



World Economic Situation and Prospects



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World Economic Situation and Prospects 2016



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Chapter III

International finance for sustainable development

The year 2015 has been a significant one for global cooperation in development. In September, world leaders adopted a new set of Sustainable Development Goals (SDGs) and targets as part of the 2030 Agenda for Sustainable Development. They also agreed in July on a new financing framework for achieving sustainable development, embodied in the Addis Ababa Action Agenda (AAAA) (box III.1). Earlier in March, Governments adopted a post-2015 framework on disaster risk reduction. Taken together, these new global agreements provide a comprehensive framework within which international finance should flow.

Although the amount of financing needed to achieve the SDGs is vast, global public and private savings would be sufficient—if the financial system were to effectively intermediate savings and investments in line with sustainable development objectives. This is not currently the case: the international finance system is neither stable nor efficient in allocating finance where it is needed for sustained and inclusive growth. Additionally, finance is not generally channelled with social outcomes or environmental sustainability in mind.

These are very large challenges. The world requires action at both the national and international levels to simultaneously finance sustainable development and to develop sustainable finance.¹ Nationally, countries need to craft sustainable development financing strategies, based on their national developmental models. These strategies should seek to unlock the potential of people and the private sector, and incentivize changes in consumption, production and investment patterns to support sustainable development. At the international level, there is a need for a coherent set of rules and policies that can channel finance to support sustainable development, leaving sufficient policy space for countries to pursue their chosen development model.

These issues are at the core of the new international agreement on financing for development. The AAAA provides the guidance needed, covering domestic and international public finance, private finance, and cross-cutting and systemic issues. Member States need to implement the commitments contained in the AAAA, including forging a true global partnership in support of sustainable development. That partnership of nations, supported by other stakeholders, should shape a supportive international environment and provide the basis for further progress towards sustainable development. Achieving the SDGs and transforming the world depend on this.

The Addis Ababa Action Agenda establishes a framework to realign the international financial system with the sustainable development agenda

¹ Sustainable finance is defined as finance that is long-term oriented and aligned with economic, environmental and social values through products and markets that balance inclusion with stability.

Box III.1

The Addis Ababa Action Agenda

At the Third International Conference on Financing for Development, held in Addis Ababa, Ethiopia, from 13 to 16 July 2015, United Nations Member States adopted the Addis Ababa Action Agenda (AAAA). The Agenda provides

- A new global framework for financing sustainable development that aligns all financing flows and international and domestic policies with economic, social and environmental priorities.
- A comprehensive set of policy actions by Member States, with a package of over 100 concrete measures that draw upon all sources of finance, promote technology and innovation, reform trade, harness data, and address systemic issues to transform the global economy and achieve the Sustainable Development Goals (SDGs).

The AAAA serves as a guide for actions by Governments, international organizations, businesses, civil society and philanthropists. The Agenda reiterates that countries have primary responsibility for their economic and social development, while committing the international community to creating an enabling environment. Together, these positions support a revitalized and strengthened global partnership for sustainable development that can end extreme poverty and deliver sustainable development for all.

The policy framework presented in the AAAA seeks to realign financial flows with public goals, underpinned by country-led development models that reflect the diverse stages of a country's development and its specific circumstances and financing needs. Official development assistance remains crucial, particularly for countries most in need. But aid alone will not be sufficient. As in the Monterrey Consensus, the AAAA recognizes that finance is not just about financing flows; it depends on public policies that strengthen the national and international enabling environments and seek to align private behaviour with public goals. The AAAA offers a nuanced understanding of the benefits and risks associated with different types of finance: It stresses the importance of long-term investment and the need for all financing to be aligned with sustainable development. It puts forward specific public policies and regulatory frameworks to encourage private investment to support the SDGs. It spells out the potential contributions of public finance, highlighting the growing role of national, regional and multilateral development banks.

But the AAAA goes beyond the Monterrey Consensus to fully take into account the regulatory and other policy requirements for realizing all three dimensions of sustainable development—economic, social and environmental—in an integrated manner. It emphasizes that trade, development and dissemination of technology, as well as capacity-building, are key means of implementation for the 2030 Agenda for Sustainable Development.

The AAAA is an integral part of the 2030 Agenda for Sustainable Development. To ensure adequate implementation and follow-up, the AAAA establishes an annual Financing for Development Forum, with intergovernmentally agreed conclusions and recommendations that will inform the review of the 2030 Agenda for Sustainable Development.

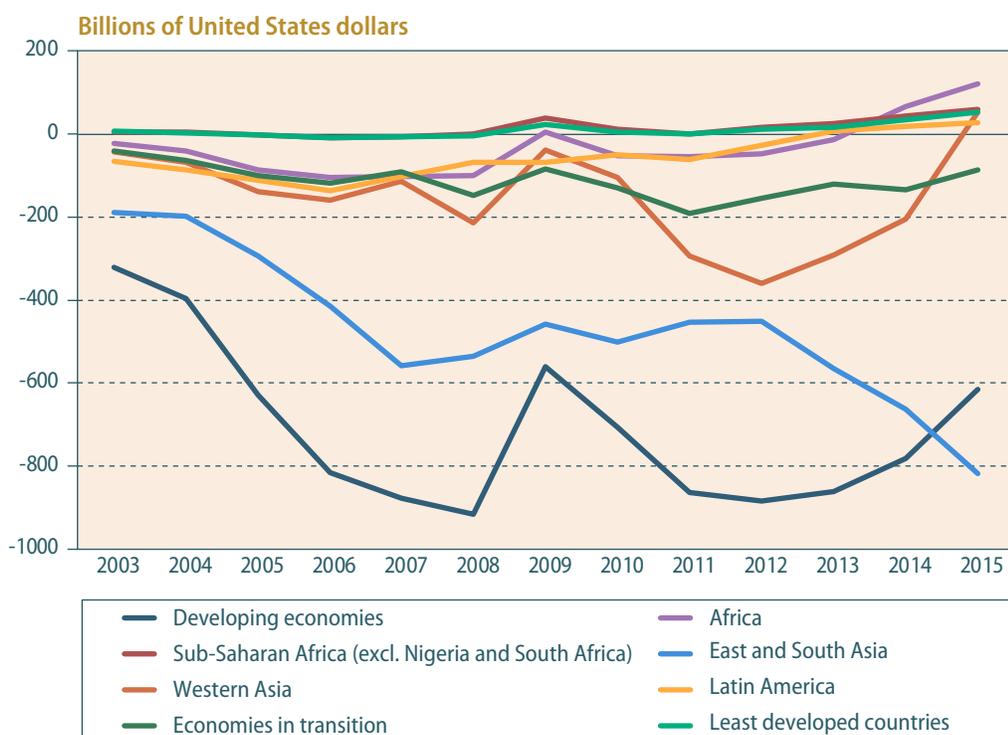
Source: UN/DESA.

Trends in net resource transfers

As articulated in the AAAA, the new financing framework for sustainable development incorporates all sources of financing, including the transfer of resources to developing countries in the form of foreign private capital inflows, official development assistance (ODA) and other forms of international cooperation. As can be seen in figure III.1, net resource transfers² to developing countries as a whole have been negative, implying that resources are flowing from developing to developed countries. Least developed countries (LDCs), where resource shortfalls have been most acute, have been receiving almost no resources in net terms.

² Net transfer of resources refers to the net flow of capital and capital servicing, the net foreign earnings of labour, plus the net change in reserves. Cf. United Nations (1990), box IV.1.

Figure III.1
**Net transfer of resources to developing economies and economies in transition,
 2003–2015**



Source: UN/DESA, based on International Monetary Fund, World Economic Outlook Database, October 2015 and World Bank remittance data. Note: Data for 2015 are partly estimated.

Highly volatile private capital flows

Table III.1 and figure III.2 show the recent trends in capital flows to developing countries and economies in transition. While most forms of capital inflows initially rebounded following the 2008 crisis, they began to slow after 2010, with total net capital flows to developing countries and transition economies turning negative in 2014, driven by large net outflows from transition economies, particularly the Russian Federation. In 2015, it is estimated that over \$700 billion of capital left developing and transition economies, greatly exceeding the magnitude of net outflows during the Great Recession. It is estimated that foreign direct investment (FDI) fell by \$145 billion, driven by large declines in East and South Asia, and that portfolio flows, which tend to be more volatile, turned negative. The greatest decline, however, was in “other” investment (mostly interbank loans and currency/deposits, trade credits and other equity), which has historically been the most volatile form of capital flow (table III.1). This decline partly reflects a continuation of commercial banks reducing their exposures to higher risk economies (including emerging markets) and could potentially be further impacted going forward by the introduction of Basel III capital adequacy standards for banks.

Foreign direct investment, especially greenfield direct investment, typically has longer-term investment horizons and is generally attracted by factors such as high growth rates, lower factor costs (including labour costs), rule of law and strong macroeconomic fundamentals. This, to a large extent, explains the lower volatility of FDI relative to portfolio investment and cross-border interbank lending, which are typically driven by short-term

In 2015, net capital outflows from developing and transition countries exceeded the magnitude of net outflows that occurred during the Great Recession

Table III.1

Net financial flows to developing countries and economies in transition, 2006–2015

Billions of United States dollars										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015 ^a
Developing countries										
Total net flows	-24.5	292.3	20.5	496.5	614.6	421.4	177.1	379.2	104.3	-614.9
Direct investment	241.1	344.8	368.4	270.8	371.6	454.0	415.8	474.9	404.3	259.7
Portfolio investment ^b	-187.5	-81.6	-129.6	29.7	153.1	102.6	119.6	-13.1	48.3	-47.7
Other investment ^c	-78.2	29.1	-218.3	196.0	89.9	-135.2	-358.3	-82.6	-348.2	-826.9
Change in reserves ^d	-669.4	-1058.4	-745.3	-711.6	-884.5	-756.2	-477.9	-643.0	-285.9	395.2
Africa										
Total net flows	-33.2	27.0	18.1	54.3	12.0	29.8	47.1	62.3	80.2	91.9
Direct investment	23.5	40.9	55.4	46.3	46.2	40.6	39.2	34.4	33.1	42.8
Portfolio investment ^b	16.8	4.7	-36.9	-5.3	4.3	12.8	21.5	17.9	17.9	8.2
Other investment ^c	-73.5	-18.6	-0.4	13.2	-38.4	-23.6	-13.5	10.0	29.3	40.9
Change in reserves ^d	-78.1	-85.4	-74.7	5.4	-20.0	-29.4	-25.9	9.6	30.7	59.7
East and South Asia										
Total net flows	53.9	109.6	-39.5	349.7	382.0	276.3	15.7	238.2	-44.7	-795.4
Direct investment	139.9	162.9	155.7	99.6	199.3	259.9	212.9	270.6	229.2	87.2
Portfolio investment ^b	-128.2	-55.4	-45.3	38.0	35.2	24.7	2.8	-85.4	48.7	-104.5
Other investment ^c	42.2	2.1	-150.0	212.2	147.5	-8.2	-199.9	53.1	-322.6	-778.1
Change in reserves ^d	-433.1	-675.2	-490.8	-667.6	-684.9	-505.3	-219.6	-515.1	-264.1	214.3
West Asia										
Total net flows	-48.5	43.4	-35.3	14.3	14.6	-110.2	-106.6	-138.7	-170.4	-60.2
Direct investment	44.3	48.1	57.7	54.4	35.4	22.7	26.0	6.0	5.8	17.0
Portfolio investment ^b	-71.3	-75.4	-54.1	-26.8	-17.7	-53.3	-19.2	-50.6	-130.0	-21.1
Other investment ^c	-21.4	70.7	-38.8	-13.4	-3.1	-79.6	-113.4	-94.1	-46.2	-56.2
Change in reserves ^d	-105.2	-167.3	-138.8	5.7	-89.1	-110.7	-173.2	-131.2	-15.1	99.1
Latin America and the Caribbean										
Total net flows	3.2	112.3	77.3	78.2	206.0	225.4	220.8	217.4	239.2	148.8
Direct investment	33.4	92.9	99.6	70.5	90.7	130.8	137.8	164.0	136.3	112.6
Portfolio investment ^b	-4.7	44.5	6.7	23.8	131.3	118.4	114.6	105.0	111.7	69.8
Other investment ^c	-25.5	-25.1	-29.1	-16.0	-16.0	-23.8	-31.5	-51.6	-8.8	-33.5
Change in reserves ^d	-53.0	-130.5	-40.9	-55.1	-90.5	-110.8	-59.2	-6.3	-37.3	22.2
Economies in transition										
Total net flows	32.5	132.1	-102.4	-2.6	-6.9	-56.7	-14.1	-15.4	-122.7	-87.5
Direct investment	28.4	34.8	55.4	22.0	12.9	21.0	30.6	8.8	-14.2	20.0
Portfolio investment ^b	7.5	-2.7	-36.0	6.1	14.3	-15.8	-1.3	2.3	-26.5	-19.5
Other investment ^c	-3.3	100.1	-121.8	-30.7	-34.1	-61.9	-43.4	-26.5	-82.0	-88.0
Change in reserves ^d	-134.5	-170.2	29.6	-10.5	-51.5	-26.6	-25.6	22.3	114.1	43.5

Source: UN/DESA, based on IMF World Economic Outlook database, October 2015.

Note: WEO has adopted the sixth edition of the Balance of Payments Manual (BPM6). 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 World Economic Outlook.

^a Preliminary.

^b Including portfolio debt and equity investment.

^c Including short- and long-term bank lending.

^d Negative values denote increases in reserves.

interest-rate differentials and/or the expectation of short-term returns. However, there is also evidence of recent increasing financialization of FDI, with cross-border merger and acquisition sales in developing countries surpassing pre-crisis peaks to hit an historic high of \$120 billion in 2014 (United Nations Conference on Trade and Development, 2015c, annex table 9). FDI also remains concentrated in a few regions (mostly Asia and Latin America), countries (mostly middle-income and upper-middle-income) and sectors (e.g., a significant portion of the investment in LDCs is geared towards resource-rich countries).

Overall, the largest net capital outflows in 2015 were from East and South Asia and Commonwealth of Independent States (CIS) countries. Similar trends were observed in virtually all major emerging economies, particularly those that received large inflows of capital during 2009-2013, such as Brazil and Turkey. Capital outflows from China were the major driver of the trend, which could intensify further in the medium term as the country moves to a slower growth path.

Figure III.2
Net financial flows to developing countries and economies in transition, 2005–2015



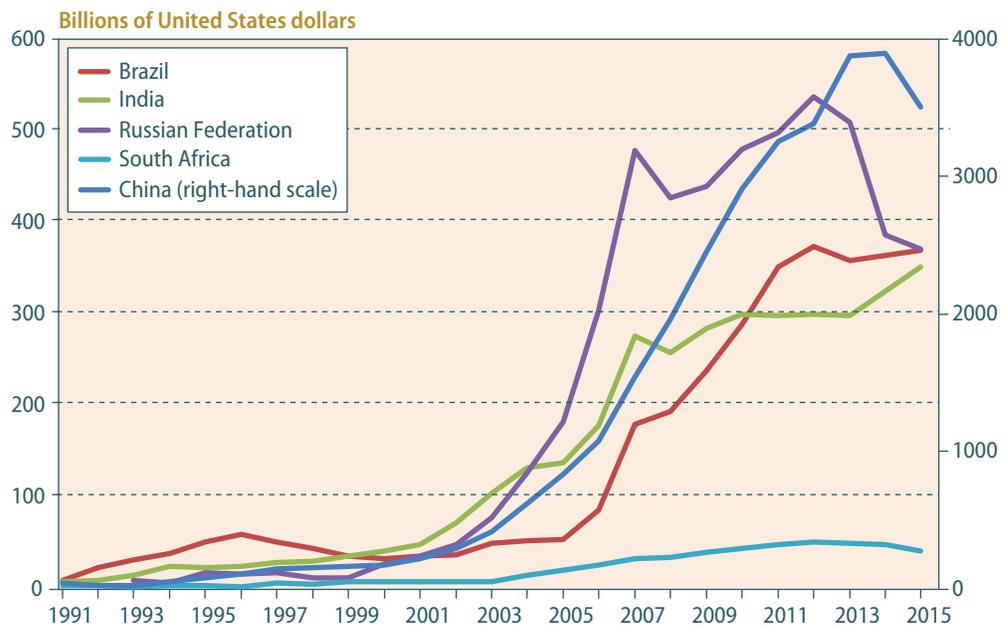
Source: Table III.1 of this publication.
Note: A positive value means inflow of capital and increase in reserves.

As discussed in Chapter I, declines in commodity prices, the slowdown in China and other emerging economies, and the prospects of higher interest rates in the United States of America all contributed to the reduction in inflows and acceleration of capital outflows from developing economies. In the past, Governments facing large net capital outflows typically responded by raising interest rates and/or letting their currencies devalue. These types of measures often failed to stem outflows and/or had negative repercussions on the domestic economy, often adversely affecting growth because of the higher costs of capital for domestic borrowers. Recently, many Governments have used foreign-exchange reserves to support their currency. Some have also implemented other forms of direct or indirect capital-account management (e.g., macroprudential regulations and/or direct capital controls). The choice of policy option is often predicated on the exchange-rate regime as well as the monetary policy framework. In practice, countries generally combine these policy options. For example, China spent a significant amount of its reserves to counteract

Declining commodity prices, the slowdown in many emerging economies, and the prospects of higher interest rates in the United States have all contributed to net capital outflows from developing economies

the downward pressure on the currency, which partly contributed to the decline in total reserves from nearly \$4 trillion in mid-2014 to \$3.65 trillion in mid-2015 (figure III.3). To discourage currency speculation, China also mandated a deposit of 20 per cent of sale on currency forwards. At the same time, in one of the most visible events that marked the reversal of the trend in global capital flows, China adjusted its mechanism to determine the daily reference rate of the renminbi yuan against the dollar on 11 August 2015, which was followed by the increase of the reference rate by 4.4 per cent over the ensuing three days. A drop in reserves combined with currency depreciation was also observed in most other emerging economies, with the Russian Federation hit particularly hard by the oil price decline, sanctions and geopolitical uncertainties. Russian reserves declined from over \$500 billion in early 2014 to \$370 billion in early October 2015 (figure III.3), while the Russian rouble lost over 50 per cent of its value in the same period. The changes in foreign-exchange reserves virtually coincide with the recent decline in net capital flows (figure III.2).

Figure III.3
Year-end foreign-exchange reserves, including gold, in BRICS countries



Source: IMF, International Financial Statistics.
Notes: For China, use right-hand scale; for all other countries, left-hand scale. Figures for 2015 are as of end-September.

Capital flows and long-term economic growth

In the 1990s, a common argument advanced in favour of capital-account liberalization was that capital would flow from industrialized countries, where capital has low marginal returns, to developing countries, where its relative scarcity implies high marginal returns. This phenomenon should help relax the foreign-exchange constraint of developing countries that run large current-account deficits. In other words, capital-account liberalization was expected to delink investment from domestic savings, allowing developing countries' investment rates to exceed their savings rates and lead to increased growth. However, empirical studies have found that most if not all countries that managed to achieve high growth rates were net creditors, not net borrowers—meaning that they were saving more

Box III.2

The “financial account”, the “capital account” and twin surpluses

The balance of payments generally refers to the current account plus the capital account plus the inverse of the change in international reserves. A positive current account is usually associated with a negative capital account (or capital outflows), although the question of causality between the current and capital account is complex, and depends on country circumstances.

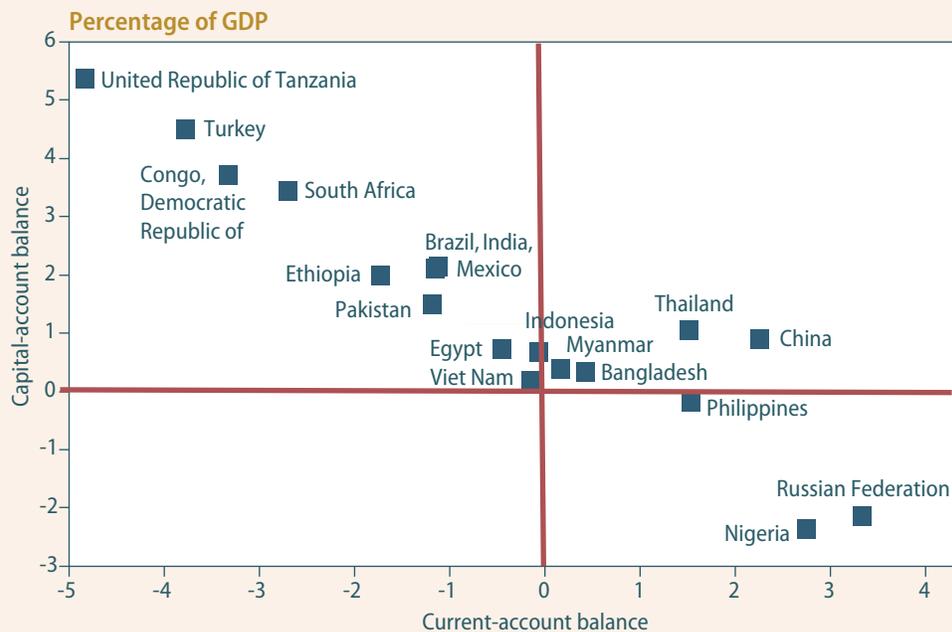
In economic literature, the “capital account” generally refers to the portion of the balance of payments that includes both financial flows and capital transfers. However, since 1993, the International Monetary Fund (IMF) balance-of-payment statistics have used the term “capital account” to only include capital transactions (e.g., capital transfers and acquisition or disposal of non-produced, non-financial assets), while using the term “financial account” to denote all financial flows classified according to type of investment (i.e., direct investment, portfolio investment, derivatives and other investment) as well as the change in reserve assets.^a The IMF financial and capital accounts together are, therefore, roughly equivalent to the traditional capital account in the economic literature plus the change in international reserves. This chapter uses the term “capital account” to refer to four types of capital flows: direct investment, portfolio investment, derivatives and other investment.

The relationship between current and capital account is not straightforward. In some countries, a trade deficit (negative current account) is financed by foreign capital inflows, while in other countries a surge in capital inflows can lead to an overvalued exchange rate, which will drive down demand for the country’s exports and increase imports, leading to a negative current account.

In the early 2000s, however, several emerging-market countries maintained both positive current and capital accounts, running what is called “twin surpluses”. Central banks intervened in the foreign-exchange market, keeping exchange rates from appreciating while also building international reserves. China is the most often cited case, but a number of countries witnessed this phenomenon in some years (figure III.2.2), although only four large developing countries (with a population of more than 50 mil-

^a In many ways, the IMF balance-of-payments statistics “financial account” plus “capital account” is similar to the United Nations concept of net resource transfer, as presented at the beginning of this chapter, as it includes both capital flows and reserve accumulation. The main difference is that the net resource transfer also addresses capital servicing (such as income from direct investment) and the net foreign earnings of labour, both of which are recorded on the current account.

Figure III.2.1

Average current-account balance and capital flows, large developing countries, 2000–2014

Source: IMF Balance of Payments.

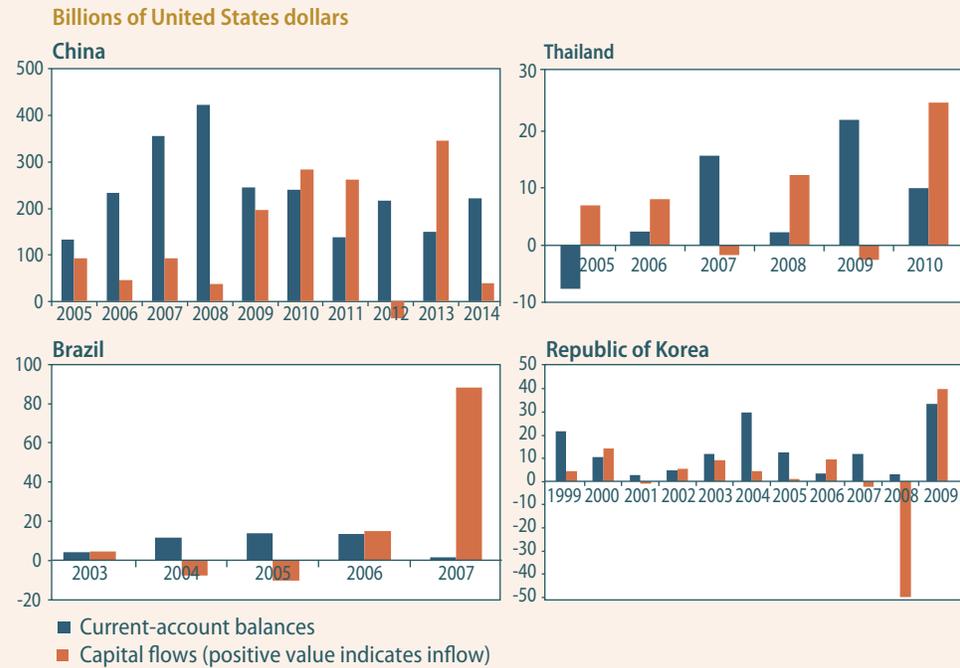
(continued)

Box III.2 (continued)

lion) did so over a 15 year period (figure III.2.1). As the balance of payments must be equal to zero, twin surpluses generally reflect a build-up in international reserves, while twin deficits generally reflect the opposite. The build-up of reserves usually entails opportunity costs in terms of missed investment or consumption opportunities, but it may also help to reduce exchange-rate volatility.

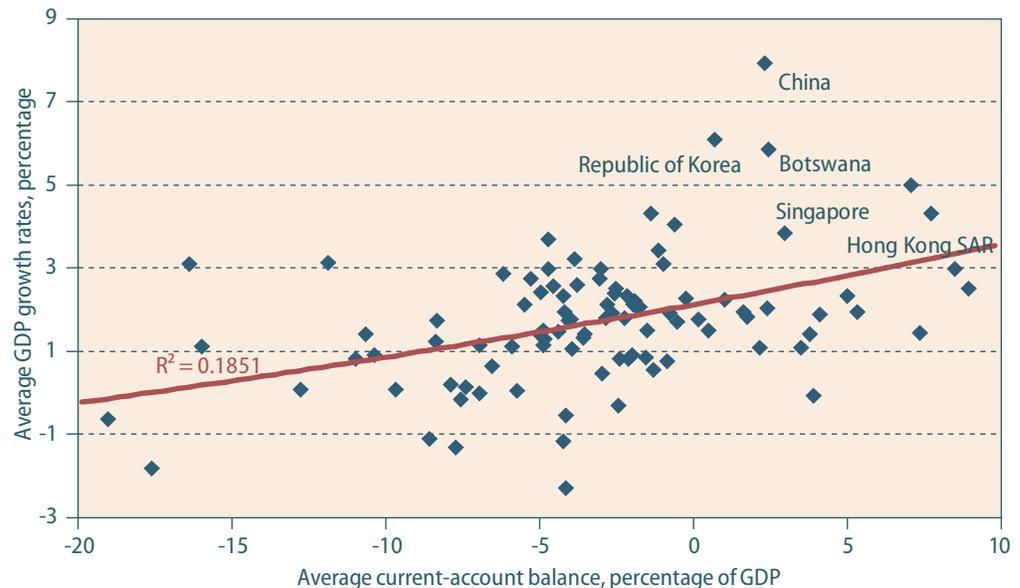
Source: UN/DESA.

Figure III.2.2
Current-account balance and capital flows, selected countries



Source: IMF Balance of Payments.

Figure III.4
Average annual growth rates of GDP per capita and average current-account balance, 1970–2007



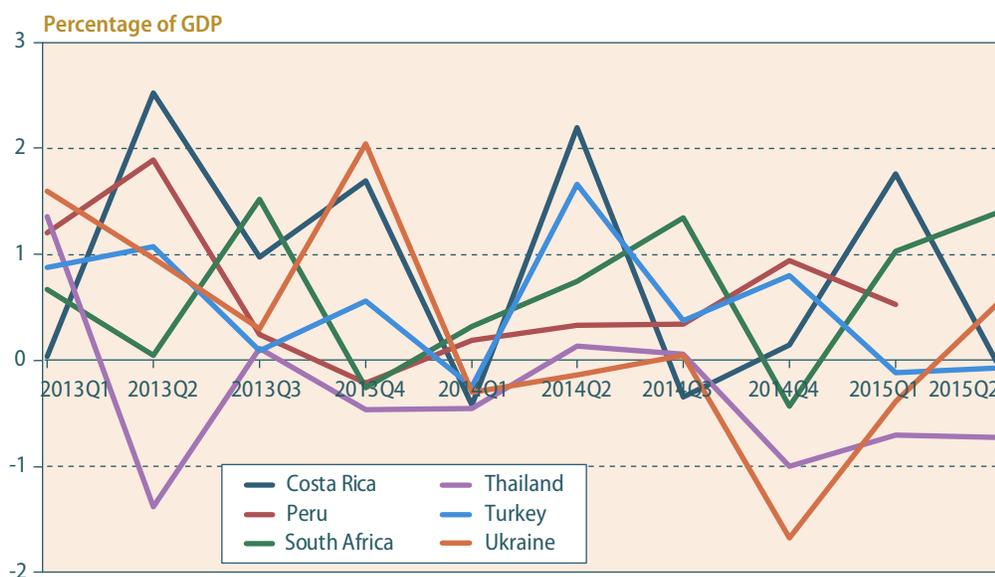
Source: UN/DESA calculations, based on World Bank World Development Indicators and IMF Balance of Payments.

than investing domestically—and that their current accounts were in surplus.³ As shown in figure III.4 the relationship between the current-account surplus and growth rates has been positive.⁴

More broadly, there has been a high correlation between investment and domestic savings, even among countries with relatively open capital accounts, a phenomenon also known as the Feldstein-Horioka puzzle (Feldstein and Horioka, 1980). Three factors explain the puzzle. First, in some developing countries with open capital accounts, there has been a lower absolute level of foreign capital inflows than would have been predicted by theory. Second, in countries with large capital inflows, a significant portion of the inflows facilitated by an open capital account have tended to be based on a short-term investment horizon and, by definition, have been volatile in nature (figure III.5). Third, countries with high domestic savings rates generally intervened in the foreign-exchange market to maintain their competitiveness as an integral part of their export-oriented industrialization strategy, and managed their foreign-exchange inflows, including by building foreign-exchange reserves, which explains the strong correlation between investment and domestic

There is a high correlation between investment and domestic savings, even in countries with open capital accounts

Figure III.5
Portfolio flows by non-residents, selected countries, 2013 Q1–2015 Q2



Source: UN/DESA calculations, based on IMF Balance of Payments.

³ The investment rate can be held back despite high saving rates when countries face a binding foreign-exchange constraint. The savings rate eventually falls to equate with the investment rate. See literature survey by Thirwal (2011).

⁴ The relationship is significant, even after controlling for the level of development:

$$y = 0.85 Y_{cap} + 0.08 CA + 1.06,$$

(3.07) (2.19)

N=91, $R^2 = 0.23$, robust standard errors, T-statistics in brackets below, where

y – annual average growth rates of per capita GDP in 1970-2013, %,

Ycap – logarithm of per capita PPP GDP in 2000,

CA – average current-account balance to GDP ratio in 1970-2013, %.

This regression does not imply causality, but shows that growth and current-account surpluses more often than not go hand in hand.

savings. The growth of exports stimulates the economy, creating a virtuous circle of high saving and investment rates (see the section on global imbalances). A few countries thus enjoyed surpluses on both current and capital accounts (box III.2). This is associated with an accumulation of reserve assets, part of which are essentially recycled back into developed countries as capital and typically held in developed-country government bonds. This phenomenon runs contrary to the objectives of capital-account liberalization.

Pitfalls of short-term capital flows

Since the early 1980s there have been several waves of large short-term capital flows to developing countries, but not one of them resulted in a growth miracle. On the contrary, large waves of short-term capital inflows often ended in financial crises (Krugman, 2009). This was largely owing to procyclical capital flows—induced by irrational exuberance and herding behaviour—as well as the short-term nature of many of these flows, which often induced currency and maturity mismatches, leading to sudden reversals of capital flow.

The impact of sudden surges or exits of short-term capital flows can seriously undermine sustainable development

The impact of sudden surges or exits of short-term capital flows can seriously undermine sustainable development, as was seen in past financial crises in the Russian Federation, East Asia and Latin America.⁵ For example, a sudden surge in outflows generally causes large exchange-rate depreciation, which raises the costs of servicing foreign-currency denominated debt. This can force firms into bankruptcy, destroy jobs and increase macroeconomic instability. Bankruptcies among exporters can also result from surges in inflows, which can suddenly appreciate the exchange rate, thereby making exports less competitive. Contrary to the claim by the proponents of capital-account liberalization, short-term capital flows do not contribute to the deepening of the domestic financial sector (Stiglitz and others, 2006). Instead, they may increase the fragility of the domestic financial sector and increase the risk of financial and banking crises as observed in South-East Asia during 1997-1998. In sum, short-term capital flows cannot be regarded as part of sustainable finance. Additionally, one recent International Monetary Fund (IMF) study finds that capital-account liberalization has contributed to a rise in inequality, arguing that foreign capital is more complementary to skilled workers, which can increase wage gaps and inequality (Furceri and Loungani, 2013).

The link between open capital accounts and increased volatility is now relatively well understood. In 2012, the IMF developed an institutional view which recognized that capital flows “carry risks, which can be magnified by gaps in countries’ financial and institutional infrastructure” (International Monetary Fund, 2012, p. 1). Nonetheless, capital-account liberalization continued to be encouraged in practice; they are frequently included in bilateral and regional trade agreements between developed and developing countries, even for countries such as Chile, which had previously used capital-account restrictions effectively.⁶ The AAAA thus includes an agreement for countries to use necessary macroeconomic policy adjustment, supported by macroprudential regulations and, as appropriate, capital flow management measures when dealing with risks from large and volatile capital flows. The AAAA also contains a pledge that trade and investment agreements would have appropriate

⁵ For more on these crises, see Muchhala, ed. (2007); Dasgupta, Uzan and Wilson, eds. (2001); and De Paula and Alves (2000).

⁶ See Article 9.8 and Annex 9-E of the Trans-Pacific Partnership (TPP) Agreement. Chile negotiated a special clause to the TPP, which allows it to maintain reserve requirements on capital transfers, but the clause limits these in size and duration.

safeguards that protect the public interest by preventing a constraint in domestic policies and regulation.

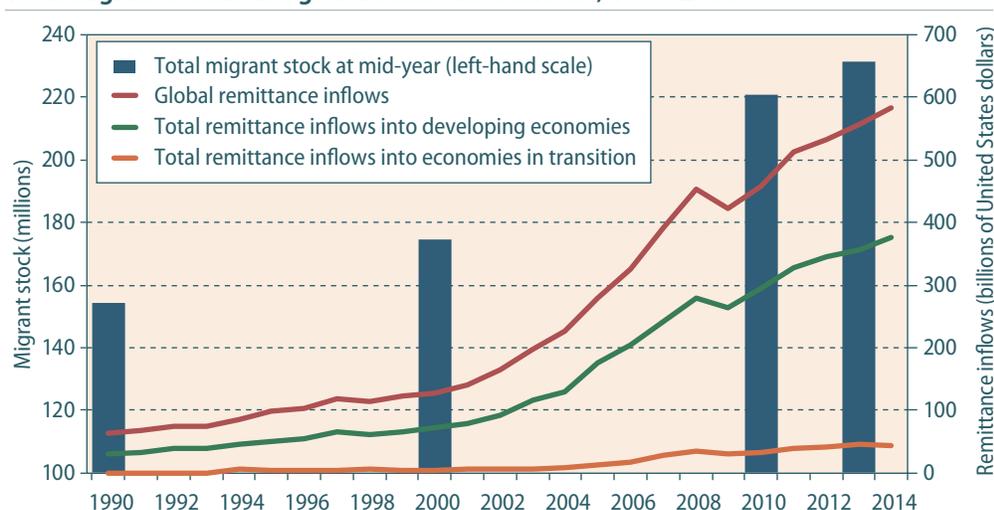
Remittance flows: rising, but different

While more stable than most private capital flows, personal remittances have also been affected by the weakened global economy (figure III.6). The World Bank expects the growth rate of remittance flows to developing countries and economies in transition to decline in 2015 because of subdued growth in Europe and the Russian Federation. This follows the enormous growth of remittances over the last 15 years, to reach more than \$580 billion in 2014 (with \$436 billion to developing countries).⁷ Remittances are resource transfers between resident and non-resident households (generally in the form of wages transferred from migrant workers to their families) reported in a country's current account, which includes the balance of trade, net income from abroad and net current transfers.

Some countries are highly dependent on remittance flows as indicated by the remittance share in their gross domestic product (GDP) (figure III.7). For example, remittances account for over 40 per cent of Tajikistan's GDP, even though in volume terms, it is not one of the large remittance-recipient countries. On the other hand, India, which receives the highest amount of remittances, has a flow accounting for less than 5 per cent of its GDP. Obviously, the size of remittances in relation to a country's GDP has important implications for its economy, even though the impact of remittances on economic growth and development in recipient countries depends on a variety of factors. In many ways, remittances have a similar effect on the economy as wages earned domestically. Similar to domestic wages, remittances increase the disposable income of households, stimulating consumption with a multiplier effect on the economy. Their impact on savings and investment, and hence on growth, will depend, to a large extent, on financial inclusion.

Remittance flows to developing countries have been restrained by the global slowdown

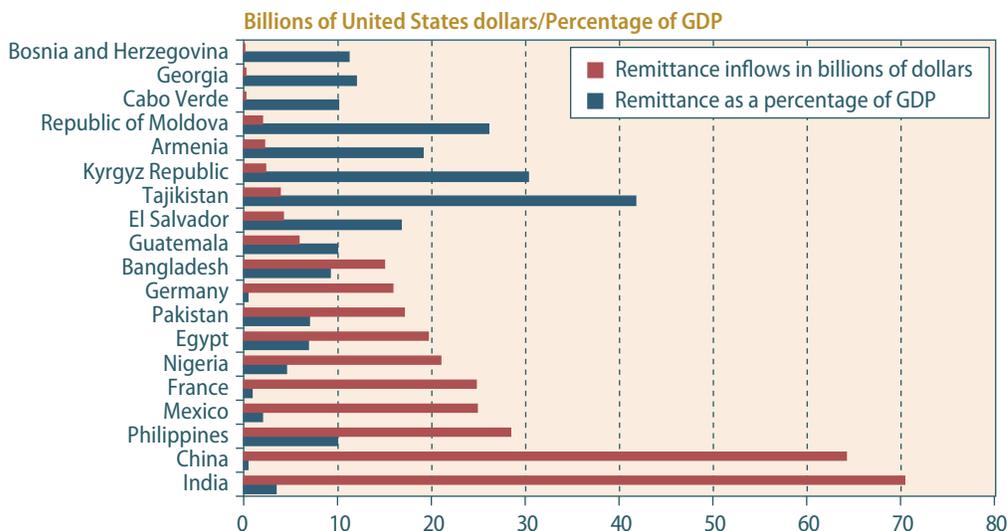
Figure III.6
Total migrant stocks and global remittance inflows, 1990–2014



Source: World Bank.

7 Overall remittance flows from World Bank; additional figures from World Bank (2015c).

Figure III.7
Selected countries' remittance inflows, 2014



Source: World Bank/World Development Indicators.

Remittances are predominantly spent on smoothing consumption and on human capital

Unlike domestic wages, remittances have cross-border and balance-of-payments effects. For example, remittances can support the balance of payments (figure III.8) and help cover a country's trade deficit or foreign-exchange shortfall. However, large-scale inflows of foreign exchange also strengthen the exchange rate, which can erode domestic competitiveness—a phenomenon known as Dutch disease. The impacts on the balance of payments and the exchange rate will depend on how the incoming funds are ultimately used. Existing data indicate that remittances are predominantly spent in smoothing consumption and on human capital, such as expenditure on education and health care, although there is some evidence of increased direct investment of remittances into small and medium-sized enterprises (SMEs) and real estate in some countries.⁸ When primarily used for consumption, remittances are more likely to cause inflationary pressure and appreciation of the exchange rate (Narayan, Narayan and Mishra, 2011).⁹ On the other hand, the use of remittances in productive investment, such as in SMEs, should help prevent inflationary pressure and consequent loss of competitiveness. Access to the formal financial system can help remittance-recipient households to save and facilitate investments.

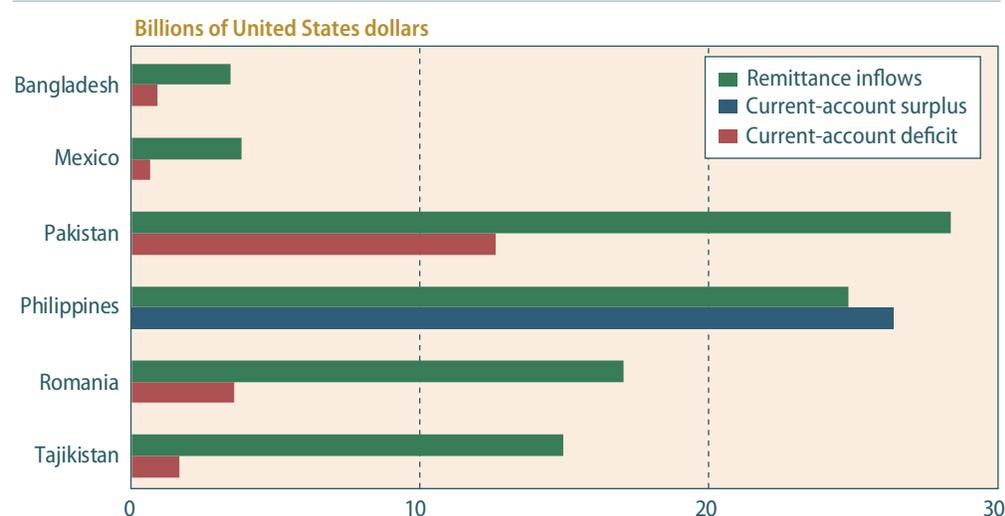
Remittances are also directly linked to economic cycles in both the host and home countries, and some studies have found that remittances demonstrate countercyclical tendencies (Frankel, 2010). Other studies, however, have found that remittances are procyclical in most countries, especially those with less financial depth (Giuliano and Ruiz-Arranz, 2009). There is evidence that remittances regularly increase after natural disasters (Mohapatra, Joseph and Ratha, 2009). Nepal is the most recent example, where shortly after the devastating earthquake in April 2015 remittance inflows increased by 26.3 per cent.¹⁰ High

⁸ See, for example, Yang (2008).

⁹ For Bangladesh, one study found that a 1 per cent increase in remittance inflows will raise inflation by 0.72 per cent, while food inflation would rise by 1.91 per cent. See Roy and Rahman (2014).

¹⁰ See <http://kathmandupost.ekantipur.com/news/2015-10-03/remittance-jumps-to-rs53b-in-first-month.html>.

Figure III.8
Current-account balances and remittance inflows in selected countries, 2014



Source: World Bank.

levels of remittances might be an indicator that insufficient domestic investment in productive enterprises is serving as a push factor for emigration.¹¹

Better access to financial services can lower the high remittance transaction costs in underserved areas, as called for in the AAAA. Combining remittance receipts with broader access to other financial services can increase the impact of remittances on growth by facilitating savings and investments. If a portion of earnings is saved in the financial system, financial institutions can turn such savings into productive investments, even if the household ultimately uses the earning for consumption. Pools of small savings in rural areas can allow an expansion of support to agribusiness and SMEs. Indeed, one study estimates that if the predominantly informal savings of remittance receivers in four Central American countries could be mobilized, formal savings would increase by \$2 billion, representing about 1.7 per cent of GDP (Orozco and Yansura, 2015). The AAAA stresses the need to protect labour rights in accordance with International Labour Organization core labour standards and that destination countries should promote and effectively protect the human rights of all migrants.

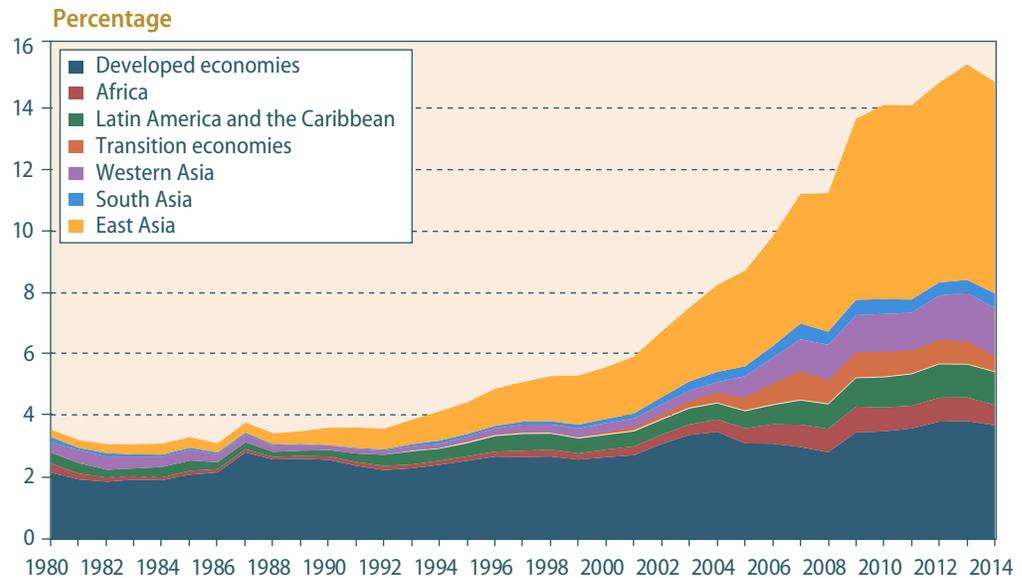
Global imbalances and international reserves accumulation

International reserve accumulation by monetary authorities constituted the most prominent macroeconomic policy shift of the late 1990s. Accumulated reserves increased from 5.9 per cent of world gross product, or \$1.9 trillion in 2000, to 14.4 per cent or \$9.3 trillion in 2010 (figure III.9). However, since 2014, the process of accelerated reserve accumulation stopped, mirroring the decline in capital inflows (figure III.2). Reserves in developing and transition economies increased by only \$172 billion in 2014 (table III.1). In 2015, reserves in developing and transition countries are expected to decline by nearly \$440 billion in

Since 2014, the rapid accumulation of reserve assets in developing and transition economies has halted

¹¹ Economic theory describes push and pull factors in migration decisions as being equally important, however recent evidence on migration to OECD countries finds that origin country unemployment rates are not significantly correlated with migration. See Mayda (2010).

Figure III.9
Foreign-exchange reserves as a percentage of world gross product, 1980–2014



aggregate. It remains to be seen whether this is a temporary interruption of the trend or a permanent change.

Countries accumulate reserves as “self-insurance” against potential external shocks in the current account (often due to fluctuations in commodity prices) and in the capital account (often due to volatility of capital flows). Reserve accumulation also allows countries to better manage and smooth capital flow cycles, and can also be a by-product of export-led growth strategies that maintain an undervalued currency through interventions in the currency market (Griffith-Jones and Ocampo, 2010). The level of development, investment climate, the accumulated level of reserves and the level and dynamics of foreign trade can also explain reserve accumulation by a country. Empirical research indicates that there is no single explanation for reserves accumulation that applies to all countries at all times (International Monetary Fund, 2010). One study finds that deliberate policy-induced foreign-exchange reserve accumulation is an important explanatory variable in growth regressions, implying that development models involving accumulation of reserves may help spur long-term growth in developing countries (Polterovich and Popov, 2004).

Countries can also accumulate reserves to prevent asset price bubbles in the short run, and to prevent the overvaluation of the currency in the long run, both of which can have significant adverse consequences on macroeconomic stability and long-term growth. Consequently, reserve accumulation can have positive externalities on the production and export of tradables and industrial development and can thus be a feature of the country’s development model. Undervaluation of the exchange rate can increase the competitiveness of exports, without the need for sector- or firm-specific subsidies or interventions.

Reserve accumulation can, however, be costly, particularly in terms of the opportunity cost of forgone domestic investment. While it may ease upward pressure on the exchange rate, it also maintains upward pressure on the costs of capital for domestic borrowers. Furthermore, the strategy of reserve accumulation by all countries might not be sustainable because it suffers from a fallacy of composition. To be sustainable, there must be at least

one country—as has been the case with the United States—that is large enough and willing to run consistent and ever larger current-account deficits and provide reserve assets to the rest of the world. The mechanism facilitates an almost unlimited supply of credit from reserve-accumulating countries, resulting in increased global liquidity. This, in turn, has to be intermediated by the financial system, which, as discussed, has not been effective in allocating resources to support investment growth and sustainable development.

International financial stability and growth

A primary role of the international financial system is to channel savings to productive uses and support investment necessary for inclusive and sustainable economic growth. The existing system does not adequately allocate resources for long-term sustainable development needs (box III.3). Furthermore, vulnerabilities and instability in the financial system pose risks to the real economy and sustainable development, as demonstrated by the global financial crisis. Vulnerabilities include volatile capital flows (discussed above) and additional risks generated by the financial sector, as well as risks posed by debt overhangs and debt distress. Ultimately, stability and sustainability should be mutually reinforcing: stable markets encourage greater investment, while long-term investment can play a stabilizing, countercyclical role. There are, however, trade-offs between stability and enhancing access to credit necessary for achieving sustainable development, particularly in higher risk areas. The balance between stability and access is at the crux of the AAAA, which emphasizes the importance of policy and regulatory environments that support both financial market stability and access to credit and financial services in a balanced manner. In its strategy for implementing the 2030 Agenda for Sustainable Development, the IMF also prioritized “policy analysis and capacity building to balance financial market deepening with financial stability” and promoting “a stable and inclusive financial system that mitigates the trade-offs between financial deepening and financial stability” (International Monetary Fund, 2015d, p. 2).

The existing international financial system does not adequately allocate resources for long-term sustainable development needs

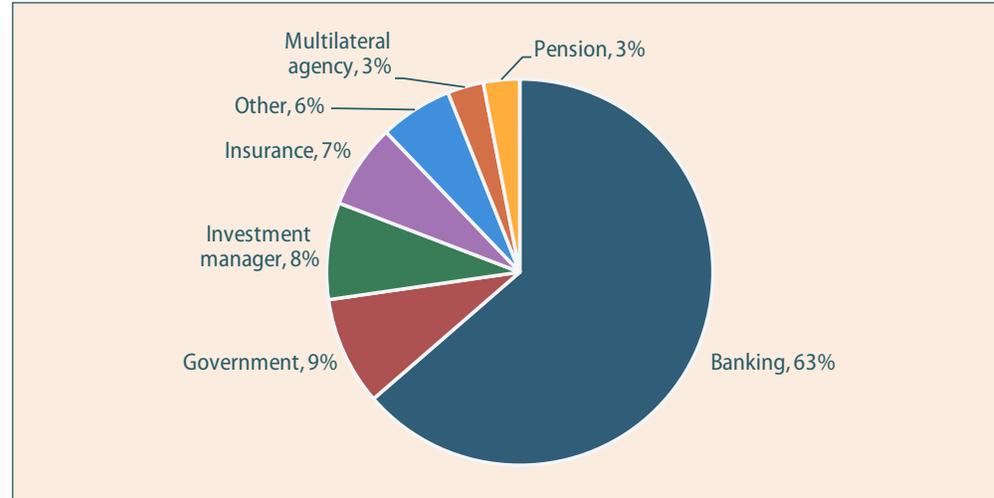
The financial sector: stability, financial depth, and access

The current international financial regulatory standards have focused on stability and, in particular, ensuring the safety and soundness of financial institutions, as well as reducing systemic risks. There is, however, growing recognition of the effect of regulations on incentives for investment, and on what have come to be known as the “unintended consequences” of the impact of financial regulations on access to credit.

Concerns have been expressed about the potential but unintended negative impact of Basel III regulations on long-term financing, trade finance, SMEs and other areas of importance for achieving sustainable development (Financial Stability Board, 2012). For example, international banks had been major providers of project finance for infrastructure (figure III.10). However, there are concerns that Basel III’s treatment of risk weights for long-term finance in developing countries may constrain infrastructure lending by commercial banks going forward. The Financial Stability Board (FSB) has started surveying its members about unintended consequences of Basel III. As of their last survey, FSB members did not report any empirical evidence or data suggesting that internationally agreed regulatory reforms have had material adverse effects on the provision of long-term finance in their jurisdictions (Financial Stability Board, 2014). However, it was emphasized that it is too

Figure III.10
Global project finance by funding institution, January 2012–January 2013

Percentage



Source: World Economic Forum (2014); Standard & Poor's Rating Services (2013).

early to fully assess the effect of regulatory reforms, since many of them are still in the early stages of implementation and some are still in the process of being developed.

On the other hand, there has been an emphasis on increasing access to credit and on developing and deepening financial and capital markets—often without sufficient concern for issues of stability and sustainability (UN System Task Team, 2013). A common argument is that the deepening of financial sectors is associated with greater investment and stronger economic performance (Levine, 2005). However, preliminary research indicates that for countries with shallow financial markets, a larger financial system is associated with greater productivity growth (Cecchetti and Kharroubi, 2012; Cottarelli and Jaramillo, 2012), but in more developed markets this relationship is unclear, with financial instability increasing with financial sector depth (Sahay and others, 2015). One possible explanation is that credit growth is not directed towards productive investments. Excess market liquidity can increase financial market volatility and risk, particularly when markets are short-term oriented.

Policy intervention can contribute to increasing access to finance for small enterprises

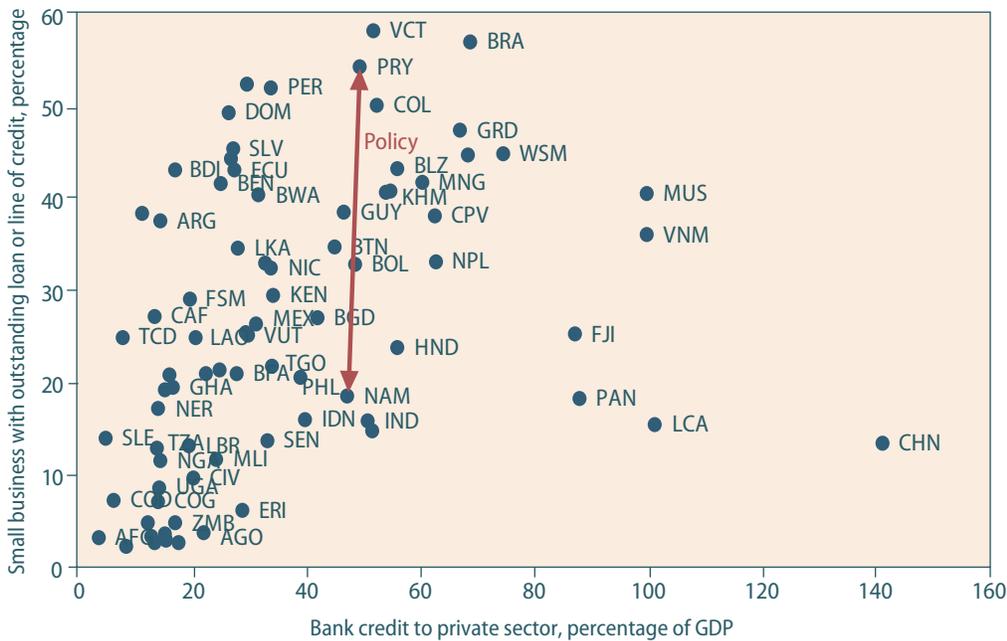
Furthermore, the correlation between financial depth—measured by domestic credit to the private sector as a percentage of GDP—and access to banking-sector financing by small enterprises is low in a large number of countries (figure III.11). The large differences in small firm access to credit among economies with similar levels of financial depth suggests that there exists a space for policy interventions that can contribute to increasing access to finance for small enterprises.

In developed countries, much of the growth in financial depth has been through shadow banking, which includes financial intermediation that is often outside of the regulatory framework.¹² Shadow banking entities can create leverage or engage in maturity and liquidity transformation. Its growth has been driven by a multitude of country-spe-

¹² The term “shadow banking” is sometimes used to refer to unregulated financial intermediation that facilitates the creation of credit; however, the FSB defines shadow banking as credit intermediation involving entities and activities outside of the regular banking system.

Figure III.11

Financial depth vs. financial access by small firms, most recent year



Source: World Bank Enterprise Surveys, World Bank World Development Indicators.

Notes: Most recent data for 80 developing countries from Asia, Latin America and sub-Saharan Africa with data from 2009 or later. See table J in the Statistical Annex of this publication for a definition of country codes.

cific factors, including hedging activity, financial innovation, regulatory or tax arbitrage, efforts to increase leverage cheaply and reap high returns, and efforts to take advantage of information asymmetries, as well as means to increase financial inclusion.¹³ According to FSB data, shadow banking grew by \$5 trillion during 2013-2014, to about \$75 trillion worldwide. The 2008 crisis exposed risks associated with unregulated shadow banking, which dramatically increased leverage in the system, with a lack of transparency regarding counterparty exposures, insufficient collateralization, uncoordinated default management, and concerns about market misconduct. There is a need to continue to enhance central counterparties' resilience, as well as recovery planning and resolvability. The FSB has spearheaded the process of designing a framework for managing systemic risks in the shadow banking system with the goal of preventing impacts on the regulated banking sector.

While shadow banking in emerging markets is experiencing the fastest growth, the sector has a different profile in these economies than in developed countries. In some countries, it includes elements of inclusive finance (i.e., non-bank financial intermediaries that fill an important credit gap, such as unregulated microfinance institutions). However, the growth of for-profit microfinance, along with recent crises in some microfinance institutions, confirms the importance of including all forms of financial intermediation in a robust regulatory framework that balances safety and soundness with access, as highlighted in the AAAA.

In view of the 2030 Agenda for Sustainable Development, the international community may wish to explore new methods for regularly assessing the impact of international financial regulatory reforms on access to long-term and sustainable finance in developing

It is important to include all forms of financial intermediation in a robust regulatory framework that balances safety and soundness with access

13 For a fuller discussion, see United Nations (2013), box III.1.

countries. This will support the goal of reaching the SDGs, particularly for countries that are not members of the FSB.¹⁴

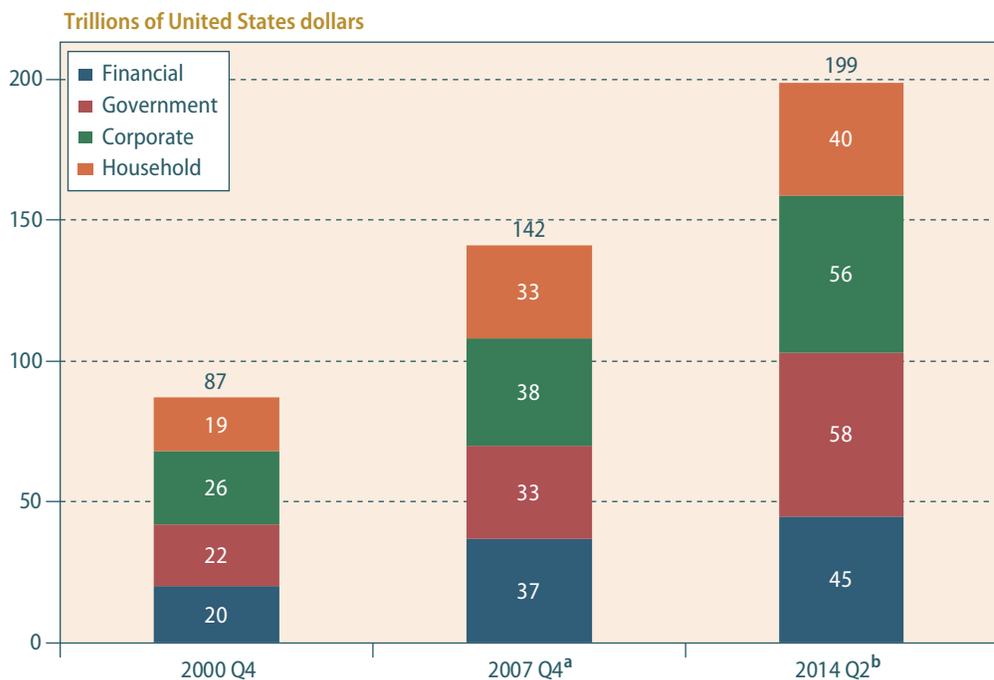
Debt and debt sustainability

One of the triggers of the global financial and economic crisis in 2007-2008 was the build-up of excessive debt and leverage in the private financial sector in many advanced economies. The risks emanating from global debt and leveraging continue in the global economy as global debt is reported to have increased by \$57 trillion between 2007 and the second quarter of 2014 (figure III.12), with government debt accounting for the fastest growth.¹⁵ Developing-country debt accounts for half of that growth, with China alone accounting for 37 per cent of the global growth in debt (Dobbs and others, 2015, p. 16).

The global debt securities market—meaning debt that is publicly traded and excluding bank loans—grew from just over \$60 trillion in 2007 to about \$100 trillion by 2013 (figure III.13) (Gitlin and House, 2015, p. 5).

Overall, traded corporate debt has been roughly stable since the financial crisis in 2008, with government debt accounting for most of the increase. However, emerging-market corporate debt has risen from \$4 trillion in 2004 to well over \$16 trillion in 2014

Figure III.12
Global stock of debt outstanding



Sources: Bank for International Settlements; Haver Analytics; IMF World Economic Outlook; national sources; McKinsey Global Institute analysis.

Note: Constant 2013 exchange rates.

^a Figures do not sum to total, because of rounding.

^b 2014 Q2 data for advanced economies and China; 2013 Q4 data for other developing countries and economies in transition.

¹⁴ See, for example, United Nations Conference on Trade Development (2015d, chap. IV), for further discussion.

¹⁵ Total debt is defined as household, corporate, government and financial sector debt and stood at 286 per cent of GDP in 2014 Q2.

Box III.3

Development finance in a changing climate

The year 2015 is projected to be the hottest since recordkeeping began; the global temperature is now 0.85 degrees higher than pre-industrial levels (National Oceanic and Atmospheric Administration, 2015). As the costs related to climate change intensify, impacts on public finance, financial institutions and businesses, not to mention human life, will become more profound. However, the current incentives structure is such that corporate management at publicly listed companies is incentivized to focus on short-term equity prices rather than longer-term risks to businesses. In addition, the full cost of climate change will not be borne by any one company, making it a classic externality. The Addis Ababa Action Agenda (AAAA) includes commitments to increasing regulations, designing incentives to change production and consumption patterns, and aligning private and public behaviour with a low-emissions and climate-resilient economy.

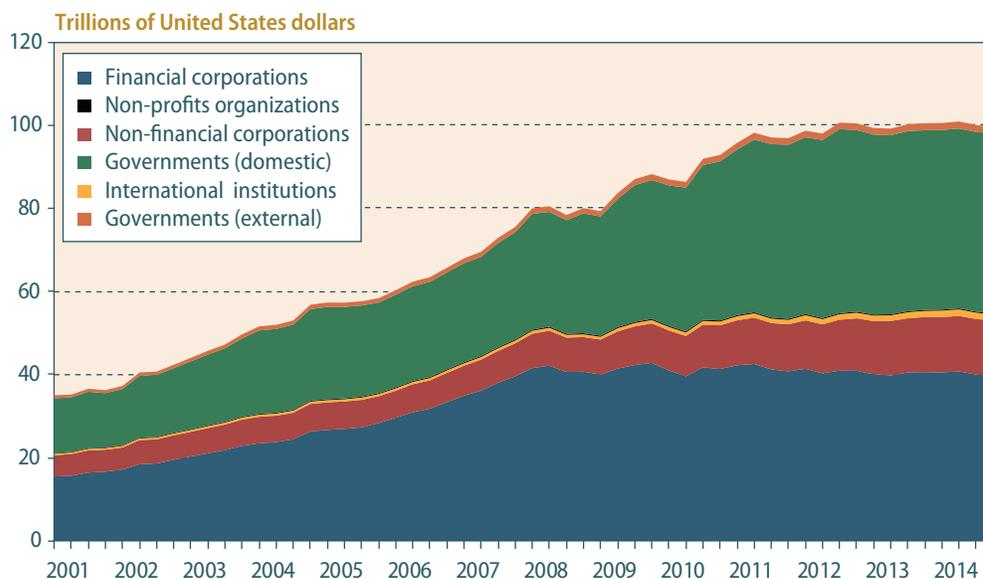
Amidst entrenched policies that perversely support an unsustainable energy economy, 2015 signalled renewed momentum for nations to review and reform their ecological footprint in the lead-up to the twenty-first climate change conference in Paris in December 2015. In all, 119 intended nationally determined contributions (INDCs), or national climate plans, were submitted prior to the conference, covering 80 per cent of global emissions (United Nations Framework Convention on Climate Change, 2015a), and have the capability of limiting the forecast temperature rise to about 2.7 degrees Celsius by 2100 (United Nations Framework Convention on Climate Change, 2015b). This could be achieved either through direct regulation of emissions or by having private actors internalize the cost of emitting greenhouse gases into the atmosphere. Efforts at the latter are proliferating by pricing carbon through taxation or through emissions trading systems under cap-and-trade (CAT) markets.^a

Globally, a lack of coherence characterizes carbon market policy and other initiatives to price pollution more generally. The spread on carbon pricing is significant, ranging from the Swedish valuation of carbon at \$130 per ton to the Mexican carbon tax at less than \$1 per ton (World Bank and Ecofys, 2015, fig. 6). The INDC system also adheres to a pledge and review framework for climate action, which is a fragmented, bottom-up model for global climate action. The lack of coordinated environmental policies poses two major information gaps for private actors to effectively internalize the cost of emitting greenhouse gases and encourage more effective financial intermediation: (i) the economic value of potential damages arising from climate change is uncertain and variable, and (ii) there is a lack of reliable information on the cost of mitigating greenhouse gas emissions. Furthermore, there is a risk of “carbon leakage”, as firms and industries may respond to robust carbon mitigation regimes by migrating to jurisdictions where emissions costs are lowest. The World Bank’s review of the carbon market suggests that leakage has not yet significantly materialized, perhaps owing to the predominance of other investment factors shaping the location decisions of emissions-intensive industries. The AAAA stresses the need for regulations and policies that shift incentives and realign financing with low-carbon investments.

At the same time, developed countries have committed to deliver \$100 billion annually for climate finance by 2020. According to the United Nations Climate Tracker, in 2013-2014, donor countries pledged \$62 billion towards climate mitigation and adaptation activities and multilateral development banks offered \$15 billion (Organization for Economic Cooperation and Development, 2015b). However, it remains unclear how these figures are calculated, how much is double-counted as official development assistance (ODA), and whether it will be annually recurring. According to the most recent (2013) project-level data from the Organization for Economic Development and Cooperation Development Assistance Committee, only \$13 billion of climate finance was administered as a grant. While this number may be incomplete, it points to a credible assumption that the bulk of climate finance is private finance or loans (concessional and non-concessional). In addition, it remains unclear how the funds will be allocated between climate change mitigation—which contributes to a global public good and is generally geared towards middle-income countries—and adaptation—which is generally geared towards more vulnerable countries and for which there is a higher overlap with development impact. In addition, there is no international system for defining and tracking climate finance, which gives rise to the possibility of double counting of ODA and climate commitments. The Green Climate Fund, which was established under the Copenhagen Accord in 2009 to support climate financing goals, currently has pledges of only \$10 billion. There is also concern that there are insufficient incentives to guarantee that the pool of climate finance flows to those hardest hit and least able to respond to climate impacts, such as the LDCs and small island developing States. The AAAA underscores the need for transparent methodologies for reporting climate finance.

^a CAT market is a system whereby a regulatory entity sets a limit (a cap) on total pollution units, or “emissions rights” within a boundary, but allows firms the ability to sell their emissions rights (or trade) among each other. The result is that emissions occur at locations where it would be costliest to avoid them, while firms that can increase their emissions efficiency are rewarded with revenue from the sale of their emissions rights.

Figure III.13
Global debt securities market, 2001–2014



Source: Gitlin and House (2015), p.5.

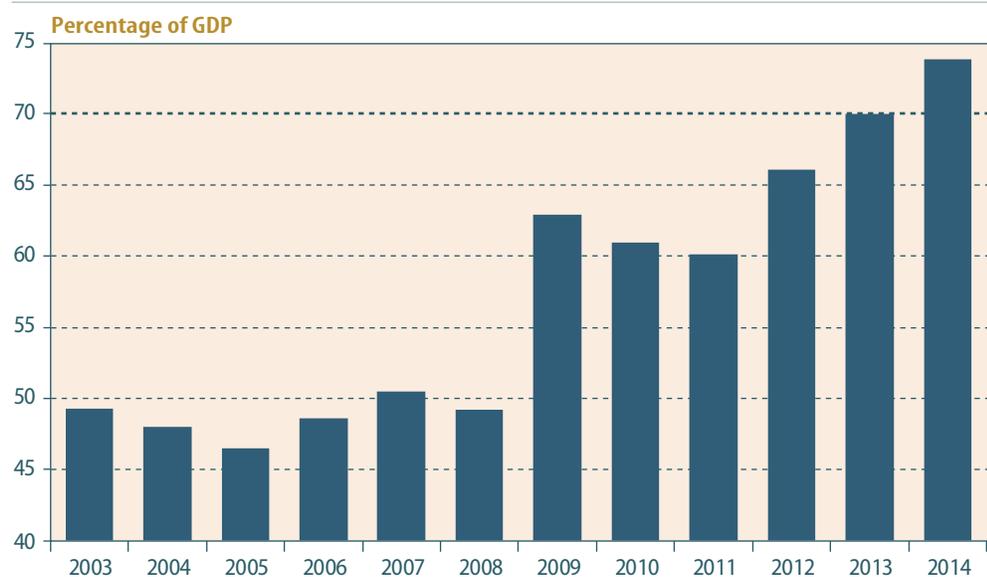
(figure III.14) (International Monetary Fund, 2015e, chap.3). Many emerging-market firms have borrowed in foreign currency to take advantage of low international interest rates, with 45 per cent of emerging-market corporate debt (excluding Chinese firms) since 2010 being denominated in foreign currencies, compared to 40 per cent before 2007 (ibid., p. 97). A recent study has found that a significant portion of the proceeds of borrowing in Latin America are being held in cash deposits, rather than being invested in corporate expansion (Inter-American Development Bank, 2014). Analysis at the level of global firms suggests that such borrowing by non-financial corporates has, in part, been driven by interest-rate differentials. This may indicate that they are participating in carry trade activities by keeping United States dollar-denominated bond issuance on their balance sheets in cash and liquid assets (Bruno and Shin, 2015). These partly explain the growing disconnect between the growth in finance and real sector activities, as discussed above, as well as in chapter I.

There is a growing risk that some debtors, public or private, will have problems refinancing their foreign-currency-denominated debt when United States interest rates rise, as discussed in chapter I. While many countries have strengthened bank balance sheets and reduced currency mismatches through macroprudential regulations—to the extent that currency mismatches remain on non-financial firms' balance sheets—currency depreciations can still have systemic implications, including through a rise in non-performing loans (Acharya and others, 2015). The risks arising from non-financial corporate issuance of foreign currency-denominated bonds are compounded when corporate debt is backed by sovereign guarantees. Even when the debt is not formally backed by the sovereign, corporate bailouts, particularly in the financial sector, exacerbate the risk of sovereign debt problems.

Sharp depreciations combined with interest rate increases may overwhelm the ability of companies to repay debt and prohibit new borrowing, particularly for corporations that have not used financial instruments to mitigate these risks, or that do not have sufficient foreign-currency earnings to cover their foreign-currency debt exposures. Bankruptcies may follow, as happened in the context of the Asian financial crisis in 1997-1998.

Some debtors will have problems refinancing their foreign-currency-denominated debt when United States interest rates rise

Figure III.14
Emerging-market corporate debt, 2003–2014



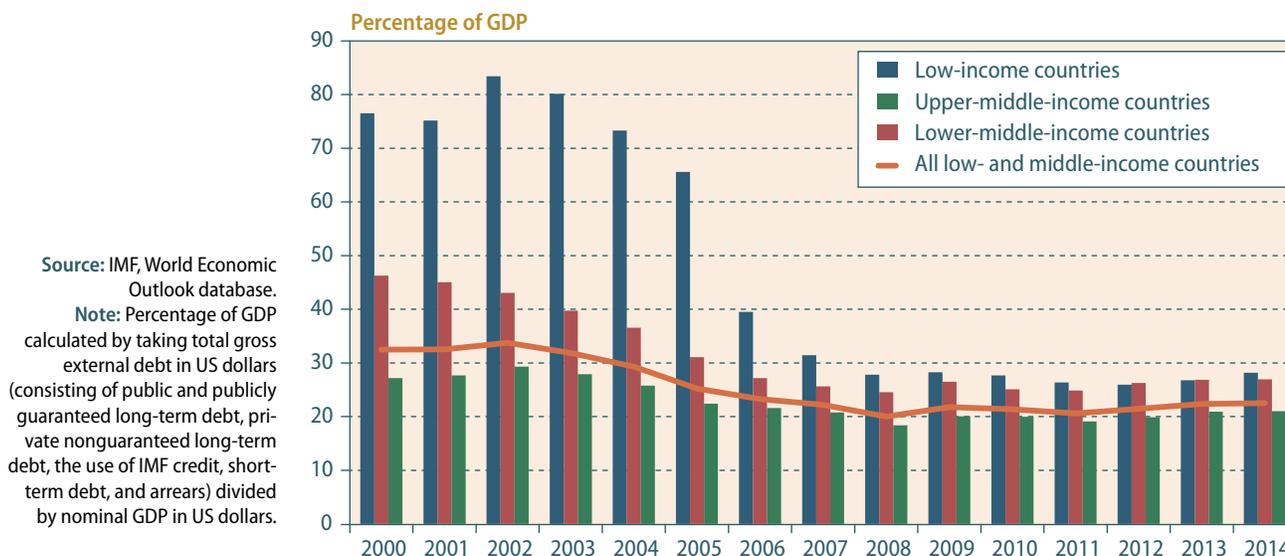
Source: International Monetary Fund (2015e).

Despite the increased foreign-exchange borrowing by non-financial corporates, aggregate (public and private) external debt of developing countries, which measured 23.2 per cent of their GDP in 2014 (figure III.15), appears moderate. Nonetheless, the aggregate masks the rapid build-up of debt in some countries. Some low-income countries issued bonds on international capital markets during the period of low interest rates. Rwanda's ten-year bond was priced with a yield of 6.875 per cent in April 2013, a time of high market liquidity. However, subsequent issuances from African countries have all yielded above 8 per cent, with some as high as 10 per cent. There is a risk that some countries will have difficulties servicing these debts when interest rates rise, potentially leading to new sovereign debt crises. Among low-income countries, many are caught in debt difficulties and exhibiting persistently high external debt-to-GDP ratios. Using a broader set of indicators and analysing both external and public sector debt, as of April 2015, 3 low-income countries are in debt distress, 13 are at high risk, 32 are at moderate risk, and only 22 low-income countries are at low risk of debt distress.¹⁶ The environment of moderated global growth described in chapter I will make it more difficult for countries with high debt burdens to grow quickly enough to reduce their risks of debt distress.

To help attenuate the risks, Governments can take a number of actions at the domestic level, including enacting macroprudential policies and reforming domestic corporate insolvency procedures, as endorsed in the AAAA. Sovereign debt issuers can also explore GDP-linked bonds, commodity-linked bonds, or other warrants that can help attenuate the macroeconomic risks. While financial market participants have thus far not been willing to buy these at reasonable prices, official lenders should consider these risk sharing instruments as ways to reduce the risks of default for borrowing countries. At the same time, the international community needs to put in place an effective and credible framework to ensure that creditors and debtors are taking appropriate responsibility for borrowing. In the

16 See <https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf>.

Figure III.15
External debt of developing countries, 2000–2014



case of sovereign borrowing, the current incentives reward creditors with risk premiums for higher risk credits, yet strongly discourage that losses be imposed on creditors in the case of debt distress. Once a country is in debt distress, its options are more limited. While some countries, such as Ecuador, have had success with buybacks, these are difficult to do because of the need for finance and the rapid response of market prices to such market activity. There is, thus, a new urgency to promote responsible borrowing and lending, as Member States committed to doing in the AAAA.¹⁷

**Improvement is needed
in the process for
resolving sovereign
debt crises**

The process for sovereign debt restructuring remains fragmented, ad hoc, and uncertain, carrying high costs for debtors and, in the case of systemically important countries, a threat to financial stability. Although sovereign debt restructurings do take place, these are often “too little too late”. The most recent example is Greece, which also illustrates how the official sector often pays for the exit of private capital from countries in debt crisis. The cases of Argentina and the Democratic Republic of the Congo have illustrated the problems in creditor coordination, hold-outs and the costs of litigation by hold-out creditors (Schumacher, Trebesch and Enderlein, 2014).

Following the 2014 United States court judgement against Argentina and in favour of hold-out creditors (United Nations, 2015b, box III.I), the International Capital Markets Association and the IMF endorsed reforms to contractual clauses in sovereign bonds, including enhancing collective action clauses (International Monetary Fund, 2015f). Since then, a number of countries have adopted key features of these recommendations in their new international sovereign bond issuances, although this still leaves out the outstanding stock of bonds estimated to be approximately \$915 billion (International Monetary Fund,

¹⁷ In September 2015, the United Nations General Assembly adopted a resolution specifying a set of nine basic principles to guide how a government and its creditors should go about reducing repayment obligations when they become unpayable (United Nations, General Assembly, 2015c). See http://www.un.org/ga/search/view_doc.asp?symbol=A/RES/69/319&Lang=E.

2015g). Correspondingly, the AAAA affirms the need to further improve the processes for the resolution of sovereign debt crises and emphasizes the need for mechanisms to deal with hold-outs in a debt restructuring.¹⁸

International cooperation and public resources for sustainable development

As reiterated in the AAAA, the mobilization and effective use of public resources is central to the pursuit of sustainable development. The AAAA stresses the importance of ODA, but also brings fresh thinking to the challenges of international public finance. It emphasizes the importance of international tax cooperation in boosting efficient resource mobilization and the possibility of public development banking serving as a complement to the private financial system.

International tax cooperation and illicit capital flows

Tax evasion, tax avoidance and illicit financial flows have become a major difficulty in efficient resource mobilization.¹⁹ The ability to raise revenue domestically is not only a function of domestic policies and institutions but is also strongly affected by international tax norms, the policy environment, and the prevalence of international tax avoidance and evasion.²⁰ Indeed, in an interdependent world with high levels of capital mobility, international tax norms function as a global public good. International rules have important distributional implications, as the structure of tax agreements affects the distribution of resources between corporations and Governments, as well as among Governments.

In October 2015, the Organization for Economic Cooperation and Development (OECD) provided a glimpse of the extent of tax avoidance and evasion by multinational enterprises (MNEs). Its report “confirms that profit shifting is occurring, is significant in scale and likely to be increasing, and creates adverse economic distortions” (Organization for Economic Cooperation and Development, 2015c, p. 16). Their conservative estimate is that between 4 and 10 per cent of corporate income tax is evaded, meaning between \$100 billion and \$240 billion annually.

Setting tax norms

The global response to illicit financial flows will need to include reforms to international tax norms. MNEs often transact across borders through multiple branches or subsidiaries, but for purposes of taxation, operations in each branch or subsidiary are generally treat-

Tax evasion, tax avoidance and illicit financial flows have become a major difficulty in efficient resource mobilization

¹⁸ On 12 July 2015, Belgium became the first country to pass a comprehensive law to deal with this problem. Under the new Act, any creditor which is determined by a Belgian judge to be acting as a “vulture” (i.e., one who pursues an “unfair benefit” by purchasing government bonds/receivables) cannot claim more than the discounted price paid for the bonds/receivables. See <http://www.stibbe.com/en/news/2015/september/bru-fin-act-introducing-measures-to-restrict-vulture-fund-activities>.

¹⁹ There is no agreed definition of the concept of illicit financial flows (IFFs), but it is generally used to convey three different sources of IFFs: the proceeds of commercial tax evasion, revenues from criminal activities, and public corruption.

²⁰ See African Union Commission and United Nations Economic Commission for Africa (2015); Kar and Spanjers (2015); United Nations Conference on Trade and Development (2014).

ed separately. When two related companies trade with each other, implicit prices (called transfer prices) are used to attribute profits. The United Nations Conference on Trade and Development (UNCTAD) estimates that about 30 per cent of all international trade is intra-firm trade, which must be accounted for with transfer pricing, valued at over \$6 trillion in 2010 (United Nations Conference on Trade and Development, 2013, p.136).

Transfer mispricing should be addressed through international tax cooperation

Transfer mispricing is one of the most-often-used techniques of MNEs to shift profits to low- or no-tax jurisdictions, irrespective of the actual location of economic activities, and thus reduce their total tax burden. This can frequently be accomplished through the prices applied to intangible goods or services, such as intellectual property, where no clear market price exists. Through such techniques, MNEs can avoid paying taxes in both the MNE home (residence) country and in the country that hosts the economic activity of the MNE (source country). This double non-taxation is a key problem to be addressed through international tax cooperation.

Both the United Nations Committee of Experts on International Cooperation in Tax Matters and the OECD have chosen to use the arm's-length principle enshrined in most bilateral tax treaties. According to the arm's-length principle, transfer prices charged between associated enterprises reflect market prices (i.e., prices charged between independent entities at arm's length), taking into account the circumstances specific to the transaction. However, questions have been raised about the efficacy of this principle, particularly with difficult-to-price assets, such as intellectual property. Alternative approaches would treat profit-maximization as occurring at the level of the MNE itself (unitary taxation), with mechanisms to allocate group profit internationally; for example, allocation could follow a fixed formula agreed in advance and intended as a proxy for the level of economic activity in each jurisdiction (formulary apportionment) (Independent Commission for the Reform of International Corporate Taxation, 2015). In turn, questions have been raised about how effective and beneficial a unitary approach—particularly a global one—would be for developing countries, and whether an agreed formula is even possible.²¹

How taxation is divided between the source and resident country can be critically important to helping developing countries finance sustainable development

To realign taxation with economic substance and value creation, the OECD and Group of Twenty (G20) launched a base erosion and profit shifting (BEPS) project in 2013. A BEPS Action Plan, including 15 action items, was published in October 2015, and endorsed by G20 leaders at their November 2015 summit. The BEPS package includes guidance in eleven substantive areas, including on how MNEs may allocate profits derived from intellectual property, on the use of management fees, and on other intra-group service provision charges, which have been used to shift profits to shell companies in low-tax or no-tax jurisdictions. While the outcome was welcomed by some developing-country Governments and civil society organizations, the initial BEPS focal areas were made without participation of developing countries and did not address the issue of ensuring adequate source-country taxation. The division of taxation rights between source countries, which are frequently developing countries, and residence countries, which are frequently developed countries, is embedded in international tax norms and constrains the ability of developing countries to realize greater resource mobilization from cross-border economic activity, including FDI. How taxation is divided between the source and resident country can be critically important to helping developing countries finance sustainable development.

Furthermore, the complex set of rules developed under the BEPS project will be difficult to implement, even for developed countries with high capacity tax administra-

²¹ See, for example, Spencer (2014).

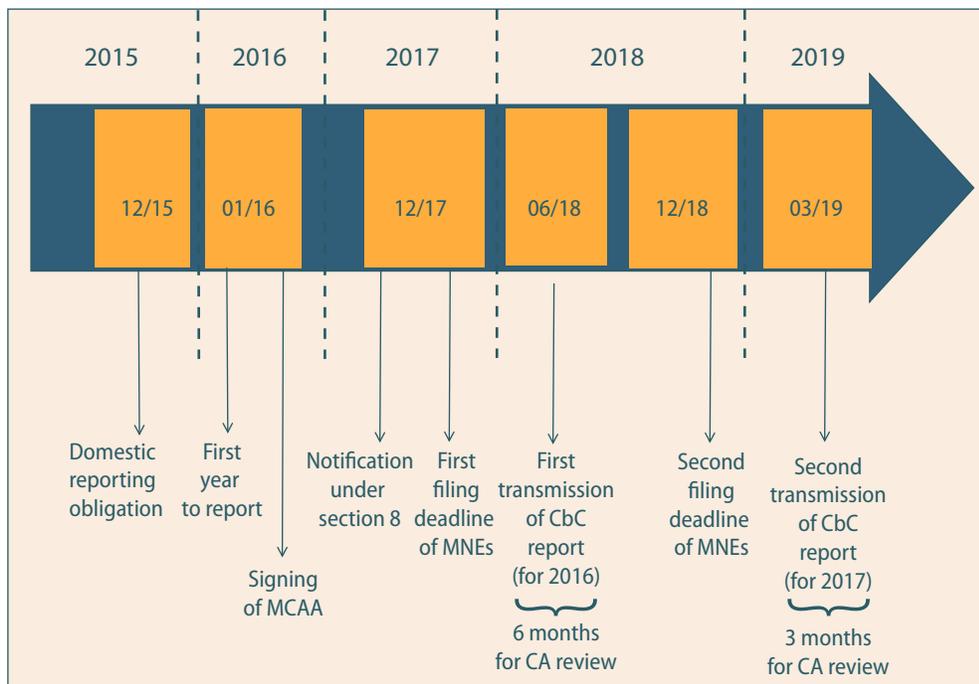
tions. Effective application of the new rules will require extensive knowledge and information on the internal structure of an MNE. While the MNE transfer pricing documentation may include some of the relevant information, full knowledge may require access to country-by-country reports by the MNEs.

The OECD endorsed an implementation package for country-by-country reporting of MNEs in May 2015, whereby the ultimate parent entity of an MNE group would file a country-by-country financial report in its jurisdiction of residence (figure III.16). There are template agreements to facilitate the exchange of such reports, but no central registry exists. Furthermore, the exchange of information will be subject to the existence of bilateral tax agreements and information technology, all of which disadvantage developing countries. The exclusion from country-by-country reporting of MNEs with total consolidated group revenue of less than 750 million euros further limits the policy's benefits. There is also no provision for public transparency on the number of such reports filed or the number exchanged among tax authorities. The inability of developing countries to effectively access such reports will hamper their ability to properly audit the activities of MNEs within their borders, and is likely to widen the gap further between the taxation capacity of developed and developing countries.

Another area of transfer pricing development under the BEPS project has been interest deductibility. Intra-MNE group loans from related parties in low-tax jurisdictions to related parties in high-tax jurisdictions allow companies to transfer profits through interest payments. The BEPS package includes the provision for countries to set limits on interest deductibility of 10-30 per cent of income, but does not link the interest deductions to actual third-party interest costs of the MNE as a whole, making it possible to shift some profit through this channel. Additional provisions that indicate that interest payments should be

Tax authorities, especially in developing countries, may lack the capacity to apportion tax burdens across different arms of an MNE group

Figure III.16
Illustrative timeline for exchange of country-by-country reports



Source: OECD.

based on the actual risks taken by different parts of the MNE will be very hard to implement in practice. Such risk weighting is difficult for bank regulators, even in the most advanced financial markets, as evidenced by the bank solvency problems experienced in the 2008 financial crisis. Again, tax authorities, especially in developing countries, may not have capacity, expertise, or information to correctly judge the financial risk-bearing capacity of different arms of an MNE group.

The BEPS project also included recommendations, but not minimum standards, on the formulation of controlled foreign corporation (CFC) rules. CFC legislation seeks to combat the sheltering of profits for companies residing in low- or no-tax jurisdictions, but the rules are complicated and difficult to implement; countries need help to develop and apply these effectively. Greater beneficial ownership information can improve the operation of CFC rules. While there has been no agreement that all countries should pursue the creation of centralized, public beneficial ownership registries, which require full disclosure of corporate control structures, some countries are proceeding unilaterally. The United Kingdom of Great Britain and Northern Ireland has already legislated to implement a centralized, public beneficial ownership registry, which will be fully operational by April 2016. Norway and Denmark also committed to operate such registries, while in May 2015, the European Union (EU) promulgated rules stipulating that all EU member States must have centralized registries available to country authorities, although it did not require them to be public. United Kingdom dependencies, such as the Cayman Islands, have not yet decided how they will respond to the United Kingdom's policy that they must maintain beneficial ownership registries.

Tax norm implementation

A multilateral instrument to implement new tax norms is needed

The mechanism of implementation of tax norms also has implications regarding which countries gain and which lose. Action 15 of the OECD BEPS package is the development of a multilateral instrument to implement the treaty-related new tax norms that have been agreed by the OECD/G20 countries. Because of the existence of over 3,000 tax treaties, implementation of the treaty-related BEPS outcomes through amendment of existing treaties would be a laborious process. Instead, a BEPS project report concluded that a multilateral instrument would be desirable, and that negotiations for the instrument should be convened quickly (Organization for Economic Cooperation and Development 2015d; 2015e). As of September 2015, 89 countries, including the United States, had indicated their participation in the negotiations for a multilateral instrument.

Some Member States are interested in including binding arbitration for tax disputes, though there is no consensus on the scope of its application. Such arbitration would speed resolution of tax disputes when source countries and resident countries have unresolved differences of opinion on how to allocate the profit of a particular MNE operating in both countries. Yet, sovereignty is often raised as a concern with third party arbitration of disputes, including possible biases towards taxpayers and away from Governments. Overall, many developing countries are wary of being obliged to implement the tax norms that were set in the OECD/G20 forum, as they have not participated equally in the setting of the norms. Progress is also expected in automatic exchange of information for tax purposes. The Global Forum on Transparency and Exchange of Information for Tax Purposes, hosted by the OECD, now has 127 full members. The G20 member States agreed to have automatic exchange of information fully functional by the end of 2017, while other members of the Global Forum have committed to implementing automatic exchange by the end of

2018. However, the majority of developing countries are not ready or able to take advantage of automatic exchange. In particular, they do not have sufficient capacity, including information technology, to fully analyse the large volume of information that would become available through automatic exchange. This would be especially complicated by the need to dedicate human resources to production and dissemination of information on actors from their own jurisdiction.

Capacity-building and accountability

It is clear that capacity in tax administration is important both for improving the effectiveness and efficiency of domestic revenue mobilization as well as in implementation of international tax norms. Currently, many developing countries lack the resources, information technology or human capacity to participate effectively in international tax cooperation. One important first step is using international finance, usually in the form of ODA, to build the capacity of developing countries' tax administration. Estimates of the proportion of ODA devoted to projects that are primarily aimed at tax capacity-building or domestic resource mobilization stood at 0.06 per cent of ODA in 2013, or just \$93 million (figure III.17).²²

A number of important initiatives in this regard were announced in Addis Ababa, including the Addis Tax Initiative, a commitment for developed-country participants to at least double the amount of ODA they give for tax capacity-building. The Addis Tax Initiative includes, among others, Canada, Germany, the Netherlands, the United Kingdom and the United States. The initiative and other commitments made during the Addis Ababa Conference in 2015 are welcome first steps towards the investment needed in domestic resource mobilization and tax capacity and administration. Such initiatives, however, do not replace the need for inclusive norm setting. The most effective capacity development will be related to norms over which developing countries feel ownership, and thus are more likely to implement rigorously.

In the AAAA, Member States agreed that “efforts in international tax cooperation should be universal in approach and scope and should fully take into account the different needs and capacities of all countries, in particular least developed countries”. This implies that norm setting should be done in an inclusive, universal forum. There is thus an ongoing debate as to whether the OECD is the appropriate forum for discussions on global taxation norms, or whether a more universal forum situated at the United Nations would be more appropriate.

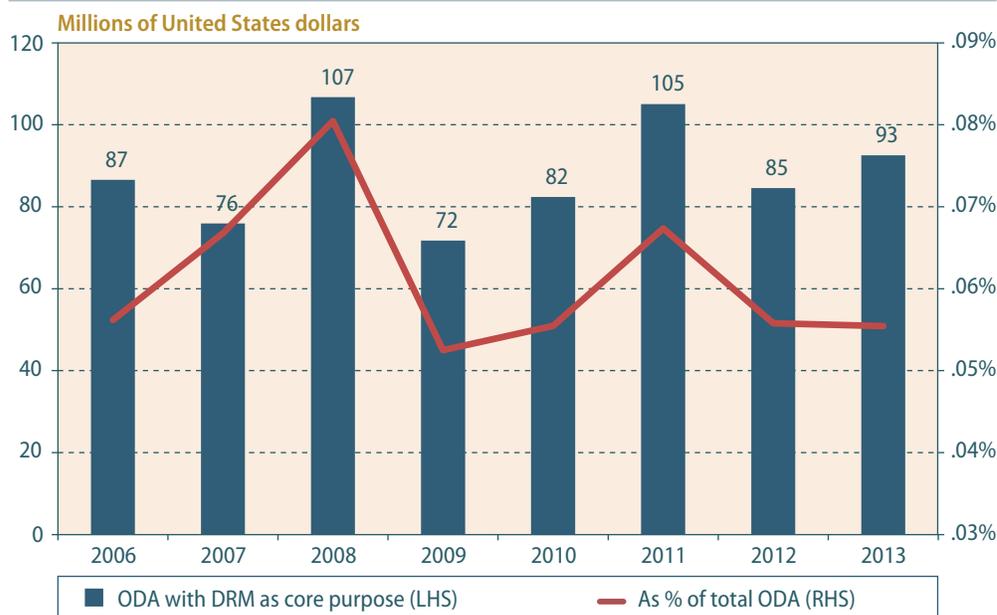
Transparency about implementation of international tax norms will be critical, especially to facilitate monitoring and accountability of implementation of the AAAA. Follow-up and accountability require public information about the status of international norm implementation (at least in the aggregate)— a report of volume of transactions on which tax information has been exchanged, for example. The follow-up process of the AAAA should give an opportunity for stakeholders and peers to discuss success and areas for further work. However, such a discussion will be frustrated by a lack of empirical evidence and data (box III.4), especially when it comes to global data on international tax cooperation.

Many developing countries lack the resources, information technology or human capacity to participate effectively in international tax cooperation

Transparency about implementation of international tax norms will be critical

²² Development Initiatives (forthcoming), based on an assessment of the OECD Creditor Reporting System database.

Figure III.17
ODA with domestic revenue mobilization (DRM) as the core aim, 2006–2013



Source: Strawson and Ifan (2014); Development Initiatives (forthcoming).

International public finance

ODA will continue to play a key role in the poorest countries and in those areas and sectors where risks and returns are not attractive for private investment

Achieving the 2030 Agenda for Sustainable Development will put significant demands on public budgets and capacities in developing countries. This will require additional and more effective international public finance, including ODA, South-South cooperation and other official flows. ODA will continue to play a key role in the poorest countries and in those areas and sectors where risks and returns are not attractive for private investments such as health and education. In Addis Ababa, ODA providers reaffirmed their respective ODA commitments, including the commitment by many to provide 0.7 per cent of their gross national income (GNI) in ODA to developing countries.

ODA flows reached \$135.2 billion in 2014, according to preliminary estimates by OECD (2015f). However, as a group, developed countries continue to fall short of their commitments, with DAC donors providing 0.29 per cent of their GNI as ODA in aggregate as compared to the 0.7 per cent commitment (United Nations, 2015d). ODA to LDCs has also been far below target, at less than 0.10 per cent of GNI (the target is 0.15–0.2 per cent of GNI). Preliminary 2014 data indicate a fall of 16 per cent in bilateral ODA to LDCs in real terms.

South-South development cooperation is increasingly important

South-South development cooperation is playing an increasingly important role. Estimates based on available data show that South-South development cooperation may have reached \$20 billion in 2013 as a result of a major increase in contributions from a few Arab countries.²³ Southern partners have further committed to increasing their cooperation in

²³ Many partners participating in South-South development cooperation do not publish data on a yearly basis. Figures are based on data collected in preparation for the forthcoming second International Development Cooperation Forum Report (UN/DESA).

the context of the 2030 Agenda for Sustainable Development, with China committing to set up a fund with an initial contribution of \$2 billion to support South-South cooperation.

Given the large financing needs associated with implementing the 2030 Agenda for Sustainable Development, particularly for sustainable, resilient and green infrastructure, existing public funds will not be sufficient. For this reason, the potential of ODA and South-South cooperation flows to catalyse additional resources for sustainable development has come into sharper focus. Highly effective aid should help build institutions, human and productive capital in recipient countries, improving the enabling environment and laying the foundations for greater sustainable-development-oriented investment, both public and private.

In recent years, donor countries have increasingly looked towards using ODA in specific market-like instruments that crowd-in (or leverage) private financing and other public financing flows. Generally used by development banks and development finance institutions (DFIs), such instruments include blending of grants with private flows, equity investments and guarantees. It is difficult to estimate the amount of ODA used to leverage private flows, but all evidence points to a steady increase in recent years, albeit from a low base. Market-like instruments are less suitable in sectors and areas where private returns are limited—such as social spending—and in the poorest countries.²⁴ They should not come at the expense of traditional ODA, with its focus on social issues. ODA equity flows amounted to \$1.8 billion and ODA that was channelled via a limited number of formally recognized public-private partnerships amounted to \$669 million in 2013.²⁵ Southern partners have also set up new institutions (i.e., funds and development banks) that leverage public contributions to mobilize additional private finance (see the section on multilateral, regional and national development banks).

A core appeal of these new instruments is financial additionality, whereby the public component of the package facilitates a private contribution that would not have otherwise been made. Public involvement can also have impacts on project design to improve its development impact, and can have positive demonstration effects. However, financial additionality is difficult and costly to determine. Instead of catalysing additional private resources, the public finance contribution could also subsidize private investments that would have been undertaken anyway. The results of a review of additionality for infrastructure projects of five major DFIs were mixed. It found that a majority of projects had financial additionality, but that more than a third of the projects would have gone ahead without DFI involvement. Relatedly, there are concerns over the development impact of blending and other market-like instruments, particularly if there are trade-offs between commercial and sustainable development objectives. The same review found that DFI involvement tends to enhance growth effects of projects, but does little to increase their direct poverty impacts (Spratt and Ryan-Collins, 2012). The technical capacity needed to implement such instruments effectively points to development banks as the most suitable institutions to put them in place.

Donor countries have increasingly looked towards using ODA in specific market-like instruments that crowd-in private financing and other public financing flows

²⁴ For example, guarantees for development have mobilized \$15.3 billion from the private sector for development purposes from 2009 to 2011, but have benefited upper-middle-income countries disproportionately, see Mirabile, Benn and Sangaré (2013).

²⁵ Based on OECD/DAC Stats. The PPP component includes ODA channelled through a limited number of formally established and DAC-recognized PPPs such as GAIN, the Global Water Partnership and others. See also Martin, 2015.

Multilateral, regional and national development banks are integral to financing sustainable development

Multilateral, regional and national development banks

As existing public funds remain inadequate and private resources are also currently not being effectively channelled into sustainable development investments, the AAAA underscores the role of alternative mechanisms, and, in particular, multilateral, regional and national development banks (DBs). DBs are integral to financing infrastructure, agriculture, SMEs, capital market development, and stimulating sustainable private finance. DBs have a long-term developmental perspective, can provide affordable long-term financing, and should play a vital role in supporting sustainable development strategies. In general, DBs operate by borrowing from the private sector at low interest rates through quasi-sovereign bonds, and then lend or invest in areas of public need.²⁶

Overall, DBs play three valuable functions: (i) mobilizing financial resources to support development, for example by leveraging private sector resources; (ii) intervening in cases of market failure and in areas where there is a dearth of private long-term financing, such as investments with positive social and environmental externalities; and (iii) providing countercyclical finance.

DBs complement and provide an alternative to the private financial sector, particularly in those credit market segments in which private financial institutions and channels are inadequate or ineffective. An additional contribution by DBs can be bridging the so-called missing middle for development finance. As countries transition from low-income to middle-income status, the decline in grants and concessional finance comes much more quickly than countries can compensate for, either by raising financing from other sources or by increasing domestic revenue mobilization (Kharas, Prizzon and Rogerson, 2014). While some countries may prefer bond issuance to multilateral development bank (MDB) borrowing because there are no policy strings attached to the funds, financing from DBs is generally at lower interest rates than that offered by the private sector through sovereign bond issuance, and generally longer term. For example, the most recent sovereign bonds of Ghana (a lower-middle-income country) were floated with a coupon rate of 8.25 per cent in September 2014, whereas World Bank ten-year loans would have carried interest rates of about 1.3 per cent plus origination fees of about 0.5 per cent. In the AAAA, Member States encourage shareholders of MDBs to develop graduation policies that are sequenced, phased and gradual, facilitating smoother transitions from MDB grant windows to their ordinary lending windows, and using more blending of terms and fewer cut-offs and thresholds.

Recent studies have also shown that DBs have played a valuable countercyclical role, especially in cases of crisis when private sector entities become highly risk averse (Brei and Schlarek, 2013). This was particularly salient during the financial crisis, when the MDBs increased lending, as did many national development banks (NDBs) in both developed and developing countries.

Recent developments

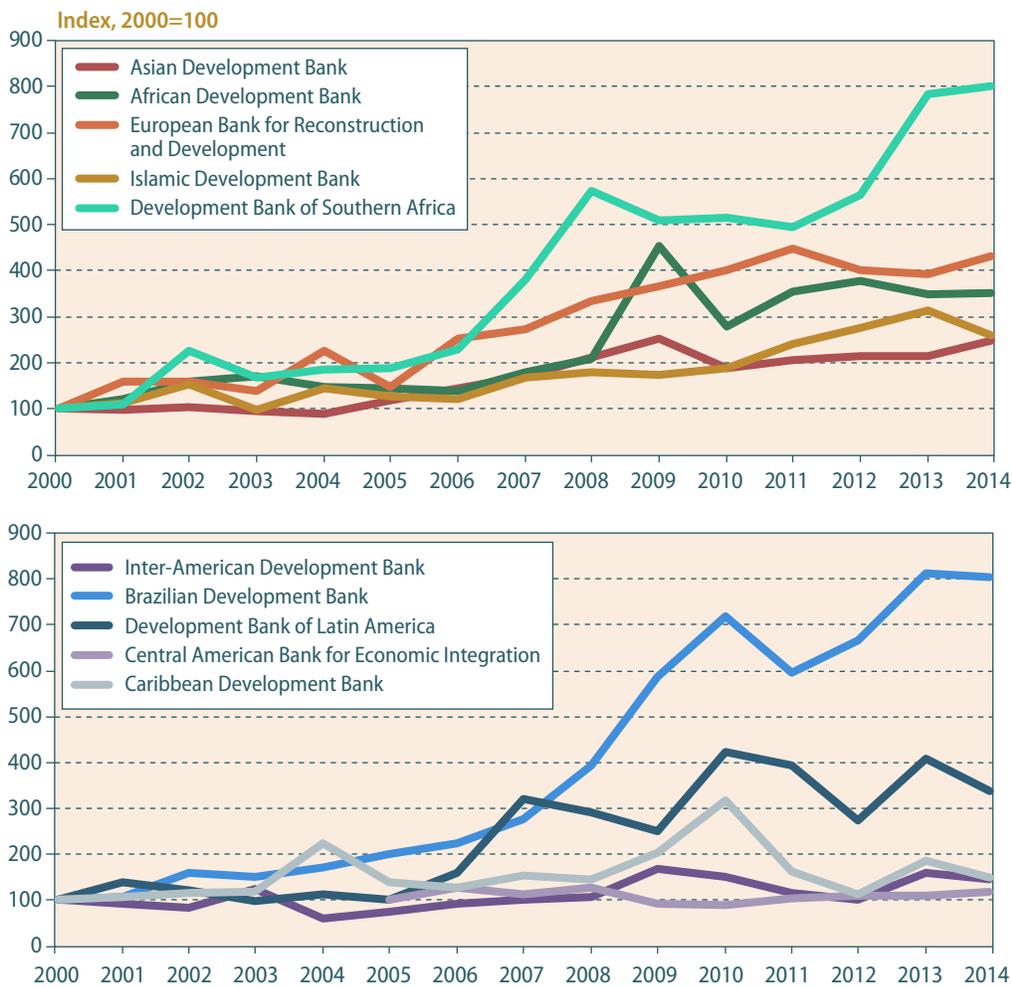
Figures III.18 and III.19 show recent trends in regional and national development bank and MDB lending, respectively. Annual commitments of non-grant subsidized finance from seven MDBs reached \$71.1 billion in 2014-2015. In July 2015, a set of six MDBs and the

²⁶ As a matter of fact, development banks are not new. They have been one of the main vehicles for industrial policy, but were largely dismantled during the era of financial sector deregulation in the 1980s.

IMF signalled plans to extend more than \$400 billion in financing over the subsequent three years (World Bank, 2015d).

There are more than 40 NDBs, and an additional 40 export credit agencies, based in all regions of the world. The term “NDB” generally denotes the ownership structure rather than the sphere of operation; a majority of NDBs are state-owned, but within public ownership models the structure varies. Some banks have mixed federal and state ownerships, such as the German Kreditanstalt für Wiederaufbau (KfW) Development Bank, which operates as part of the KfW Group. In addition, a number of NDBs in developing countries are starting to operate internationally, joining KfW and similar NDBs that operate overseas in traditional donor countries such as Japan and the Netherlands. For example the Brazilian Development Bank (BNDES), one of the largest lenders in the world by exposure, has begun international operations alongside their national development lending, much as KfW began channelling international development finance in the 1960s along with its own work on German economic development.

Figure III.18
Annual disbursements of selected regional and national development banks, 2000–2014



Source: UN/DESA, based on data from annual reports from relevant organizations.

Figure III.19
Multilateral development bank financing, 2000–2014



Newly established development banks have the potential to significantly contribute to the SDGs

Newly established development banks have the potential to significantly contribute to the SDGs. After the formal establishment of the New Development Bank with a \$50 billion subscribed capital base, and the signing of a Memorandum of Understanding on the Asian Infrastructure Investment Bank (AIIB) with a \$100 billion subscribed capital base, estimates of their lending capacity of \$30 billion each per year were made (United Nations, 2015b). In June 2015, the AIIB was formally established and the Articles of Agreement adopted by 50 founding members, including 33 countries from the Asia-Pacific region,²⁷ 15 European countries, 1 African country and 1 Latin American country. In July 2015, the New Development Bank was inaugurated in Shanghai and its president-designate Kundapur Vaman Kamath indicated that the Bank would approve financing for its first infrastructure projects in April 2016. During the Addis Ababa conference, Canada and Italy also announced that they would set up new development banks, while the United Kingdom promised a capital increase for its DFI, the CDC Group.

Key issues for the future

Existing MDBs greatly stepped up cooperation in the last few years to more effectively contribute to the 2030 Agenda for Sustainable Development, including coordination in the context of preparing the AAAA. MDBs have also been more conservative than private banks in the amount of risk they will take in leveraging their paid-in capital. Many of the MDBs have announced plans to optimize their balance sheets in order to take on more risk and increase lending (Group of Twenty, 2015). This is supported in the AAAA with the proviso that the DBs should maintain financial integrity.

²⁷ Includes Western Asia.

An equally important question is how all DBs—multilateral or national, existing or new—modify their business practices to ensure coherence with the new sustainable development agenda. To align with the SDGs, the DBs need both “do no harm” as well as promote positive social, environmental and economic outcomes while respecting human rights. For the “do-no-harm” and human rights agendas, safeguards are critical. The AAAA calls for all the banks to move towards operations that are coherent with all the SDGs in an integrated manner, and suggests that the DBs establish processes to examine their own role, scale and functioning.

The AIIB issued new draft safeguards in early September. The World Bank is in the final phase of a safeguards review, which began in 2012. The AAAA calls for safeguard policies that are timely and efficient, as well as effective. At the same time, DBs can actively support projects that are mostly closely aligned with all the multiple sustainable development goals as an integrated whole, rather than those projects that might align with just one goal—on economic growth, for example.

Global architecture

The 2030 Agenda and the AAAA contain an ambitious set of goals and a new vision for the global economy. To achieve these aims, a more inclusive form of global coordination, which better reflects the ideal of the global partnership set out in both agendas, is strongly needed. The close interlinkages among the economic, social and environmental systems are now recognized. Still, the rules and institutions that govern these systems have not yet adapted. Ineffective intermediation and existing deficiencies in the international financial system can be further exacerbated by failures of international cooperation in promoting coherence and a robust implementation of the new agenda.

The AAAA recognizes the need for strengthening the permanent international financial safety net, and for enhancing cooperation between the IMF and regional financial initiatives. Despite progress, most of the regional safety net mechanisms are still insufficient to offer an adequate safeguard in times of emergency. The fact that some of these arrangements have not been used undermines their ability to work as deterrents to financial speculation. The largest element of the global safety net—\$1.25 trillion—is provided by the IMF, but portions of these funds are not permanent. Making them permanent requires the approval of the IMF governance reforms agreed in 2010, reforms that remain unimplemented in late 2015 and are seen as only a step towards a more representative, responsive and accountable governance structure, not as the final result. The United States, which maintains veto power over governance changes at the IMF due to its 17 per cent voting share, is yet to have the reforms ratified by the United States Congress. The failure to implement the 2010 reforms has delayed the next round of reforms, which were to be completed by January 2014. Also in 2010, at the World Bank, member States agreed to move towards equitable voting power between developed and developing countries. Yet, its 2010 reforms only marginally changed voting rights, with the shares of high-income OECD countries declining from 60.7 per cent in 2008 to just 58.8 per cent in July 2015. Taking all countries currently classified as “high-income” as a group, they still wield 69.3 per cent of voting rights at the World Bank. The World Bank members agreed to review shareholding every five years, but in the first such regular review in 2015, the members were unable to agree on a concrete set of reforms, and instead pushed the deadline by an additional two years (World Bank,

To align with the SDGs, the DBs need to both “do no harm” as well as promote positive social, environmental and economic outcomes—all within the context of continuing respect for human rights

Most of the regional safety net mechanisms are still insufficient to offer an adequate safeguard in times of emergency

Box III.4

Data and the Addis Ababa Action Agenda

The final section of the Addis Ababa Action Agenda (AAAA) considers how the international community should monitor implementation of the agreed actions. It emphasizes the importance of high quality disaggregated data for policymaking and for monitoring progress of implementation of the AAAA and the 2030 Agenda for Sustainable Development, and also prioritizes capacity-building in this area.

Hard data on international financial flows is a key component of efforts to track implementation and to better understand the risks and possibilities for sustainable development. However, despite strengthened technical capacities, high-quality data on financial flows can be scarce, delayed and insufficiently detailed for policymakers to manage risks and fine-tune their development models and strategies.

There is, for example, no accurate, comprehensive and robust data on private portfolio investments. Data presented in table III.1 are based on balance-of-payments data collated by national authorities such as central banks. However, this data is neither disaggregated by source nor by fine-grained destination. Only a handful of countries maintain robust data on the maturities of these flows. It is difficult to examine—let alone mitigate—the risk that short-term private sector portfolio investment will experience a sudden stop when it is not possible to know the volume of such flows. While the International Monetary Fund had previously produced estimates that separated private and non-private portfolio flows, these estimates are no longer being made.

This is but one example of the many areas where financing data is lacking. Data on economic activity is notoriously inaccurate and subject to revision. Even databases on sovereign debt levels are not comparable across institutions. Data on tax-to-GDP ratios are not comparable across official institutions. Data on cross-border capital flows are not tracked on the source side, let alone matched to recipient side data, providing scope for misreporting or illicit conduct. Ultimately, a to-whom-from-whom framework for all financial flows would be important for monitoring implementation and tracking risks. Such a framework has become commonplace for flows of official development assistance. It would have many applications relevant to financing sustainable development: monitoring financial stability, resolving bankrupt financial institutions, implementing innovative financing mechanisms, countering money laundering and preventing the financing of terrorism, enforcing financial regulation, as well as eliminating other types of illicit financial flows and facilitating the return of stolen assets.

The technologies to track such data are available and being implemented. The global legal entity identifier system being implemented to help resolve insolvent financial institutions is a relevant model for beginning to build such a framework. Some countries are already experimenting with to-whom-from-whom information in some sectors, such as extractive industries. Global data on a to-whom-from-whom basis can be a long-term goal that will further efforts towards achieving the 2030 Agenda for Sustainable Development as well as monitoring the implementation of the AAAA. The capacities needed to monitor financial flows are different than the statistical capacities needed to track achievement of most of the SDGs. Monitoring the outcomes in terms of health, education or the environment can often be done by line ministries in conjunction with national statistical offices. Tracking financial flows will involve investing in central banks, tax authorities, and financial regulators, among others. As countries move to invest in sustainable development data, it is vital that some investment is directed to improvements in the tracking of financial flows.

Source: UN/DESA.

2015e). This unresolved imbalance in the governance of the main international financial institutions has undermined their credibility and encouraged proliferation of new development banks and regional financial safety nets described earlier in this chapter.

The outcomes sought in Addis Ababa and the 2030 Agenda for Sustainable Development can be achieved through concerted political will. All stakeholders need to contribute and be accountable for their commitments, including Member States, the private sector, civil society, and other actors. The role of the annual Financing for Development Forum,

Achieving the Addis Ababa Action Agenda will require concerted political will

the dedicated follow-up process for monitoring the implementation of the AAAA, will be crucial. Good faith efforts by all actors to assess their progress and take further steps will be vital. Financing the transformation of our world requires the commitment of high-level political actors and leaders of all types.