptional debt relief operations, the recent fall in ODA is the largest since 1997. The OECD has attributed this fall to the continuing financial crisis and euro area turmoil, which caused austerity measures to be implemented in Europe and weak fiscal positions across the developed world. Indeed, the sharpest drops in ODA, which were observed in Greece (-17 per cent), Italy (-34.7 per cent), Portugal (-13.1 per cent) and Spain (-49.7 per cent), tend to confirm this interpretation.

These negative developments represent a clear retreat from the internationally agreed aid targets. OECD Development Assistance Committee (DAC) donors' ODA represents

66 UNCTAD, *Least Developed Countries Report 2012* (United Nations publication, Sales No. E.12.II.D.18).

67 The third purpose of public finance is stabilization. For further detail see United Nations, "The variety of national, regional and international public sources for development finance", Report of the UNTT Working Group on Sustainable Development Financing, chap. 2 (New York, 2013).

68 OECD, "Aid to poor countries slips further as governments tighten budgets", 3 April 2013.

0.29 per cent of their gross national income (GNI), well short of the United Nations target of 0.7 per cent. OECD DAC donors also fell short of LDC ODA targets of between 0.15 and 0.20 per cent of GNI.

As concerns about environmental degradation have grown, aid targeting environmental sustainability has increased. Between 1997 and 2010, aid that had environmental sustainability as a principal objective has grown more than threefold, reaching $11.3 billion in 2010. More broadly defined environmental aid—the sum of all activities that have environmental issues as main or principal objectives—now represents a quarter of all bilateral aid. This represents a shift in aid allocation in favour of issues of international concern and global public goods. While these often have large developmental benefits, it is important that they do not crowd out traditional ODA.

Looking forward, while country programmable aid[69] is expected to bounce back in 2013, it is expected to remain flat between 2014 and 2016, although the uncertainty of the current economic environment means that such longer-term trends are difficult to predict.[70]

South-South and regional cooperation

At the same time, South-South flows have been increasing. While a number of DAC countries, such as the United Kingdom of Great Britain and Northern Ireland, went against the above-mentioned trend and saw an increase in ODA, the sharpest increase for 2012 was recorded in two non-DAC donor countries, Turkey (98.7 per cent) and the United Arab Emirates (30.6 per cent).[71]

South-South cooperation is increasing but cannot be considered a substitute for ODA

The dramatic increase in aid originating from Turkey and the United Arab Emirates reflects the increasingly important role of South-South aid and other forms of cooperation. South-South cooperation—concessional loans, grants and technical cooperation, specifically—was estimated to have reached between $12.9 billion and $14.8 billion in 2010 and it is expected to continue growing in the near future with increases planned by China, India and the Bolivarian Republic of Venezuela.[72] However, the term South-South cooperation is often understood more broadly to cover other forms of exchange and cooperation between developing countries, including trade, loans, technology sharing and direct investment. Such investment is often integrated into packages that include commercial transactions as well as grants and loans at concessional rates.

While South-South cooperation may thus help cushion the concurrent fall in ODA from DAC members, it cannot be considered a substitute. As acknowledged in the Global Partnership for Effective Development Cooperation—established in June 2012 in a follow-up to the Fourth High-Level Forum on Aid Effectiveness, held in Busan, Republic of Korea from 29 November to 1 December 2011—South-South cooperation can work in concert with traditional ODA, which has had a tendency to focus on humanitarian assistance, social interventions, and climate change mitigation and adaptation.

69 Country programmable aid is an alternative indicator to ODA for international public financing for development which has the advantage of indicating future trends with the publication of forward spending plans by OECD.

70 OECD, "Outlook on aid: survey on donors' forward spending plans 2013-2016", 3 April 2013.

71 OECD, "Aid to poor countries slips further", op. cit.

72 United Nations, "The variety of national, regional and international public sources for development finance", op. cit., pp. 6-7.

Innovative sources of international finance for development

In the light of growing needs, there has been a search for new sources of international public financing for development, leading to increased interest in new and innovative sources of finance. However, the ability of such sources to mobilize sizeable new and additional financing has not yet materialized.

Proposals for new innovative mechanisms are technically feasible, but face substantial political difficulties

Existing innovative financing mechanisms can be categorized into three groups: those that raise new resources, those that intermediate existing resources, and those that disburse traditionally raised funds in innovative ways. Measures to raise new resources include international taxes, such as financial and currency transaction taxes, carbon taxes, and non-tax revenues, such as the IMF Special Drawing Rights for financing development. Such mechanisms have the potential to raise considerable amounts of financing. For example, the European financial transaction tax proposed by the European Commission and adopted by 11 EU member States, is expected to raise between €30 billion and €35 billion a year. It was originally supposed to enter into force on 1 January 2014, but will likely be delayed by at least six months.[73] Likewise, the World Bank estimated that a carbon tax of $25 per ton on developed countries would raise $250 billion annually by 2020.[74] This and other proposals are technically feasible, but face substantial political difficulties.

There have also been innovations in the intermediation and disbursement of existing resources, with a view to improving both the efficiency of flows and disbursement mechanisms. Existing intermediate mechanisms of innovative development finance are designed to restructure existing flows to better match financing with needs, reduce risk, pool philanthropic funds with official resources, or leverage official flows with private resources. To date, these mechanisms—such as the International Finance Facility for Immunization or Advance Market Commitments in the health sector—have been of relatively small size, but have often been effective at the task they have set for themselves. Innovations in disbursement have most prominently taken place through purpose-specific funds such as the Global Fund to Fight HIV/AIDS, Tuberculosis and Malaria and the GAVI Alliance. They have successfully brought together donor and recipient governments, philanthropists, the research community, civil society and the private sector into the health sector. However, the vast majority of contributions to such funds have come from existing ODA budgets and, to a smaller degree, from philanthropic organizations. Evidence to date therefore suggests that innovative financing mechanisms have so far created only limited resources additional to ODA (box III.1).

Box III.1
Innovative sources of financing: the case of forests

Innovative mechanisms have also increasingly been used in forest financing. However, similar to the broader experience with innovate development finance, they have largely relied on a sharp increase in public financing and official development assistance (ODA) in particular, rather than mobilizing additional public or private sources of financing.

Beginning in the late 1980s, ODA played a leading role as a source of financing for sustainable forest management. In the early 2000s, however, two innovative forms of forest financing appeared. The first of these was the establishment of a large number of national forest funds in different countries. Despite the mixed record of already established funds, such as the Indonesian Dana Reboisasi, national funds have

73 Tom Fairless, "European financial transaction tax delayed", *Wall Street Journal*, 25 June 2013.

74 World Bank Group and others, "Mobilizing climate finance", paper prepared at the request of the G20 Finance Ministers, 6 October 2011, p. 6.

been perceived as an innovative means of allocating international funds specifically for forests, while still respecting national sovereignty. Moreover, they have been put forward as a way of helping to leverage additional sources of financing and in particular attracting private sector financing, although evidence for this continues to remain scarce.

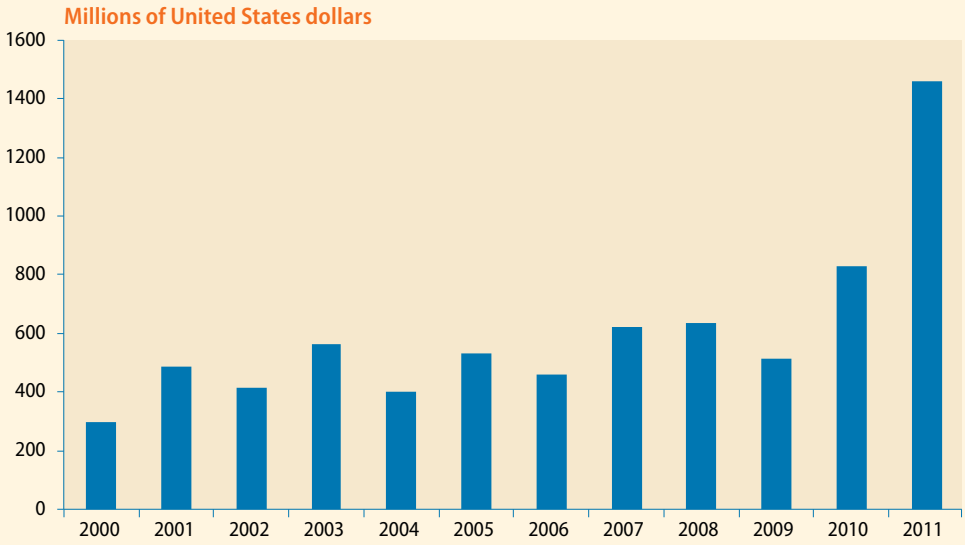
One example is Brazil's Fundo Amazônia (Amazon Fund), open to international funds and set up in 2008 by the Brazilian National Development Bank to finance the conservation and sustainable management of Brazil's share of the Amazon biome. As of August 2013, close to $150 million has been donated to the Amazon Fund. While the fund is open to financing from both public and non-government sources, the vast majority of funding has so far been provided by the Governments of Norway (88 per cent) and Germany (8 per cent), with only 4 per cent coming from private sources, namely Petrobras, which is a semi-public company itself. The Amazon Fund has thus not been successful in tapping into the complementarity of public and private funds. This is characteristic of the majority of national forest funds, which have been successful in attracting public funds but not in mobilizing private financing other than from philanthropic organizations.

Reducing Emissions from Deforestation and Forest Degradation, or REDD, is the second type of innovative forest financing. First developed in 2005 during climate change negotiations under the United Nations Framework Convention on Climate Change (UNFCCC), REDD was quickly embraced by donors, not only because it promised to simultaneously reduce deforestation while mitigating climate change, but also because many saw in it a means of leveraging private sector financing through a carbon market-based mechanism. Protracted intergovernmental negotiations and disagreements on the creation of such a market since then have not dampened the enthusiasm of donors, who continue to see REDD as an economical means of financing both forests and climate.

In short, innovative sources of forest financing have not yet delivered in their promise to raise private sources of financing. Instead, their success comes from the enthusiasm they raised among international public donors, which has translated into an almost threefold increase in ODA allocated to forests in just two years, from $515 million in 2009 to $1,459 million in 2011 (figure III.1.1). This has raised concerns about the stability of forest financing especially during a period of overall falling aid. As the growth in financing is largely attributable to the popularity of REDD, there is also a risk that access to such financing will be tied to the ability to demonstrate a reduced rate of carbon stock depletion. This focus on a single function of forests (stocking carbon to mitigate climate change, that is) could come at the expense of local and indigenous rights and the multiple values of forests, including biodiversity, providing clean water for people and agriculture, and being the source of livelihood to 1.6 billion people, which together make sustainable forest management a major building block of sustainable development.

Source: UN/DESA.

Figure III.1.1.
Forestry sector ODA, 2000-2011



Source: OECD StatExtracts database 2013.

Illicit capital flows and international tax cooperation

In the light of the increasingly urgent need to mobilize finance for sustainable development, the issue of responding to illicit financial flows, including those related to tax evasion and avoidance, has been at the forefront of high-level policy discussions. There is no universal definition of what constitutes illicit financial flows; in the context of this report, the concept refers to money that is illegally earned and/or illegally utilized and, in either case, transferred across borders.[75] Estimates of the total amount of illicit financial flows vary dramatically, in part because of definitional differences and in part because such flows are clandestine by nature. Amounts range from a 2005 estimate of $540 billion[76] to a more recent estimate of $858.8 billion to $1,138 billion—for developing countries alone—for the year 2010.[77]

Estimates of the total amount of illicit financial flows vary dramatically but are in the hundreds of billions

Two categories of illicit financial flows can be distinguished: tax-related flows, such as tax evasion and avoidance, and the funds resulting from illegal activities, such as the manufacturing, trading and selling of illegal narcotics. Concerning taxes, money illegally earned through tax evasion and then transferred abroad is illegal, but tax avoidance (exploiting the gaps in tax systems between countries) is often not defined as illegal in itself, and there is debate as to whether funds derived through tax avoidance should be considered illicit. However, Governments generally consider tax avoidance activities to be violating the will of national legislation and, as such, should result in policy and administrative responses.[78] In any case, the term "tax avoidance" is not used consistently to refer to purely legal activities;[79] anti-abuse provisions are often termed "General Anti-Avoidance Rules" or "Specific Anti-Avoidance Rules" that deny the intended legal effect of such avoidance arrangements.[80] The terms are used together in this report in the light of these issues.

Transfer pricing—the mechanism by which intragroup transactions are priced—can be done in a way representing one very specific and very complicated form of tax evasion or avoidance. Transfer mispricing most often makes use of differences in corporate tax rates by minimizing profits apparently made by group members in high tax jurisdictions and maximizing profits apparently made in low- or no-tax jurisdictions.

This issue is best addressed by ensuring that transfer pricing legislation is adapted to developing-country situations and priorities. Another challenge for developing countries is the gap in available data, information and resources they face when trying to determine what would have been charged between unrelated parties in such a transaction—the so-called arm's length price. The United Nations Committee of Experts on International Cooperation in Tax Matters has published the *Practical Manual on Transfer Pricing for*

75 Alessandra Fontana and Martin Hearson, "Illicit financial flows and measures to counter them: an introduction", U4 Brief, No. 9 (September 2012).

76 Raymond W. Baker, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free Market System* (Hoboken, New Jersey: John Wiley & Sons, 2005).

77 Dev Kar and Sarah Freitas, "Illicit financial flows from developing countries: 2001-2010" (Washington, D.C.: Global Financial Integrity, December 2012).

78 United Nations, "The variety of national, regional and international public sources for development finance", op. cit., p. 5.

79 See, for example, "Tempted by tax avoidance?: a warning for people thinking about avoidance schemes", available from http://www.hmrc.gov.uk/avoidance/tempted.htm, accessed 15 November 2013.

80 Ernst & Young, "GAAR rising: mapping tax enforcement's evolution", February 2013, p.2.

Developing Countries, [81] which offers practical guidance for administrations and taxpayers on addressing mispricing of intragroup transactions.

Curbing illicit financial flows is dependent on capable customs administrations, financial intelligence and the availability of anti-money-laundering experts. Moreover, political will from developed and developing countries is needed. Illicit financial flows affect each country in a different way, but they impact both developed and developing countries. At the St. Petersburg Summit in September 2013, G20 leaders advocated greater transparency and flows of information between jurisdictions to tackle this problem. The details of this proposal are being worked out currently; how it benefits and/or burdens developing countries will depend on the final form of the proposal, including its administrative requirements, the preconditions for accessing such information and the extent to which assistance is provided for both making and responding to information requests.

The G20 has advocated greater transparency and information flow between jurisdictions in order to curb illicit financial flows

Additional measures to enhance international financial stability

Global liquidity mechanisms and a financial safety net

One essential element in ensuring global financial stability is the capacity of the multilateral financial system to provide liquidity in times of systemic crises. Such a safety net could also reduce the incentive for countries to build up reserves as a form of self-insurance against potential external shocks, which has the adverse effect of exacerbating global imbalances.

The IMF plays a central role in the global financial safety net. It has established new flexibility facilities in its lending framework, notably with the creation of the Flexible Credit Line, providing upfront access to the IMF for members with a strong track record, as well as the Precautionary and Liquidity Line, aimed at countries with sound policies but moderate vulnerabilities. The IMF Rapid Financing Instrument was also created as a consolidation of different instruments for emergency assistance. This comes in addition to existing instruments such as the Standby Credit Facility, the Extended Credit Facility and the Rapid Credit Facility, which provides disbursements with limited conditionalities for low-income countries. Despite this, the IMF is facing a prospective drop in lending capacity after 2014—especially in the lending of the Poverty Reduction and Growth Trust—which is likely to pose a challenge to its capacity to fund low-income countries.[82]

Over time, the global financial safety net has evolved into a complex and multilayered structure composed of global, regional and bilateral components. Central banks provided the bulk of liquidity needed to ease funding pressures during the financial crisis. Their involvement is likely to remain crucial for a well-functioning safety net, prompting the United Nations to join the call for the creation of a more permanent framework of liquidity lines between central banks.[83]

A more permanent framework of liquidity lines between central banks is needed

Regional financing arrangements are another increasingly important component of the global financial safety net. In October 2012, the European Stability Mechanism was

81 United Nations, *Practical Manual on Transfer Pricing for Developing Countries* (United Nations publication, ST/ESA/347), available from http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

82 United Nations, Report of the Secretary-General on international financial system and development, op. cit., p. 14-15.

83 Ibid.

established, with a maximum lending capacity of €500 billion, replacing two temporary mechanisms. To date, it has approved two financial assistance facility agreements—one with Cyprus, the other with Spain. Earlier in 2012, the existing liquidity programme for the Association of Southeast Asian Nations plus China, Japan and the Republic of Korea doubled the size of funds to $240 billion. In Latin America and the Carribean, regional development banks, including the Inter-American Development Bank, and the Andean Development Bank, are playing increasing roles in this respect, although they act as development banks rather than monetary funds. No comparable mechanism exists in Africa.

Increased multilateral surveillance

The international architecture of multilateral surveillance is based on collaboration between the IMF, the FSB, the G20 and a number of standard-setting bodies. However, global policy coordination continues on an ad hoc and piecemeal basis, with the G20 taking the lead on promoting initiatives set up by different bodies, including the IMF. Given that many countries, particularly developing countries, are not represented within it, the G20 would need to continue strengthening collaboration with the United Nations for greater efficiency in this regard.

The IMF has implemented a range of measures to improve the quality of its surveillance work

In response to the 2008 financial crisis, the IMF has implemented a range of measures to increase the quality of its surveillance activities for early warnings on economic and financial risks. In particular, greater emphasis has been placed on cross-border and cross-sectoral linkages as well as the spillover effects of economic policies in the world's largest economies. The latest Triennial Surveillance Review in 2011 showed continued fragmentation and lack of depth in existing surveillance activities, as well as insufficient focus on interconnections and transmission of shocks. In January 2013, the Fund responded by implementing the Integrated Surveillance Decision that defines the scope and modalities of multilateral surveillance, including a framework for potential multilateral consultations.[84] At its latest Summit in September 2013, the G20 endorsed this decision and called for further proposals on how to incorporate global liquidity indicators more broadly into the Fund's surveillance work.

A pilot External Stability Report prepared by the IMF on the world's largest economies has also proved to be an additional building block of the surveillance system, particularly important in the light of increasingly interconnected economies and financial systems as well as the need to carry out external sector evaluations. The Fund also increased surveillance of the role of the financial sector in generating risks to global stability. The new Financial Surveillance Strategy acts as a basis for developing a framework that takes into account the interdependencies of financial sectors and of interactions between macroeconomic and macroprudential policies in the medium term.

Sovereign debt distress

After a hiatus of over a decade, the ongoing debt crisis in the euro area has once again highlighted gaps in the international financial architecture with regard to timely and effective solutions to problems of debt distress. Debates on sovereign debt restructuring have direct implications for financing sustainable development, as countries with unsustainable debt burdens spend a large proportion of public resources for debt servicing, which could other-

84 Ibid., p. 16.

wise be spent on development goals. In addition, uncertainty surrounding sovereign debt restructurings increases both country-specific and systemic risks.

Debt problems in Europe potentially have global systemic implications, while debt problems in developing countries are, on average, at historical lows

For the first time, debt overhangs in developed economies are more pronounced than in developing countries. Public debt as a percentage of GDP in OECD countries jumped from about 70 per cent in the 1990s to almost 110 per cent in 2012. The increase in debt levels was accompanied by downgrades of credit ratings in some countries. Debt problems in Europe have once again highlighted the interlinkages between sovereign debt problems and the financial sector. Given the size of sovereign debt generally held by the banking system, sovereign debt crises can trigger bank runs and/or banking crises, potentially leading to regional or global contagion. Similarly, given the prevalence of too-big-to-fail institutions which can entail government bailouts, banking crises can trigger sovereign debt distress, with potential systemic implications due to regional and international holdings of debt.

In contrast to developed countries, developing countries are currently running historically low public debt-to-GDP ratios, with public debt at about 46 per cent of GDP for developing countries as a whole in 2012.[85] Many low-income countries in sub-Saharan Africa benefited from comprehensive debt relief programmes over the past two decades, including Heavily-Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI). Nonetheless, sovereign debt challenges remain in some small states and low-income countries. The problem is most acute among countries in the Caribbean, which were negatively impacted by the financial crisis. As a result, since 2013, Belize, Grenada, Jamaica and Saint Kitts and Nevis all sought to restructure portions of their debt.

In addition, increased borrowing by HIPCs—including bond finance, lending from non-traditional creditors and concessional finance—is filling the newly created borrowing space. For example, over the last couple of years, ten African countries, including three low-income countries, have issued sovereign bonds on international capital markets, raising a total of $8.1 billion (box III.2). However, despite this increased borrowing, the external risk of debt distress in low-income countries, as assessed in individual countries' IMF-World Bank debt sustainability analyses, has improved or remained stable in 90 per cent of low-income countries since 2009.[86]

A number of developing countries, particularly in the Caribbean, see an increase in short-term debt as a proportion of GDP

The composition of public debt has been changing for all categories of developing countries. In particular, there has been an increase in the share of domestic debt denominated in local currencies, which reduces currency mismatch risk for countries. At the same time, there has been an increase in short-term debt as a proportion of GDP, possibly reflecting the shift in financing in domestic capital markets, which often lack longer-term bond markets.

In order to enhance the role of foreign borrowing for growth and development, efforts are needed to strengthen three pillars: responsible lending and borrowing, debt management, and a framework for sovereign debt restructuring. A central issue for domestic and international economic policy is how to reduce the occurrence of sovereign debt problems in both developing and developed countries. First and foremost, responsible lending and borrowing to reduce the chance of debt distress is crucial. Governments need to make regular use of analytical tools to assess alternative borrowing strategies, better manage their

85 United Nations, *The MDG Gap Task Force Report 2013—Global Partnership for Development: The Challenge We Face* (United Nations publication, Sales No. E.13.I.5).

86 IMF, "Review of the policy on debt limits in Fund-supported programs" (Washington, D.C., 1 March 2013).

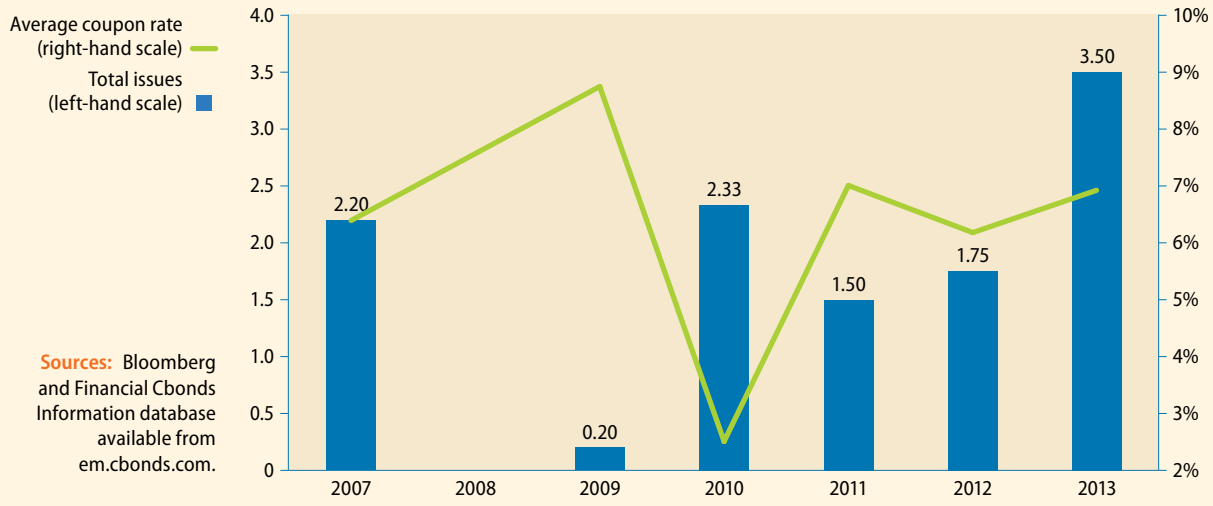
Box III.2

Sub-Saharan African sovereign bonds: an alternative source of development finance or a looming debt crisis?

In December 2009, Senegal made history as the first least developed country to issue a dollar denominated sovereign bond, popularly known as the Eurobond. Given Senegal's B+/B1 below investment grade credit rating, the $200 million bond carried a high coupon of 8.75 per cent, at a time when Senegal's other external borrowing was concessional, with an average interest rate of 1.2 per cent and maturity of 34.6 years. Senegal was not the first sub-Saharan economy to join the bandwagon of expensive borrowing from international capital markets. Since Ghana's debut Eurobond issue in 2007, 11 sub-Saharan countries—Angola, Côte d'Ivoire, Gabon, Mozambique, Namibia, Nigeria, Rwanda, Senegal, the United Republic of Tanzania and Zambia—borrowed $11.5 billion through international bonds, making it the most important source of external finance for these economies, and exceeding the total $7.9 billion concessional International Development Association (IDA) loans that they received during 2007-2011.

Figure III.2.1

Eurobond issues and coupon rate in sub-Saharan Africa, 2007-2013



Sources: Bloomberg and Financial Cbonds Information database available from em.cbonds.com.

Why would countries like Senegal or Rwanda borrow at interest rates that are 6-7 times higher than concessional rates and with far shorter maturity? First, concessional funds from bilateral and multilateral sources have been drying up for many of these economies. Second, even when available, concessional funds are often inadequate to meet the growing infrastructure development needs of these countries. Third, strict conditionalities, long gestation, and high transaction costs associated with concessional loans often render them unattractive to many Governments striving to develop their priority projects quickly. Unending dependency on concessional loans is neither possible nor desirable, and the recent spate of borrowing with sovereign bonds perhaps signals the inevitable transition to borrowing on commercial terms.

However, a risk for these economies is that they may lose eligibility for IDA concessional credit from the World Bank. Article V 1(c) of the IDA Articles of Agreement states, "The Association shall not provide financing if in its opinion such financing is available from private sources on terms which are reasonable for the recipient or could be provided by a loan of the type made by the Bank." The cost of losing access to concessional funds may be very high for Governments seeking to increase public sector investments in health, education and other social sectors. While commercial term loans may be feasible for infrastructure projects, they may be far too costly for building schools or extending social protection to the poor.

There is also the risk of rising borrowing costs. Similar to other international markets, yields on these African bonds have witnessed significant volatility since May 2013. For example, yields on Ghanese, Senegalese and Zambian bonds jumped from 4.7 per cent, 5.5 per cent, and 5.625 per cent, respectively in April or May, to over 7.0 per cent, 8.4 per cent, and 7.136 per cent between June and August, and could potentially rise further if global interest rates increase. These higher yields are likely to raise the overall cost of external finance and adversely affect growth and development of these economies.

Sub-Saharan Africa needs additional external resources to finance its development. It is encouraging that the international capital market has responded positively to meet the financing gap. There is nevertheless growing concern that although the current level of external debt of these economies is moderate, their debt burden may grow amid increasingly high borrowing costs, a possible collapse of commodity prices, and international volatility. The sub-Saharan Eurobond issuers could then be forced to cut fiscal spending to maintain their credit ratings and keep yields from rising further in a countercyclical manner, just when government spending is most needed. Countries will need robust growth to ensure that these newfound sources of finance do not lead them to yet another crisis.

Source: UN/DESA.

assets and liabilities, and restrain from irresponsible borrowing. At the same time, lenders need to better assess credit risk, improve credit screening and reduce irresponsible lending to high-risk countries.

Nonetheless, debt distress does occur, and can be costly. When debt burdens become excessive, there is a need for an effective mechanism that minimizes economic and social costs and allows countries to restructure their obligations in an effective and fair manner and that also gives countries a clean slate to be able to resume growth and investment. For low-income countries, HIPC and MDRI, while important initiatives, accounted for debt relief as development assistance, which side-stepped the broader challenge of how to address issues of debt overhang in a comprehensive manner. The international community has agreed to certain broad principles for debt restructuring, including fair burden-sharing between debtors and creditors agreed in the Monterrey Consensus, and the legal predictability called for in the Doha Declaration. However, these have yet to be institutionalized in concrete practices.

The lack of an international bankruptcy procedure for sovereign debt restructuring has implications for the cost and speed of resolving of debt problems. Historically, it has been shown that this delay in restructuring can be extremely costly.[87] Lack of legal predictability creates uncertainties for both debtors and creditors, and raises important issues of equity. Recently, the issue of hold-out creditors has elicited international concern, with litigation against Argentina having the potential to increase the leverage of hold-out creditors, thereby undermining the sovereign debt restructuring process.

The international community should more actively pursue the development of an agreed rules-based approach to sovereign debt workouts to increase predictability and the timely restructuring of debt when required, with fair burden-sharing. Such an approach would reduce risk in the global financial system and free up resources for investment in sustainable development.

87 Barry Herman, José Antonio Ocampo and Shari Spiegel, eds., *Overcoming Developing Country Debt Crises* (Oxford and New York: Oxford University Press, 2010).