World Economic Situation and Prospects 2015

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Chapter III

International finance for sustainable development

In 2015, the international community will adopt a new development agenda, aiming to end poverty and promote sustainable development globally and in every nation. Since the launch of the United Nations World Commission on Environment and Development report, "Our Common Future",[1] twenty-five years ago, the global community has significantly advanced its understanding of the interlinkages between the economic, social and environmental dimensions of sustainable development, while the rapid pace of technological progress and economic globalization has dramatically reshaped the real economy. At the same time, since the United Nations adopted the Monterrey Consensus on Financing for Development in 2002, the global financial system has become much more complex; however, the mechanisms for managing finance at both domestic and international levels have not kept pace with this increased complexity or the imperatives of sustainable development.

A transformative post-2015 sustainable development agenda will require an enabling financing framework

The realization of an ambitious and transformative post-2015 sustainable development agenda will require a comprehensive and enabling financing framework. Despite some significant changes in the frameworks for international finance, channelling savings to investments in sustainable development remains a formidable challenge, further exacerbated by the financial crisis in 2008. In intermediating credit to productive investment, the international financial system needs to ensure that resources are efficiently, equitably and sustainably allocated to sustainable development, thereby facilitating progress across its three dimensions in a balanced and integrated way, while, at the same time, minimizing the risk of financial instability and crises.

Current financing and investment patterns are inadequate in achieving significant sustainable development outcomes. Private international capital flows are not only often volatile, they are also insufficient in volume and maturity to fund sustainable development—an endeavour which typically requires long-term investment. At the same time, public financial flows (i.e., official development assistance (ODA) and concessional lending from public institutions) to realize the sustainable development goals remain deficient. Efforts to raise public resources through taxation are stymied by financial engineering, tax loopholes and accounting practices. The absence of an international system for debt restructuring contributes to greater uncertainty, and possibly higher costs, for countries seeking to raise additional resources in the sovereign bond market (box III.1). Financial sector regulations have not yet fully mitigated the risks exposed by the 2008 financial crisis. Finally, the governance reforms of the international financial architecture continue to lag behind changes in global economic and financial structures.

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1 United Nations, "Our Common Future", Report of the World Commission on Environment and Development (A/42/427).

Box III.1

Argentina and the sovereign debt litigation: implications for future debt restructuring

In recent years, almost 50 per cent of sovereign defaults[a] involved legal disputes abroad—compared to just 5 per cent in the 1980s—and 75 per cent of these litigations involved distressed debt funds, also known as vulture funds that typically oppose orderly debt restructuring as holdout creditors. Recent developments in the legal dispute between NML Capital Ltd.[b] and Argentina have set a legal precedent with grave consequences for the future of sovereign debt restructuring. The judgement of the United States court not only upheld the commercial and speculative interest of a hold-out creditor, it also undermined the notion of sovereign immunity and adversely affected third parties, including those bondholders who accepted the debt restructuring and payment settlement system.

Argentina defaulted on most of its external debt in December 2001 and managed the debt crisis with two rounds of debt swaps in 2005 and 2010. The Congress of Argentina passed the Lock Law in 2005, which prohibited the Government from reopening the swap or making any future offer on better terms. In addition, the debt swap agreement included a Right upon Future Offers (RUFO) clause, which established that if Argentina offered better terms to the creditors refusing the swap (the so-called holdouts) in the future, these terms should be extended to those who did accept the debt restructuring (the so-called hold-ins or exchange-bond holders).[c] These ensured that exchange-bond holders would not lose out on any better deal in the future and motivated 92.4 per cent of the bond holders to accept the restructuring deal and sizeable discounts on the face value of the bonds. However, the lack of a legal basis to bind in hold-out creditors prevented Argentina from bringing a closure to the 2001 debt default and led to “the sovereign debt trial of the century”.

While Argentina regularly serviced its restructured debt since 2005 and managed to reduce its external debt stock from 153.8 per cent in 2002 to 26.2 per cent of its gross national income (GNI) in 2012, the NML litigation and judgement of the United States court forced Argentina into selective or restricted default, as of 31 July 2014. The Southern District Court of New York invoked a broad interpretation of the so-called *pari passu* clause, which required Argentina not only to treat all bond holders equally but also to make rateable payments in full, in terms of what it owed to the hold-outs, equivalent to $1.33 billion. The United States court ruling became enforceable, as Argentina issued the bonds held by NML under New York state law and agreed to make payments to the bond holders through its trustee, the Bank of New York—a legal entity incorporated under New York commercial law. Accordingly, the courts prohibited the Bank of New York from making any payment to exchange-bond holders until the hold-outs received their rateable payments in full.

Furthermore, the court allowed the hold-out creditors to seek information on Argentine assets worldwide, including those of Argentine officials. Such a ruling, if accepted by other jurisdictions, would not only further infringe Argentina’s sovereign immunity, but would also have significant impact on the international financial system, as it would force third-party financial institutions to provide confidential information on the sovereign borrower’s global financial transactions to the creditors.[d]

Argentina maintains that it has not defaulted, not only because it was willing to pay, but because it is actually paying.[e] For future payments, Argentina is seeking to replace the foreign banks that have blocked (or may block) its payments with a nationally based mechanism led by the Banco de la Nación Argentina. It is also offering a new debt swap to the holders of restructured bonds, maintaining all terms unchanged, but offering Buenos Aires or Paris as alternative jurisdictions for dispute resolution. Furthermore, Argentina argued that it could not make the full payment to hold-out creditors on the grounds that the payment would violate the RUFO clause in the restructured debt. It is estimated that if the RUFO clause is triggered, Argentina may be required to pay its exchange-bond holders anything from $120 billion to $500 billion.

Critics of the ruling believe that not only is the ruling unfair, since the interpretation of the *pari passu* clause is extremely debatable, but also the ruling challenges some basic legal principles that affect the third parties not involved in the litigation (the exchange-bond holders) and extends the New York court’s ruling to other jurisdictions. The New York court injunction, prohibiting payments of euro-denominated Argentine bonds under English law, is indeed currently being challenged in the British courts.

(*continued*)

a Julian Schumacher, Christoph Trebesch and Henrik Enderline, “Sovereigns defaults in court”, 6 May 2014, available from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189997.

b A distressed debt fund and a subsidiary of Elliot Management based in the Cayman Island.

c The RUFO clause is valid until 31 December 2014.

d See UNCTAD, “Argentina’s ‘vulture fund’ crisis threatens profound consequences for international financial system”, 24 June 2014, available from http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=783&Sitemap_x0020_Taxonomy=UNCTAD%20Home.

e The Bank of New York Mellon not only channels payments of bonds issued under New York law, but also euro-denominated restructured bonds issued under English legislation. Moreover, part of the restructured debt is under Argentina’s legislation, and so far the United States judge has allowed the financial intermediary for those bonds payments, Citibank, to transfer the payments.

Box III.1 (*continued*)

The ruling has huge global and systemic implications, with the potential to derail future debt restructurings by strengthening the hands of hold-out creditors.[f] It provides creditors the incentive to hold-out in a debt restructuring, interferes with the settlement system and further erodes sovereign immunity. The court ruling also incentivizes speculation, as hold-out creditors can push down the prices of a bond and in the process collect hefty payouts in credit default swaps.

In an effort to mitigate the problem, the International Monetary Fund (IMF)[g] and International Capital Markets Association (ICMA)[h] have suggested the inclusion of aggregation clauses in future bond issues. This will provide rules by which bonds in circulation will be aggregated across a series of bond issues, complementing the collective action clauses which provide a majority rule for a single bond issue. This is predicated on the assumption that the volume of bonds required to hold out against a restructuring under the proposed aggregation clauses, would be sufficiently large and will hence create a disincentive to hold out in restructuring. This solution may work for larger economies that have a huge stock of outstanding bonds, but in the case of countries where the volumes are small with few bond issues, it will be very easy for creditors to buy bonds to meet the threshold for a hold out. Moreover, there is a huge existing supply of bonds that could not be covered by the proposed clauses. IMF and ICMA have also proposed the inclusion of a simplified *pari passu* clause to mean equal ranking and not the rateable payment version of *pari passu* applied by the New York court.

There is a need for some kind of legal arrangement to prevent hold-outs from obstructing an orderly debt restructuring. In response to concerns by Member States on the gaps in the existing framework for sovereign debt restructuring, the United Nations General Assembly adopted a resolution on 9 September 2014 entitled "Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes".

f Brazil, France, Mexico and the United States of America, among others, have filed amicus briefs in New York courts to point out the implications for future debt restructuring.

g IMF, "Strengthening the contractual framework to address collective action problems in sovereign debt restructuring", October 2014, available from http://www.imf.org/external/np/pp/eng/2014/090214.pdf.

h See http://www.icmagroup.org/resources/Sovereign-Debt-Information/.

Source: UN/DESA.

Greater synergies between public and private investments are needed to promote sustainable development

A reorientation of current investment patterns and a stronger complementarity and synergy between public and private investment are sine qua non for sustainable development. The ongoing negotiations on new sustainable development goals and an associated financing framework afford the international community an opportunity to devise a new international financial architecture that is adequate, effective and predictable for achieving sustainable development.

Global imbalances and international reserves accumulation

Structural causes of global imbalances persist…

As discussed in chapter I, global imbalances on the current accounts of major economies have continued to narrow over the past few years, somewhat reflecting a cyclical downturn, weak external demand in deficit countries, and structural changes in a few surplus countries. Global imbalances are projected to remain at a benign level in 2014 and 2015. Nonetheless, many of the structural causes of global imbalances persist, with the potential to undermine long-term economic stability.

The nearly fivefold increase in global foreign-exchange reserves—from $2.1 trillion in 2000 to $12.0 trillion in 2012—can be directly attributed to current-account imbalances in major economies, with emerging and developing countries accounting for an estimated $8.0 trillion of the total reserves.[2] In line with narrowing imbalances, reserve accumulation in emerging markets and developing economies has slowed.

2 IMF, "Currency composition of official foreign exchange reserves (COFER)", available from http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf (accessed 17 November 2014).

... and countries are accumulating reserves above recommended levels

Views on the optimal size for countries' international reserves have changed over time. In the 1980s and 1990s, reserves were thought of as insurance against trade shocks, with the rule of thumb suggesting that countries should hold reserves large enough to cover three months of imports. Given that the emerging market crises in the mid-1990s, such as the Mexican "tequila crisis", were triggered by difficulties in refinancing short-term dollar-denominated debt (rather than unexpected trade deficits), the view that reserves should be large enough to meet short-term external debt refinancing needs took hold. This view, however, did not consider that the emerging-market crises of the 1990s were also triggered by reversals in short-term portfolio flows and the unwinding of carry trades. By early 2000, many countries opted for a more comprehensive self-insurance, with adequate reserves to mitigate risks associated with volatile international capital flows and open capital accounts.

Empirical studies suggest that no single factor can explain the reserve accumulation behaviour of all countries at all times,[3] and several factors explain the continued build-up in international reserves. Reserve accumulation can be an outcome of central bank interventions in foreign-exchange markets to smooth exchange-rate volatility or maintain an undervalued currency to support export-led growth strategies. It may also be a strategy associated with the management of excessive capital inflows. As such, reserve accumulation is often correlated with high global liquidity and changes in international investor sentiment. A number of studies, however, find a positive, unexplained residual in more recent years, implying that reserves are higher than what would be predicted by precautionary motives or export-led growth strategies. Further research is required to assess the precautionary needs of individual countries, taking into account the historical trends in capital-account volatility,[4] while international policy coordination can be further strengthened to reduce risks associated with volatile capital flows and enhance financial safety nets.

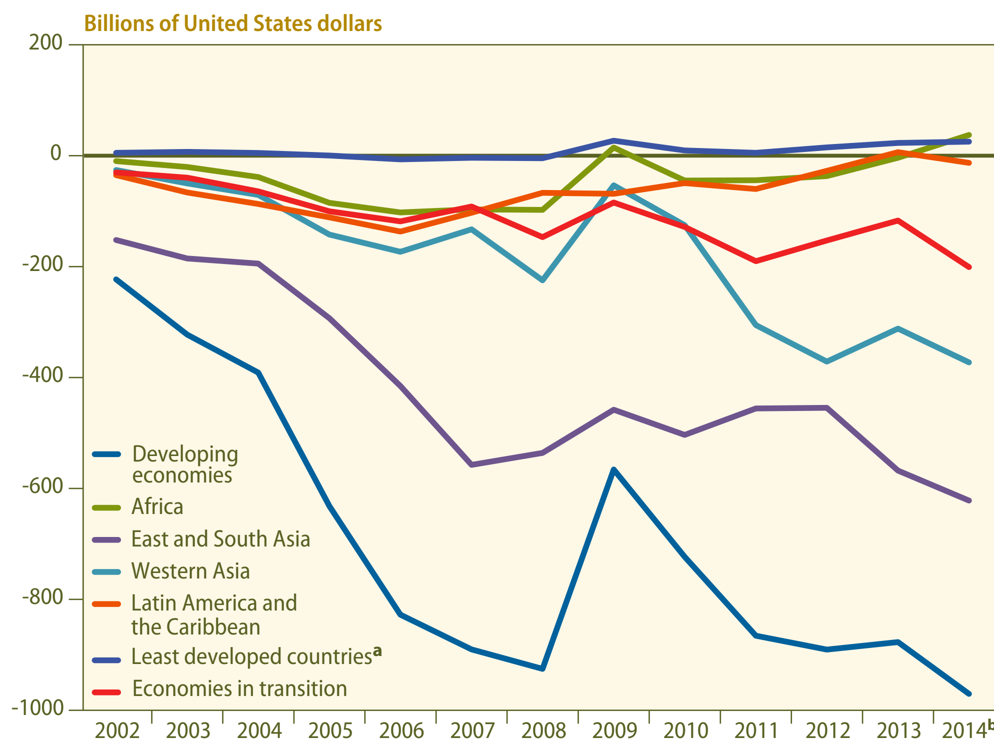
Reserve accumulation comes at high opportunity costs

There are, however, significant costs associated with holding large reserves. First, reserves are typically invested in safe liquid assets, and according to International Monetary Fund (IMF) estimates, the United States Treasury securities and euro-denominated sovereign-backed assets account for 61.0 per cent and 24.5 per cent of global reserves, respectively. The continued accumulation of reserves in safe low-yield assets comes at high opportunity costs, as these could be invested domestically to achieve greater economic, social and environmental outcomes. Second, accumulation of foreign-exchange reserves can increase domestic money supply, which can be inflationary. One way central banks combat this is by sterilizing inflows. However, this has its own costs, since borrowing in local currencies to sterilize inflows usually carries interest costs higher than what central banks can earn on their foreign assets. Furthermore, the large share of developing-country international reserves held in assets abroad implies a net transfer of resources from poorer countries to wealthier ones. A net transfer of financial resources of approximately $970.7 billion from developing to developed countries is estimated in 2014 (figure III.1). This negative net transfer of financial resources for most developing and emerging economies has continued for almost 20 years, with the exception of the least developed countries (LDCs), which con-

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

4 The International Monetary Fund (IMF) has recently adopted a new framework for exploring this further. See IMF, "Assessing reserve adequacy: further considerations", IMF Policy Paper, November 2013.

Figure III.1
Net transfers of financial resources to developing economies and economies in transition, 2002–2014



Sources: UN/DESA, based on International Monetary Fund World Economic Outlook Database, October 2014 and World Bank, *Migration and Remittances* database.
a Cabo Verde graduated in December 2007 and is therefore excluded from the calculations.
b Partly estimated.

tinue to receive net positive transfers. Finally, excessive reserve accumulation, while sensible at the national level, exacerbates global imbalances and systemic risks worldwide.

There are several proposals at the international level to address global imbalances and the excessive accumulation of foreign reserves in developing countries. A sustained reduction in global imbalances has been an objective of the Group of Twenty (G20) policy coordination. The Commission of Experts of the President of the United Nations General Assembly recommended that the international reserve system make greater use of the IMF Special Drawing Rights (SDRs) as a way to reduce systemic risks associated with global imbalances, and as a low-cost alternative to accumulation of international reserves. However, this idea has not gained sufficient political support in policy discussions.[5]

Managing systemic and idiosyncratic risks is an imperative as global imbalances persist

Absent a political agreement to reduce global imbalances, it has become imperative to effectively address the range of risks embedded in the international financial system in order to reduce the perceived need for self-insurance, and to free up reserves for potential and productive investment in sustainable development. Methods for addressing these risks include: managing risks associated with volatility of cross-border private capital flows; reducing excessive leverage in the financial system; addressing too-big-to-fail institutions; improving coordination of monetary and exchange-rate policies; and ensuring more robust international financial safety nets.

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

Trends in private capital flows

Private capital flows often do not reach countries and sectors that most need investment for sustainable development

Attracting stable and long-term private investment for human development and critical infrastructure sectors, including transport, energy, and information and communications technology, is essential for countries pursuing sustainable development. While there is a clear correlation between the level of investment and growth, the quality of investment—particularly its long-term orientation and its potential impact on social and environmental outcomes—matters for sustainable development. International private flows are highly pro-cyclical and portfolio flows, in particular, tend to be highly volatile and ill-suited to support sustainable development priorities (table III.1). Additionally, private capital flows are not necessarily invested in countries most in need and in sectors necessary for sustainable development.

There has been a strong upward trend in international private capital flows to developing countries over the last decade, with net private capital flows to developing countries increasing more than threefold from $155.7 billion in 2005 to $327.7 billion in 2013.[6] Foreign direct investment (FDI) has exhibited the largest increase over the last decade, rising in net terms from $246.4 billion in 2005 to $448 billion in 2013[7] and has also shown greater stability. Outward FDI from developing countries and economies in transition has also increased sharply during this period, reaching $553 billion, or 39 per cent of total outward FDI, in 2013.[8]

Economies in Asia and Latin America have been the largest recipients of FDI

FDI to developing countries, however, has been concentrated in a small number of countries and sectors, largely in Asia and Latin America. Although flows to Africa increased in the last decade, rising from $29 billion in 2005 to an average of $40 billion in the post-crisis years, they remain limited compared to the volume of flows to East and South Asia or Latin America and the Caribbean. In addition, greenfield FDI to developing countries has fallen by more than 50 per cent since the crisis, signalling a potential reduction of the impact of FDI on the real economy or sustainable development. Although the value of announced greenfield projects in LDCs increased by 9 per cent in 2013, it remains significantly below historical levels.

Cross-border banking flows are highly volatile and short-term

Cross border bank flows, an important source of private capital, have demonstrated high volatility in recent years, as a number of international banks—particularly in Europe—remain saddled with financial difficulties, non-performing loans and deleveraging pressures. The stock of total international claims of banks[9] stood at $20.7 trillion in June 2014, down from its peak of $25.1 trillion in March 2008 (figure III.2). The claims vis-à-vis developing countries, as a percentage of total international claims, increased from 10.2 per cent in March 2008 to 18.4 per cent in June 2014 and exceeded the pre-crisis level by September 2010. However, both the share of long-term international claims (those with a duration of one year or longer) and the share of loans flowing to the non-bank private sector declined significantly since 2008. In particular, this has affected financing infrastructure projects in emerging-market and developing countries, a significant portion of which were previously funded by large developed-country banks. There is a concern that

6 Calculations by UN/DESA based on the IMF World Economic Outlook database (October 2014) and Balance of Payments Statistics.

7 Ibid.

8 UNCTAD, *World Investment Report 2014: Investing in the SDGs: An Action Plan* (United Nations publication, Sales No. E.14.II.D.1).

9 The consolidated banking statistics of the Bank for International Settlements (BIS) define international claims of BIS reporting banks as the cross-border claims of all reporting foreign banks in all currencies, plus local claims of those banks in foreign currency, but not their local claims in local currencies.

Table III.1

Net financial flows to developing countries and economies in transition, 2005–2014

Billions of dollars

	2005	2006	2007	2008	2009	2010	2011	2012	2013[a]	2014[b]
Developing countries										
Net private capital flows	155.7	251.4	386.6	153.0	440.6	534.7	468.9	175.0	327.7	171.9
Net direct investment	246.4	241.6	342.9	364.9	267.7	352.0	455.2	412.9	448.0	400.3
Net portfolio investment[c]	-55.7	-121.8	-19.6	-61.2	8.2	91.5	57.9	78.6	27.7	73.7
Other net investment[d]	-35.0	131.6	63.3	-150.7	164.8	91.2	-44.2	-316.6	-147.9	-302.1
Net official flows	-66.0	-263.8	-96.6	-132.3	53.8	49.3	-70.6	-21.0	25.5	1.8
Total net flows	89.7	-12.4	290.0	20.7	494.4	584.0	398.3	154.0	353.2	173.7
Change in reserves[e]	-547.3	-670.7	-1056.1	-741.0	-711.7	-884.9	-754.9	-484.2	-631.3	-589.3
Africa										
Net private capital flows	26.0	109.0	11.2	52.1	30.2	-1.2	20.9	60.8	-24.2	23.3
Net direct investment	29.4	25.8	40.8	54.5	47.4	34.8	41.8	35.0	40.0	41.0
Net portfolio investment[c]	1.7	6.9	-2.9	-42.4	-16.4	-0.3	-11.7	3.5	8.9	-0.1
Other net investment[d]	-5.1	76.3	-26.7	40.0	-0.8	-35.7	-9.3	22.3	-73.1	-17.6
Net official flows	-19.6	-143.2	11.7	-37.9	23.1	22.1	10.3	-0.6	91.7	31.5
Total net flows	6.4	-34.2	22.9	14.2	53.3	20.9	31.2	60.2	67.5	54.8
Change in reserves[e]	-63.7	-75.7	-85.8	-75.9	3.3	-22.0	-29.1	-31.3	9.5	23.1
East and South Asia										
Net private capital flows	65.0	56.0	154.1	-28.4	340.5	370.0	321.3	-12.9	253.7	108.3
Net direct investment	128.6	139.9	162.9	155.7	99.6	196.8	264.6	218.2	234.2	207.1
Net portfolio investment[c]	-36.5	-138.9	-45.5	-38.3	28.9	23.0	29.7	-9.1	-79.0	-39.3
Other net investment[d]	-27.2	55.0	36.7	-145.8	212.0	150.3	27.0	-222.0	98.5	-59.5
Net official flows	5.2	-2.1	-42.5	-9.9	9.3	11.4	-49.2	25.2	-2.5	46.9
Total net flows	70.2	53.9	111.6	-38.4	349.8	381.4	272.1	12.4	251.2	155.3
Change in reserves[e]	-344.7	-433.0	-675.2	-490.9	-667.8	-685.2	-505.3	-219.6	-512.6	-524.8
Western Asia										
Net private capital flows	25.1	36.1	112.4	56.9	34.4	49.1	-54.8	-5.0	-37.0	-49.6
Net direct investment	32.1	44.0	46.9	56.7	51.8	35.7	23.1	29.1	24.4	18.3
Net portfolio investment[c]	-5.2	-0.8	-4.9	15.7	-5.8	5.6	-23.4	55.5	42.1	49.5
Other net investment[d]	-1.8	-7.1	70.4	-15.5	-11.6	7.7	-54.5	-89.6	-103.4	-117.4
Net official flows	-21.0	-72.6	-69.6	-89.1	-21.0	-38.8	-55.7	-102.4	-120.4	-141.5
Total net flows	4.1	-36.5	42.8	-32.2	13.4	10.3	-110.5	-107.3	-157.4	-191.1
Change in reserves[e]	-98.5	-107.7	-166.1	-133.0	7.2	-88.2	-110.2	-174.3	-121.8	-76.7
Latin America and the Caribbean										
Net private capital flows	39.6	50.3	109.0	72.4	35.5	116.8	181.5	132.1	135.3	89.9
Net direct investment	56.3	31.9	92.4	98.0	68.9	84.6	125.6	130.6	149.4	133.9
Net portfolio investment[c]	-15.7	11.0	33.8	3.8	1.5	63.2	63.3	28.7	55.8	63.6
Other net investment[d]	-1.0	7.4	-17.2	-29.5	-34.8	-31.1	-7.3	-27.2	-69.9	-107.6
Net official flows	-30.6	-45.9	3.8	4.6	42.4	54.6	23.9	56.7	56.7	64.9
Total net flows	8.9	4.4	112.8	77.0	77.9	171.4	205.5	188.8	192.0	154.7
Change in reserves[e]	-40.4	-54.4	-129.0	-41.3	-54.5	-89.6	-110.2	-58.9	-6.4	-10.9
Economies in transition										
Net private capital flows	36.7	68.0	140.5	-91.2	-43.2	3.0	-42.1	-12.4	29.5	-80.6
Net direct investment	11.5	28.4	34.7	55.4	22.0	12.9	21.0	30.5	8.7	4.6
Net portfolio investment[c]	7.4	5.0	8.4	-22.3	-1.0	12.2	-8.5	-5.9	1.8	-10.9
Other net investment[d]	17.7	34.6	97.4	-124.3	-64.2	-22.0	-54.6	-36.9	19.0	-74.3
Net official flows	-22.1	-31.7	-4.6	-18.3	40.5	-16.1	-18.4	-2.9	-44.2	-8.6
Total net flows	14.7	36.3	135.9	-109.6	-2.7	-13.0	-60.5	-15.3	-14.7	-89.2
Change in reserves[e]	-79.4	-134.6	-170.6	29.5	-10.6	-51.6	-26.6	-25.2	23.4	52.6

Source: UN/DESA, based on IMF World Economic Outlook database, October 2014.

Note: The composition of developing countries above is based on the country classification located in the statistical annex, which differs from the classification used in the World Economic Outlook.

a Preliminary.

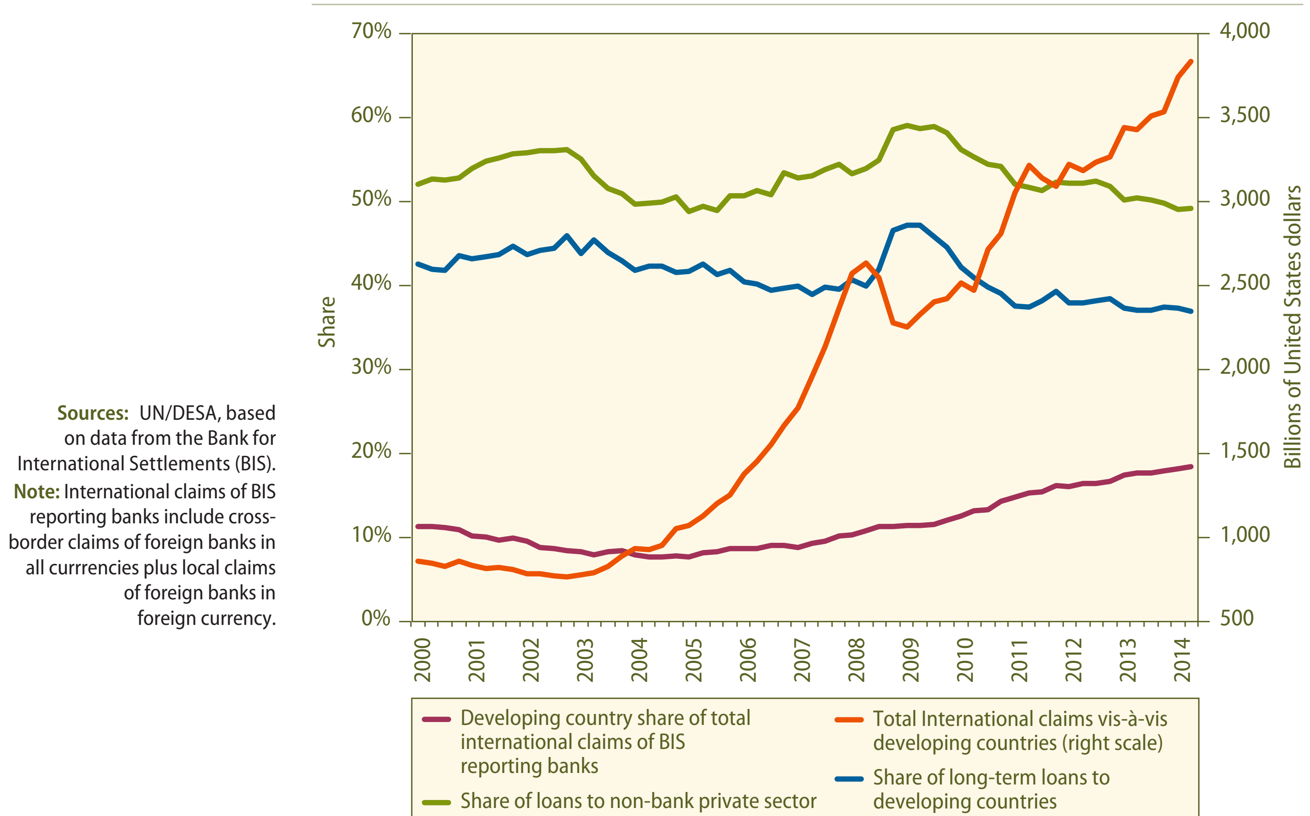
b Forecasts.

c Including portfolio debt and equity investment.

d Including short- and long-term bank lending, and possibly including some official flows owing to data limitations.

e Negative values denote increases in reserves.

Figure III.2
International claims of BIS reporting banks vis-à-vis developing countries, 2000–2014 Q2



Sources: UN/DESA, based on data from the Bank for International Settlements (BIS).
Note: International claims of BIS reporting banks include cross-border claims of foreign banks in all currrencies plus local claims of foreign banks in foreign currency.

the Basel capital adequacy rules will increase the cost of long-term lending from banks, with a potentially negative impact on infrastructure and green investments (see the section on reforming the banking system).

Portfolio investment in emerging markets has evolved, but volatility remains

Portfolio flows have also been highly volatile (box III.2), with aggregate net outflows of as much as $121.8 billion in 2008, contrasting with net inflows of $91.5 billion in 2010 (table III.1).[10] Regionally, East and South Asia experienced net portfolio outflows for the third year in a row in 2014, while Latin America and the Caribbean and Western Asia received large inflows. The nature of portfolio investment in emerging markets has evolved over the past fifteen years, as many local markets have deepened and become more globally integrated. The share of emerging-market bonds and equities in global investors' portfolios has risen sharply over the past decade. This has been driven by the growing importance of emerging markets in the world economy, improvements in the perception of their relative credit risk and credit ratings, and low yields in advanced economies. In particular, as domestic debt markets have grown, foreign investors have increased their purchases of local currency debt, and now play a dominant role in a number of emerging markets. One recent

10 A change in methodology for reporting on various elements of the capital account, introduced with the IMF Balance of Payments and International Investment Position Manual, 6th ed. (BPM6) in the last year, means that the date on private portfolio flows is not comparable to data presented in previous editions of the *World Economic Situation and Prospects*.

Box III.2

Managing capital flows to reduce the vulnerabilities of developing countries

Since the late 1970s, global financial cycles—which have featured large capital inflows from developed countries, followed by "sudden stops" or capital outflows—have affected many developing countries. These cycles are driven primarily by developed countries' economic conditions and monetary policy decisions, and often do not necessarily respond to financial needs in developing countries, although a few developing countries continue to finance their current-account deficits with short-term capital flows. Furthermore, in some cases, capital inflows have been too large for the absorption capacity of many of these economies, generating undesired macroeconomic outcomes, such as financial bubbles, excessive consumption credit, currency appreciation, trade deficits and over-indebtedness. This creates financial fragility that frequently leads to financial crises when the tide of foreign capital recedes,[a] while also limiting policy tools available to manage macroeconomic volatility.[b]

Governments need to have at their disposal a suitable set of policies and instruments for managing international capital flows to avoid or reduce disruptive macroeconomic and financial effects. In times of capital inflows, macroeconomic policy measures may include currency market interventions and lower interest rates, if inflation is subdued. Macroprudential measures such as limits on foreign-exchange exposures by financial institutions might be appropriate as well. In times of outflows, foreign reserves, if available, can be used to avoid sharp and excessive currency depreciation.

Following the global financial crisis, a new cycle of capital flows to developing countries started with inflows exceeding pre-crisis levels. To attenuate upward pressures on their currencies, excess liquidity creation and asset bubbles, developing countries such as Brazil, Indonesia, the Republic of Korea and Thailand employed specific capital-account management techniques:[c] Brazil introduced taxes on portfolio inflows and on derivatives (some of which were later removed when flows receded); the Republic of Korea reintroduced a withholding tax on foreign purchases of treasury and central bank bonds; Indonesia adopted a minimum holding period for central bank paper and a limit on short-term borrowing by banks; and Thailand adopted a withholding tax on foreign investors for state bonds. Moreover, these countries used macroprudential domestic financial regulations to influence capital inflows, including reserve requirements on banks' short foreign-exchange positions (Brazil), an increase in reserve requirements on foreign-currency deposits (Indonesia) and ceilings on foreign-exchange positions of banks (the Republic of Korea).[d] Thus, depending on the country in question, these management tools could be price- or quantity-based. While addressing the common challenge of excessive capital inflows, these tools vary across countries depending on the types of flows (and how these flows are channelled internally) and also depending on the institutional capacity to adopt one specific management form or another. Brazil, for instance, has a track record of adopting such techniques countercyclically, benefiting from experience and from having an apparatus in place to achieve greater effectiveness.[e]

During 2009–2010, these measures proved effective in moderating inflows for a period of time. Together with continued interventions in the foreign-exchange markets, upward pressures on exchange rates were reduced. Moreover, these measures provided more room for the macroeconomic policy management necessary to support the policy objectives of stability and sustained growth. For instance, Brazil maintained an expansionary fiscal policy, while Indonesia, the Republic of Korea and Thailand abstained from a more active fiscal policy to counterbalance the inflationary effects of the inflows. These outcomes suggest that the success of capital-account management measures should be evaluated not only by way of looking at what happens with the inflows themselves, but also by the policy space that they can provide to pursue effective growth policies.

Recent empirical literature suggests that capital-account management measures in times of excessive capital inflows can indeed be very useful, especially when applied to debt flows.[f] Iceland's capital management measures during the global financial crisis show that controls on capital outflows can also be a critical tool to stabilize a country's macroeconomic situation in times of a balance of payments crisis.[g] However, unlike developed countries and emerging economies, many developing countries at lower stages of economic development often lack the institutional capacity for effective capital-account management, in which case these countries may be better off maintaining some restrictions on their capital-account transactions.

(*continued*)

a Andrew G. Haldane, "The big fish, small pond problem", speech delivered at the Annual Conference of the Institute for New Economic Thinking, Bretton Woods, New Hampshire, 9 April 2011; and UNCTAD, *Trade and Development Report 2013: Adjusting to the Changing Dynamics of the World Economy* (United Nations publication, Sales No. E.13.II.D.3).

b United Nations, *World Economic and Social Survey 2010*: *Retooling Global Development* (United Nations publication, Sales No. E.10.II.C.1).

c IMF, "Recent experiences in managing capital inflows–Cross-cutting themes and possible policy framework", prepared by the Strategy, Policy, and Review Department. Washington, D.C., February 2011.

d UNCTAD, *Trade and Development Report 2014: Global Governance and Policy Space for Development* (United Nations publication, Sales No. E.14.II.D.4).

e Barry Eichengreen, and Andrew Rose, "Capital controls in the 21st century", CEPR Policy Insight, No. 72 (June). London: Centre for Economic Policy Research.

f Adrian Blundell-Wignall, and Caroline Roulet, "Capital controls on inflows, the global financial crisis and economic growth: evidence for emerging economies", *OECD Journal: Financial Market Trends*, vol. 2013/2. Paris.

g Robert H. Wade, "Iceland's boom, bust and capital outflow management", presented at the UNCTAD-GEGI workshop on CAR and global economic governance, 3 October 2013, available from http://unctad.org/en/pages/MeetingDetails.aspx?meetingid=404.

Box III.2 (*continued*)

Governments wishing to apply such policies may face de facto and de jure constraints. De facto restrictions on the capital account refer to pressures from existing and potential lenders and investors. Countries that never adopted such capital management measures before may fear that their adoption for the first time may show weakness in their ability to address their problems with a more conventional set of policies. De jure obstacles stem from multilaterally or bilaterally agreed rules that can forbid or limit a resort to capital-management measures.

Multilateral rules in the IMF Articles of Agreement and in the World Trade Organization General Agreement on Trade in Services do not restrict Governments from managing their capital accounts. There are views that capital-account management measures can be useful in certain circumstances, together with macroeconomic policy and macroprudential measures. However, direct capital-account management may afford many advantages, which can include enhancing the independence of monetary policy and creating space for pro-growth fiscal policy, in addition to reducing the market stigma associated with crisis-driven capital controls, allowing for adaptive development of measures to respond quickly to changes in flow composition, and facilitating the lengthening of maturities in accordance with long-term sustainable development financing needs. Their primary objective should be to prevent crises, not to mitigate their costs.

Bilateral and multilateral agreements can undermine effective capital-account management. In particular, within regional and bilateral trade agreements, countries often pledge to liberalize trade in financial services, which often comes with a commitment to opening up their capital account. Therefore, Governments that aim to maintain macroeconomic stability and wish to better regulate their financial systems should carefully consider the risks in taking on such commitments.

Developing countries should have appropriate capital-account management tools at their disposal. At the same time, the developed countries, where the procyclical capital flows typically originate, would need to better coordinate their monetary, macroprudential and financial sector policies to address the spillover effects of their policies on the developing countries and the global economy. Stronger and more effective international cooperation for managing capital accounts is likely to foster both financial stability and sustainable development.

Source: UNCTAD/DGDS.

study of United States investors found that in their emerging-market bond portfolios, the share of local currency denominated bonds has grown from about 2 per cent in 2001 to about 37 per cent in 2011.[11] Financial deepening and strong macroeconomic fundamentals in these economies, along with higher yields of local currency bonds, largely explain the surge in demand for domestic bonds. There is also evidence that financial deepening in emerging markets and developing countries reduces the sensitivity of domestic financial asset prices to external shocks, but that the participation of foreign investors can increase volatility, financial fragility and contagion.[12]

Emerging-market currencies experienced high volatility with the winding down of quantitative easing

Market concerns regarding the tapering of quantitative easing (QE) by the United States Federal Reserve (Fed) contributed to higher volatility and significant capital outflows from emerging markets during 2013–2014. In 2014, portfolio flows to emerging markets experienced two episodes of "taper tantrums" (i.e., sell-offs by investors in emerging-market securities, driven by the winding down of QE and the forthcoming increases in Fed policy interest rates), with significant depreciations of emerging-market currencies in January and again in September and early October. The currencies of Brazil, South Africa and Turkey were particularly hard hit. Their large current-account deficits are typically financed with

11 John Burger, and others, "International investors in local bond markets: indiscriminate flows or discriminating tastes?", November 2013, available from http://macrofinance.nipfp.org.in/PDF/12Pr_Rajeswari_BSWW_EP_First_Draft_Nov2013.pdf (accessed 18 November 2014).

12 IMF, *Global Financial Stability Report: Moving from Liquidity- to Growth-Driven Markets*. Washington, D.C., April 2014.

short-term portfolio flows, and in the case of Brazil and South Africa, falling commodity prices added further pressure (see chapter II).[13] There is significant risk that portfolio flows will reverse as the Fed starts to raise interest rates in 2015 (see chapter I).

Macroprudential measures, capital-account management techniques, and foreign-exchange interventions can reduce the volatility of private flows, and therefore be seen as an essential part of the policy toolkit to manage international capital flows. In addition, given the cross-border spillover effect of monetary policy decisions in the advanced economies, better international and regional coordination of monetary and capital-account policies, and more effective management of global liquidity, are also needed to reduce the risks associated with volatile capital flows.

International public resources for sustainable development

ODA is growing again and remains important ...

Public finance is essential for providing public goods and services, increasing equity, enhancing macroeconomic stability, and protecting environmental sustainability. Official development assistance (ODA) and other forms of international public finance play an important role in financing development priorities (particularly combating poverty) and increasingly global public goods in many developing countries, particularly in LDCs. Innovative financing mechanisms and South-South Cooperation (SSC) may complement ODA.[14] As part of SSC, the emergence of new public development finance institutions in developing countries presents new opportunities to transform the outlook for international public finance to promote sustainable development.

Official development assistance

In many critical areas of sustainable development, such as meeting the needs of the poorest or financing national and global public goods, public finance is necessary and cannot be substituted by other sources of finance. Stronger international collaboration on ODA and other forms of international public finance will remain critical to meeting these needs, particularly for those countries with limited capacity to raise public resources domestically. Following the Millennium Summit of the United Nations in 2000 and the 2002 International Conference on Financing for Development in Monterrey, net ODA flows from all member countries of the Organization for Economic Cooperation and Development (OECD) Development Assistance Committee (DAC) increased significantly, from $82.0 billion in 2000 to a high of $134.7 billion in 2013.[15] According to OECD surveys of donors, ODA is likely to increase further in 2014 and stabilize thereafter. Despite the increase in aggregate aid flows, many donors are yet to meet their ODA commitments. Only five OECD/DAC countries—Denmark, Luxembourg, Norway, Sweden and the United Kingdom of Great Britain and Northern Ireland—exceed the target of disbursing 0.7 per

13 Jonathan Wheatly, "Investors adapt to 'new normal' as commodity cycle ends", *Financial Times*, 6 October 2014.

14 See for example, Inge Kaul, and Pedro Conceição, eds., *New Public Finance: Responding to Global Challenges*, New York: Oxford University Press.

15 In real terms, 2012 prices. OECD International Development Statistics, available from http://stats.oecd.org/qwids (accessed 17 November 2014).

cent of their gross national income (GNI) as ODA. The combined DAC donors' ODA was equivalent to only 0.3 per cent of their total GNI.[16]

... but the share of ODA to LDCs fell in recent years ...

The LDCs are the most reliant on international public finance. According to preliminary estimates of OECD/DAC, bilateral net ODA to LDCs increased by 12.3 per cent to reach $30 billion in 2013, but this was mostly owing to the exceptional debt relief for Myanmar.[17] Overall, the share of ODA allocated to LDCs fell in recent years, from 34 per cent in 2010 to 32 per cent in 2012.[18] DAC surveys on its members' forward spending plans indicate that aid flows will increasingly focus on middle-income countries in the medium term, with further declines projected for LDCs and low-income countries, particularly in sub-Saharan Africa.[19] Donors' growing focus on climate financing and the calls for ODA to increasingly leverage private resources are likely to further exacerbate the challenge of channelling sufficient public resources to low-income countries.

... and climate finance is largely being counted as ODA

As environmental degradation and climate change have become increasingly urgent issues in international development, climate financing has taken centre stage. In the 2009 Copenhagen Accord of the United Nations Framework Convention on Climate Change (UNFCCC), developed countries agreed to jointly mobilize $100 billion annually by 2020 to address the needs of developing countries.[20] As an initial step, they committed to providing $30 billion in new and additional finance—the so-called fast-start finance—between 2010 and 2012. A preliminary assessment of the fast-start finance finds that $35 billion was mobilized between 2010 and 2012. However, it is estimated that 80 per cent of these resources were also counted as ODA, and disbursed largely through bilateral channels, indicating very little additionality in fast-start financing.[21] Furthermore, fast-start climate financing predominantly targets mitigation efforts, which largely benefits middle-income countries, while financing for adaptation—critical for the most vulnerable, low-income countries—remains inadequate.

A small but rapidly increasing share of ODA is delivered as equity investments and in the form of public-private partnerships to leverage private financing, although less than a third of this type of ODA is currently flowing to low-income countries.[22] Similarly, donor guarantees are increasingly used to facilitate private sector flows to developing countries.

16 Ibid.

17 Organization for Economic Cooperation and Development, "Aid to developing countries rebounds in 2013 to reach an all-time high", 8 April 2014, available from http://www.oecd.org/newsroom/aid-to-developing-countries-rebounds-in-2013-to-reach-an-all-time-high.htm (accessed 17 November 2014).

18 Organization for Economic Cooperation and Development, "Targeting ODA towards countries in greatest need", DCD/DAC(2014)20, available from http://www.oecd.org/dac/externalfinancingfordevelopment/documentupload/DAC%282014%2920.pdf (accessed 17 November 2014).

19 Organization for Economic Cooperation and Development, "Global outlook on aid: results of the 2014 DAC survey on donors' forward spending plans and prospects for improving aid predictability", DCD/DAC(2014)53, available from http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DCD/DAC(2014)53&docLanguage=En (accessed 17 November 2014).

20 United Nations, "Report of the Conference of the Parties on its fifteenth session, held in Copenhagen from 7 to 19 December 2009" (FCCC/CP/2009/11/Add.1).

21 Smita Nakhooda, and others, "Mobilizing international climate finance: lessons from the fast-start period", November 2013, available from http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8686.pdf.

22 United Nations, "Mapping of financial flows at the sector level: A UNTT WG contribution in response to a request from the Co-Facilitators for cluster 1", November 2013, available from http://sustainabledevelopment.un.org/content/documents/3352Sector%20mappings.pdf (accessed on 17 November 2014).

Between 2009 and 2011, guarantees mobilized about $15 billion of private sector financing, although they largely bypassed low-income countries. Currently, guarantees are not counted as ODA, but there are discussions on whether and how to include guarantees in a modernized definition of ODA. There are, however, some concerns that these new mechanisms and approaches could divert international public finance away from social needs and poverty reduction programmes that are the central aim of the post-2015 development agenda.[23]

In response to these and other changes in global development finance, and criticism of the existing ODA concept, OECD/DAC is currently reviewing the measurement and monitoring of external development finance, including modernizing the ODA concept. There are proposals to construct an additional, broader measure, known as the total official support for development,[24] which will include "donor effort" (or fiscal impact) of equity and mezzanine financing (hybrid debt and equity) and guarantees by donor-country development institutions. The measure of total official support for development may also include financing at market rates (such as non-concessional loans), financing of the "enablers of development" (such as outlays on peace and security), and private flows mobilized by public sector interventions. While the initial proposals of the DAC secretariat would lead to only modest changes in total recorded ODA flows,[25] this broadened measure of total official support for development is likely to produce significantly larger estimates. There are also discussions that due consideration of the perspectives of the recipient developing countries and an inclusive and transparent process would increase the legitimacy of the reforms in the measurement of ODA. These important discussions could, for example, take place in the context of the upcoming third International Conference on Financing for Development in Addis Ababa, Ethiopia, in July 2015.

Enabling investment through emerging public institutions

New development finance institutions could bolster sustainable development investments

As discussed earlier, much of the public sector savings of many developing countries is invested in developed countries through accumulation of international reserves. To reduce the costs and inefficiencies associated with this arrangement, international reserves of developing countries (the surpluses above and beyond what is needed for precautionary purposes) could be invested more effectively in sustainable development. In particular, new and emerging development finance institutions can make use of the surplus resources. The New Development Bank (NDB) of Brazil, the Russian Federation, India, China and South Africa (BRICS), announced in July 2014, and the Asia Infrastructure Investment Bank (AIIB), announced in October 2014, present potential for scaling up financing for sustainable development. As with any new initiatives, these institutions will take time to develop their institutional framework and operational modalities. It will be important, however, to assess their lending models as they are being developed in terms of their governance

23 Mariana Mirabile, Julia Benn and Cecile Sangare, "Guarantees for development", OECD Development Cooperation Working Papers, No. 11 (September 2013). Paris. Available from http://dx.doi.org/10.1787/5k407lx5b8f8-en (accessed on 17 November 2014).

24 See for example, Organization for Economic Cooperation and Development, "Scoping the new measure of total official support for development", DCD/DAC(2014)35, available from http://www.oecd.org/dac/stats/documentupload/DCD-DACper cent282014per cent2935-ENG.pdf.

25 Organization for Economic Cooperation and Development, "Options for modernising the ODA measure", DCD/DAC(2014)3, available from http://www.oecd.org/dac/externalfinancingfordevelopment/documentupload/ERG%20S1%20Jan%202014%20-%20Options%20for%20Modernising%20the%20ODA%20Measure%20DCD-DAC-2014-3-ENG.pdf.

structures, volume of additional resources, fragmentation of the development finance system, competition among institutions, and incentive structures in order to determine their potential impact on sustainable development finance.

SSC is increasingly viewed as an important complement to ODA and encompasses a diverse range of voluntary intergovernmental cooperation, including technical assistance, project preparation, knowledge-sharing, concessional and non-concessional finance, as well as direct project support. The United Nations estimated SSC at between $16.1 billion and $19.0 billion in 2011 and it is projected to grow as a proportion of global development cooperation.[26]

Sovereign wealth funds could boost investments in sustainable development

A number of countries have established sovereign wealth funds (SWFs) to invest national savings, although only a handful of them have legislative and institutional mandates to invest ethically and for sustainable development.[27] Developing-country-owned SWFs are estimated to have controlled over $4.5 trillion of assets at the end of 2013 (table III.2), representing dramatic growth since 2000.

Regional development banks have also expanded their capital bases and grant contributions to increase their lending volumes and grants in the last decade (figure III.3). Some of these institutions, such as the Corporación Andina de Fomento (Andean Development Corporation) and the European Bank for Reconstruction and Development, have quadrupled their volume of disbursements since 2000.

Additional investment in infrastructure and sustainable development

The African Development Bank has launched the Africa50 Infrastructure Fund, aimed at mobilizing private financing for infrastructure in Africa. Africa50 will focus on national and regional projects in energy, transport, ICT and water sectors.

Over time, lending volumes of development banks could be on par with the World Bank...

The BRICS NDB aims to mobilize resources for infrastructure and sustainable development projects in BRICS countries and other developing economies. Its articles of agreement provide for an authorized capital base of $100 billion, with $50 billion as the subscribed capital and $10 billion as the initial paid-in capital base.[28] The NDB will have equal voting rights for its founding five members. It is estimated that the Bank will have an initial disbursement between $2 billion to $3 billion annually. However, after 10 years, the NDB could disburse $34 billion annually in loans, equity participations, or guarantees with its retained earnings and on the full $100 billion capital base,[29] which would put it roughly on par with the World Bank in terms of loan volume.

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26 Many Southern partners do not publish data on a yearly basis. As a result, figures on the volume of SSC are estimates based on data collected in preparation for the second international development cooperation report (United Nations, Department of Economic and Social Affairs, forthcoming). Only partial data is available for 2012–2013. Therefore, it is not possible to report the volume of SSC for 2012–2013. It is also recognized in the present report that, due to the specificities of SSC, the reporting of the financial value of such cooperation can only be indicative and cannot capture the actual scale and impact of SSC. See United Nations, "Report of the Secretary-General on trends and progress in international development cooperation" (E/2014/77).

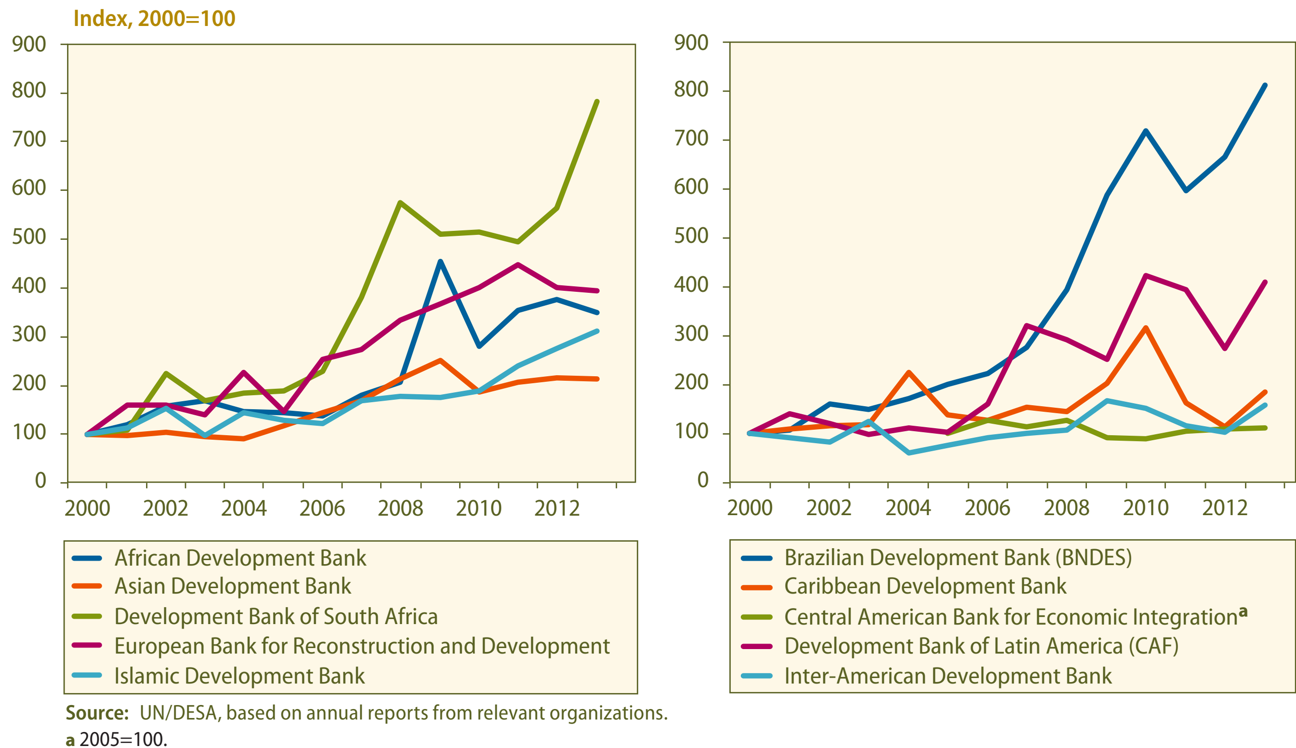
27 Benjamin J. Richardson, "Sovereign wealth funds and the quest for sustainability: insights from Norway and New Zealand", *Nordic Journal of Commercial Law*, vol. 2, pp. 1–27 (2011).

28 See "Agreement on the new development bank", VI BRICS Summit, 15 July 2014, available from http://brics6.itamaraty.gov.br/media2/press-releases/219-agreement-on-the-new-development-bank-fortaleza-july-15.

29 Stephany Griffith-Jones, "A BRICS development bank: a dream coming true", UNCTAD Discussion Paper, No. 215 (March 2014). Geneva. March. Available from http://unctad.org/en/PublicationsLibrary/osgdp20141_en.pdf.

Figure III.3

Growth in annual disbursements of selected regional and national development banks, 2000–2013



Source: UN/DESA, based on annual reports from relevant organizations.
a 2005=100.

Similarly, the new AIIB has an initial authorized capital base of $100 billion and $10 billion as the initial paid-in capital. China is expected to provide half of the capital. AIIB intends to launch operations in 2015 for infrastructure finance, and is planned to work in concert with the Asian Development Bank and the World Bank. Given that China has the highest credit rating among the BRICS countries, its outsized capital contribution may result in a better credit rating for the AIIB, and may enable it to borrow on better terms than the BRICS NDB. This could potentially enable AIIB to disburse higher volumes of loans compared to the BRICS NDB, particularly for infrastructure investment.

...and their long-term bonds to finance infrastructure investments are likely to attract institutional investors

The continued growth in existing regional development banks and sovereign wealth funds, and the emergence of new institutions such as the NDB and AIIB, can provide additional resources for investment in sustainable development. These institutions may also issue long-term bonds to finance investment in infrastructure and green growth. As many institutional investors, such as pension or insurance funds, are typically unable to invest directly in infrastructure projects, the long-term bonds issued by these development finance institutions could be useful in channelling institutional savings into sustainable development.

Starting up and scaling up sustainably

The volume of resources cannot be the only consideration for development banks to facilitate investment in sustainable development. There needs to be stronger consideration of the quality of financing and investment, as well as how international financing can increase synergies across economic, social and environmental dimensions of sustainable development. One lesson from past experiences with development finance has been the importance

Table III.2

Sovereign wealth funds owned by developing countries and economies in transition with assets above $15 billion

Country	Fund Name	Assets (billion dollars)	Inception
United Arab Emirates - Abu Dhabi	Abu Dhabi Investment Authority	773.0	1976
Saudi Arabia	SAMA Foreign Holdings	757.2	
China	China Investment Corporation	652.7	2007
Kuwait	Kuwait Investment Authority	410.0	2008
Hong Kong SAR[a]	Hong Kong Monetary Authority Investment Portfolio	400.2	1993
Singapore	Government of Singapore Investment Corporation	320.0	1981
Qatar	Qatar Investment Authority	170.0	2005
United Arab Emirates - Abu Dhabi	Abu Dhabi Investment Council	90.0	2007
Russian Federation	National Wealth Fund of the Russian Federation	88.0	2008
Russian Federation	Reserve Fund	86.4	2008
Kazakhstan	JSC Samruk-Kazyna	77.5	2008
Algeria	Revenue Regulation Fund	77.2	2000
Korea, Republic of	Korea Investment Corporation	72.0	2005
United Arab Emirates - Dubai	Investment Corporation of Dubai	70.0	2006
United Arab Emirates - Abu Dhabi	International Petroleum Investment Company	68.4	1984
Libya	Libyan Investment Authority	66.0	2006
Iran (Islamic Republic of)	National Development Fund of Islamic Republic of Iran	62.0	2011
United Arab Emirates - Abu Dhabi	Mubadala Development Company	60.9	2002
Malaysia	Khazanah Nasional	40.5	1993
Brunei Darussalam	Brunei Investment Agency	40.0	1983
Azerbaijan	State Oil Fund of the Republic of Azerbaijan	36.6	1999
Iraq	Development Fund for Iraq	18.0	2003
Timor-Leste	Timor-Leste Petroleum Fund	16.6	2005
Chile	Economic and Social Stabilization Fund	15.2	2007
Total		**4468.4**	

Source: Sovereign Wealth Fund Institute.

a Special Administrative Region of China.

of country ownership, with excessive conditionalities undermining the effectiveness of development finance.[30] So far, non-conditionality and horizontality are important features of SSC and potentially that of new development banks, affording the flexibility to support existing and evolving key priorities in host-country national development programmes.[31]

Incorporating existing intergovernmental commitments could bolster sustainable development impact

Absent effective public policies, regulation and monitoring, there is also a risk that new lending may breed inefficiencies and negatively impact social or environmental objectives. Appropriate lending standards (not necessarily conditionalities) will thus be crucial for achieving positive development impact. New development finance institutions could incorporate existing intergovernmental commitments, including internationally agreed labour and environmental standards, in their lending practices to bolster sustainable devel-

30 See, for example, World Bank, Independent Evaluation Group, "The World Bank's country policy and institutional assessment: an evaluation", available from http://ieg.worldbankgroup.org/Data/reports/cpia_eval.pdf; IMF, Independent Evaluation Office, "Structural conditionality in IMF-supported programs", available from http://www.ieo-imf.org/ieo/pages/CompletedEvaluation111.aspx.

31 United Nations, "Report of the Secretary-General on trends and progress in international development cooperation" (E/2014/77).

opment impacts and synergies. Ensuring policy coherence at an early stage of institutional development, and learning from past experience, can also strengthen the new institutions' legitimacy and credibility, as well as improve sustainable development outcomes.

Additionally, information on all forms of development cooperation, including from emerging public institutions, should be readily available to policymakers and stakeholders. The 2014 Development Cooperation Forum (DCF)[32] discussed the imperatives of enhancing transparency and accountability in development cooperation, and instilling trust among development partners. Timely data that is understandable and accessible to all was a key discussion point. Since the 2009 United Nations Conference on South-South Cooperation, a number of developing-country partners from the South have decided to further strengthen their work, including through evaluation and additional analysis of evidence. Under the auspices of the DCF, a group of southern partners are sharing information on the quantity and quality of SSC, while the United Nations Office for South-South Cooperation continues to strengthen SSC. Better and more consistent data would facilitate greater understanding of SSC and give more visibility to its positive contributions to sustainable development finance.

Enhancing the stability of the international financial architecture

Along with changes in the development landscape, there have been significant efforts at reforming the international financial architecture, which include strengthened financial market regulations, efforts to improve tax cooperation, and reforms of global economic governance. Yet more concerted efforts are needed to ensure the stability and sustainability of financing for sustainable development.

Financial regulations need to be strengthened, particularly for the too-big-to-fail financial institutions, shadow banking and over-the-counter derivatives market, but also to ensure adequate access to financing. Greater international cooperation can enhance domestic revenue mobilization, which is constrained by international tax avoidance and evasion. Reform and institutional innovation in the areas of sovereign debt resolution can reduce the risks of default and crisis and facilitate greater investment in sustainable development. Achieving such changes would also require revamped governance arrangements to give more voice and representation to countries and interests currently underrepresented in the international monetary and financial decision-making processes.

Reforming financial sector regulation

The financial system intermediates the flow of funds between savers and borrowers and allocates these funds to productive uses within and across economies. Safety and soundness of both individual institutions and the system as a whole are crucial for economic growth and sustainable development. The financial system also needs to broaden the access to credit and other financial services to facilitate sustainable investments. Managing the trade-offs in reducing risks while promoting access to resources presents a complex challenge for policymakers. For example, in an extreme version of a safe financial system, credit would only

32 The biennial Development Cooperation Forum is one of the principal new functions of a strengthened Economic and Social Council (ECOSOC) of the United Nations.

flow to AAA borrowers, such as the developed-country sovereigns, but this clearly would be inadequate for promoting sustainable development worldwide.

Global actions have enhanced the resilience of the financial sector, but more concerted efforts are needed

In recent years, the international community has taken important steps to strengthen the resilience of the financial sector and reduce the risk of future crises through regulatory reforms. To date, these reforms have focused on ensuring safety and soundness of the financial system, primarily through regulation of the banking sector through Basel III. These have been supplemented by a series of recommendations and initiatives by the Financial Stability Board (FSB), which include improved oversight of the shadow banking system, recovery and resolution planning for systemically important institutions, and regulation of the over-the-counter derivatives market.

Reforming the banking system

Basel III has introduced important reforms on solvency and liquidity

Through Basel III, which will come fully into force in 2019, the Basel Committee on Banking Supervision (BCBS) has introduced new measures aimed to bolster both solvency and liquidity of banks. The pillars of Basel III include: pillar 1 on capital and risk coverage and containing leverage; pillar 2 on risk management and supervision; and pillar 3 on measures to strengthen what the Bank for International Settlements (BIS) refers to as market discipline, including regulations of both on- and off-balance-sheet exposures and disclosures of financial intermediaries.

A new leverage ratio will take effect in January 2015

As part of the first pillar, banks adopting Basel III must increase their minimum common equity capital ratio to 4.5 per cent of the net risk-weighted assets (RWA).[33] Tier 1 capital must grow from 4.5 per cent to 6.0 per cent.[34] Banks will have to add a conservation buffer of 2.5 per cent to their total minimum capital, raising the rate to 10.5 per cent. Along with traditional microprudential approaches, which focus on reducing risks of individual banks, Basel III attempts to strengthen the macroprudential policy framework through the introduction of a countercyclical capital buffer. This buffer, comprised of common equity, will be determined by the relevant regulator in each jurisdiction within a range of 0.0 to 2.5 per cent, and it would kick in when a regulator would consider credit growth has led to an unacceptable build-up of systemic risk. However, it is unclear whether this will be strong enough to achieve its objective. Basel III also introduces a leverage ratio, a separate and additional requirement from the binding Basel risk-based capital requirements,[35] which is currently set at 3 per cent, subject to further calibration.[36] The first globally consistent definition of the leverage ratio—which is aimed at adequately capturing on- and off-balance-sheet sources of banks' leverage—was agreed in January 2014 and its disclosure requirements will take effect in January 2015.[37] Other areas of regulation include risk coverage, risk management and supervision, as well as market discipline.[38]

33 "Common equity capital" refers to common stock, retained earnings, and other assets that allow a firm to withstand financial stress by offering liquidity.

34 Bank for International Settlements, "Basel Committee on Banking Supervision: Basel III phase-in arrangements", available from http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf.

35 The Basel III leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator), with this ratio expressed as a percentage.

36 Bank for International Settlements, "Basel Committee on Banking Supervision: Basel III leverage ratio framework and disclosure requirements", January 2014.

37 Financial Stability Board, "FSB Chair's letter to G20 Ministers and Governors on financial reforms—Completing the job and looking ahead", 21 September 2014.

38 Bank for International Settlements, "Basel Committee on Banking Supervision: Seventh progress report on adoption of the Basel regulatory framework", October 2014.

Basel III calls for a minimum liquidity coverage ratio that will require banks to have sufficient high-quality liquid assets to withstand a 30-day stressed funding scenario specified by supervisors. It further introduces a net stable funding ratio (NSFR)—a longer-term structural ratio designed to address liquidity mismatches. It will cover the entire balance sheet and provide incentives for banks to use stable sources of funding. The liquidity framework also includes a common set of monitoring metrics to assist supervisors in identifying and analysing liquidity risk trends at both the bank and system-wide levels.[39] In September 2014, the Basel Committee published the results of its latest Basel III monitoring exercise, which showed that banks now meet the Basel III risk-based minimum capital requirements (table III.3).

Table III.3
Basel III stress test from end-2013

	Weighted average LCR		Average NSFR	Percentage of banks with NSFR > 90%
	End-2013	Mid-2013		
Large banks[a]	119	114	111	88
Small banks	132	132	112	

Source: Bank for International Settlements, September 2014, "Basel III Monitoring Report as of 31 December 2013".
a With Tier 1 capital of more than 3 billion euro.

Challenges with banking regulatory reform

Basel III may impact access to credit and sustainable development finance...

As banks implement Basel III, there are concerns about its potential impact on access to credit and sustainable development finance, as well as about its efficacy in creating a more stable financial system. The growth in complexity of regulations is a cause for concern. Regulations on Basel I were summarized in 30 pages, while Basel III regulations are captured in almost 1,000 pages, a number that multiplies rapidly when translated into national rulebooks. Generally, complex regulations can be difficult to implement, supervise and enforce, especially in developing countries where regulatory and supervisory capacities are limited. This argues for broad-based, simpler regulations that incorporate both on- and off-balance-sheet exposures, such as the leverage ratio, along with additional countercyclical buffers.

Through generally raising the cost of credit, the Basel III rules may have the effect of discouraging riskier lending. Indeed, the rules are designed to impose higher costs on riskier activities. Longer-term lending, lending to entities with low credit ratings, as well as investment in locations where it is more costly to get information (for example, where there is insufficient data on default histories) are deemed risky and subjected to higher capital requirements and provisioning costs.[40] Yet, some of the sectors deemed as higher risks in Basel III are precisely the sectors that would need more investments for achieving sustainable development. There has been particular concern regarding the impact of these regulations on infrastructure lending, trade finance, investments in innovation and green technologies, financing of small and medium-sized enterprises (SMEs), as well as lending to

39 Bank for International Settlements, "Basel Committee on Banking Supervision reforms—Basel III", available from http://www.bis.org/bcbs/basel3/b3summarytable.pdf.

40 The Financial Stability Board finds that "it remains too early to fully assess their impact on the provision of long-term finance or changes in market behaviour in response to these reforms." See Financial Stability Board, "Update on financial regulatory factors affecting the supply of long-term investment finance", Report to G20 Finance Ministers and Central Bank Governors, 16 September 2014.

developing countries in general. In response to these risks, a number of countries have made some adjustments. For example, the European Union (EU) excluded SME exposures from the calculation of the capital conservation buffer requirements in order to avoid reducing lending to SMEs.[41]

Furthermore, variability in RWA calculations across countries has led to large differences in capital held by banks with similar portfolios, a challenge the Basel Committee intends to address next year. There is thus a tension between countries adjusting regulations to reflect domestic needs and policy objectives and the uniformity of outcomes. There are also concerns that differing regulations can create room for regulatory arbitrage, particularly with regard to implementation of regulations in developing and emerging economies. Although the Basel III rules are primarily designed for financial institutions in major advanced economies, the Basel Committee has reached out to countries that are not members of the FSB to facilitate a wider implementation of Basel III rules. The relevance and potential impact of the full range of Basel III rules on developing and emerging economies remains unclear.

...any may continue to promote procyclicality

Although Basel III includes a countercyclical buffer, there is a risk that the overall package will continue to promote procyclicality. Capital requirements are, by nature, procyclical; they treat financial risk as exogenous and only capture risk after it is realized, and not when financial imbalances actually build up. In that context, the dependence of some of the rules of Basel III on credit ratings is a further source of concern, although this is being addressed in many jurisdictions. Recent research shows that credit-rating standards are generally procyclical, as rating standards tend to be stricter during a recession than in economic expansions.[42] However, regulators need to be careful not to restrict the emergence of new rating agencies in developing countries, which could create more locally relevant risk assessments and contribute to more diverse perspectives on risks associated with long-term, sustainable investments.

Concerns over too-big-to-fail financial institutions remain

Systemic risks associated with very large financial institutions still need to be adequately addressed. In this regard, in November 2014, the G20 leaders agreed to strengthen the oversight and regulation of global systemically important financial institutions (G-SIFIs) and welcomed a framework, proposed by the FSB, that includes a requirement for additional loss-absorbing capacity for banks (a capital buffer above the minimum requirements of Basel III) and enhanced supervisory intensity for G-SIFIs.[43]

Progress in regulating shadow banking

The term "shadow banking" was originally introduced to refer to activities of financial intermediaries that are involved in facilitating credit creation but are not subject to regulatory oversight. In recent years, the term has been used more broadly to refer to any type

41 See Bank for International Settlements, "Basel Committee on Banking Supervision: International Convergence of Capital Measurement and Capital Standards: A Revised Framework—Comprehensive Version", para. 231; and European Union, Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms, Article 501.

42 Jun Kyung Auh, "Procyclical credit rating policy", November 2013, available from http://siteresources.worldbank.org/INTFR/Resources/JunKyungAuhJan212014.pdf.

43 G20 Leaders' Communiqué, Brisbane Summit, 15–16 November 2014.

of credit intermediation outside the conventional banking system.[44] In the build-up to the crisis of 2008, highly leveraged but unregulated financial intermediaries were holding large portfolios of illiquid assets financed by short-term liabilities, exposing the risks inherent in an unregulated shadow banking sector.

Regulating rapidly growing shadow banks remains a challenge

While the advanced economies continue to have the largest non-bank financial systems by absolute size, emerging markets showed the most rapid increases in non-bank financial system assets, outstripping the growth in the formal banking sector. However, shadow banking in many developing countries is often of a different nature than its counterpart in developed countries. For example, to the extent that the growth in the non-bank financial system in developing countries represents the development of capital markets and improvement in financial inclusion, it could have positive impacts on sustainable development finance. Even in developed countries, various non-bank financial intermediaries—investment funds in particular—provide long-term credit in the absence of significant bank lending.[45] The question, though, is how these activities should be regulated, taking into account the full scope of activities while balancing risk mitigation objectives with the imperative of increasing access and financial inclusion.

The discussions on shadow banking often do not pay adequate attention to its linkages to the repo market for sale and repurchase of securities, where loans are granted against collateral, generally government bonds and notes. Although the maturities of the repurchase agreements range from one night to one year, the market is heavily skewed towards overnight to one-month repos. In other words, the repo market provides borrowers with short-term leverage. The market is used by banks, but also by shadow banking entities such as institutional money managers, insurance companies, and hedge funds to manage their cash flows, and is often used to finance longer-term assets. Some experts have expressed concerns that the repo market appears to reinforce the maturity mismatches in the assets and liabilities of financial intermediaries.[46] The systemic risk in the repo market is partially induced by the size of “haircuts”, which are additional collateral that the lending institutions request, taking into account the movements in the value of the collateralized securities. These haircuts reflect the risk when the cash realized by the liquidation of securities may turn out to be less than the value of the loan. Consequently, larger haircuts can help restrain the build-up of excessive leverage. Haircuts are, however, procyclical, since they tend to be low during booms and very large in moments of crisis, leading to liquidity shortfalls for institutions relying on the repo market for financing. To deal with the procyclicality of haircuts, the FSB published a new set of minimum standards for their calculations in October 2014.[47] However, debate is ongoing as to whether these standards are insufficient and their coverage too limited.

Coherent regulatory frameworks are needed for all financial intermediaries to manage risks and spillover effects

Major efforts are needed to move the shadow banking sector under a coherent regulatory framework to minimize systemic risks and potential spillover effects. The BCBS has final-

44 IMF, *Global Financial Stability Report: Risk Taking, Liquidity, and Shadow Banking: Curbing Excess While Promoting Growth*, Washington D.C., October 2014.

45 Ibid.

46 Matthias Thiemann, and Stephany Griffith-Jones, “Limiting financial crises: demands upon the new financial architecture”, *Brot für die Welt*, 20 October 2014, available from https://info.brot-fuer-die-welt.de/sites/default/files/blog-downloads/thiemann_and_griffith-jones_final.pdf.

47 Financial Stability Board, “Regulatory framework for haircuts on non-centrally cleared securities financing transactions”, October 2014.

ized its supervisory framework for large exposures (and risk-sensitive capital requirements) of banks' equity investments in funds to mitigate the spill-over effects between banks and shadow banking entities. The FSB is currently designing a framework for managing systemic risks in the shadow banking system with the goal of preventing these risks from impacting the regulated banking sector. It has also established an annual monitoring exercise to assess global trends and risks of the shadow banking system, and has put forward a calendar for national implementation of these new regulations with a peer review set for 2015.

Although these regulatory challenges are complex, they have a large potential impact on financial stability and may amplify the fragility of the financial systems if they are not designed and implemented effectively. More broadly, careful monitoring of the growth of non-bank financial activities needs to be part of the broader macroprudential regulatory framework to avoid significant increases in risks associated with excessive financial leverage.

Derivatives

Over-the-counter derivatives transactions are yet to be settled through central clearinghouses in most countries

In a major step forward, the G20 agreed that all standardized over-the-counter derivatives should be traded on formal exchanges or electronic platforms and cleared by central counterparties, with a view to reducing risks in the over-the-counter derivatives transactions, including lack of transparency in counterparty exposures, insufficient collateralization, uncoordinated default management, and concerns about market misconduct. Although this was meant for implementation by the end of 2012, progress has been slow. The majority of jurisdictions have announced that they have completed their legislative reforms or expect to have necessary legislative frameworks in place in 2014. Recent disagreements between the EU and the United States of America on the treatment of clearinghouses have further stalled progress. Clearinghouses are meant to prevent a market-wide collapse by ensuring either party in a derivatives transaction would get paid in case the other side defaults. While the goal is to establish a system to ensure that home-country rules for clearinghouses are largely equivalent across borders, different views persist regarding whether or not the United States clearinghouses are regulated equivalently to those in the EU.[48]

International tax cooperation and illicit financial flows

Domestic revenue is the largest and most reliable source for investment in sustainable development. While the primary responsibilities for mobilizing domestic resources lie with national Governments, international rules, policies and cooperation play an important role in ensuring that Governments have the ability to raise sufficient revenue domestically. Current rules and conditions, particularly regarding illicit flows, as well as tax avoidance, often limit what Governments can raise as domestic revenues.

Illicit financial outflows pose a formidable challenge to domestic revenue mobilization in many developing countries

There is no agreed definition of illicit financial flows (IFFs),[49] but it is generally used to mean three different types of flows: (i) the proceeds of commercial tax evasion; (ii) revenues from criminal activities; and (iii) flows from public corruption. IFFs have become a matter of major concern because of the scale and systematic adverse impact of such flows on global governance and the development agenda. While improved domestic policies in tax administration are vital to increasing revenue collection for sustainable investment, there

48 Andrew Ackerman, Katy Burne and Viktoria Dendrinou, "U.S., Europe hit impasse over rules on derivatives", *Wall Street Journal*, 26 September 2014.

49 This definition stems from Raymond W. Baker, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System*. Hoboken, New Jersey, USA: John Wiley & Sons, Inc.

is a limit to what they can achieve based on the existing international policy environment within which IFFs have blossomed.

While it is difficult to estimate the size of IFFs, one estimate of untaxed off-shore wealth holdings puts the amount between $21 trillion and $32 trillion on the high end, which if taxed at the floor rates, would yield $189 billion a year in new revenues globally.[50] On the low end, other studies estimated off-shore wealth holdings between $5.9 trillion and $8.5 trillion in different years.[51] It is also difficult to assess the relative sizes of the different components of IFFs with any accuracy, although some researchers have argued that commercial tax evasion, which involves cross-border activity to hide money from tax administrations, is one of the main types of IFFs.[52] Others have argued that corruption is a more important source of IFFs in developing countries and that the various types of IFFs are intrinsically linked.[53] While the amount of money lost to IFFs is subject to much debate, all available evidence suggests that it is significant and poses a systemic problem that impedes the mobilization of domestic resources needed for investment in sustainable development.

Existing tax codes and weak enforcement foster transfer mispricing and tax evasion

Multinational enterprises often engage in transfer mispricing (i.e., the mispricing of cross-border intra-group transactions) to evade taxes. They can shift profits to low-tax or no-tax jurisdictions, while shifting losses and deductions to high-tax jurisdictions and thereby reducing their profits and tax liabilities in the latter. National and international tax codes interact in a way that offers loopholes to companies engaged in cross-border trade, and existing standards to prevent double taxation insufficiently address the cases of no or low taxation. The pricing of intangibles, such as intellectual property rights, are particularly subject to transfer mispricing because of the ease of transferring ownership internationally and the difficulty in valuing unique intangibles. The provision of other intra-group services, including management, information technology and financial services, are frequently subject to transfer mispricing. The past decades of growing international trade and capital mobility have increased the levels of cross-border economic activity, resulting in greater potential for mispricing. Multinational enterprises also engage in aggressive tax planning, including making use of complex corporate structures to exploit mismatches and loopholes in tax systems. These tax avoidance activities may be legal under existing tax codes, but undermine the volume of revenues that a government can collect to make public investment in sustainable development.

Furthermore, tax avoidance and evasion distort markets and prevent fair competition. There are unfair advantages granted to multinational enterprises that operate across borders and can cherry-pick jurisdictions to minimize their tax liabilities and achieve unfair cost competitiveness (often by so-called tax-treaty shopping and other means to lower their own tax bills). Domestic enterprises may be unable to take advantage of the same methods of tax avoidance and evasion, increasing their relative cost base and thus limiting their opportunities for growth.

50 James S. Henry, "The price of offshore revisited", Tax Justice Network, July 2012, available from http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf.

51 Gabriel Zucman, "The missing wealth of nations: are Europe and the US net debtors or net creditors?", *Quarterly Journal of Economics*, vol. 128, No. 3, pp.1321–1364.

52 See, for example, Global Financial Integrity, "Illicit financial flows from Africa: hidden resource for development", Washington, D. C., March 2010.

53 David Chaikin, and J. C. Sharman, *Corruption and Money Laundering: A Symbiotic Relationship*. New York/London: Palgrave Macmillan.

The competition often fails to attract long-term investment

Harmful tax competition among governments also presents a challenge to the realization of sufficient revenue for investment in sustainable development. International tax competition involves not only comparison over headline tax rates, but also the application and duration of tax incentives and tax holidays. Recent studies find an increase in tax cooperation, although tax competition remains a challenge, with the potential for a race to the bottom.[54] The policy of giving tax holidays or lower tax rates to particular sectors or under particular circumstances is rarely successful in attracting long-term sustainable development investment in developing countries. While taxation is one factor in investment decisions, investors also take into account factors such as political stability, growth, market size, human capital and infrastructure in the host economy.[55] "Good" tax policies can foster rather than deter foreign direct investment, as taxpayers seeking long-term partnerships with countries tend to welcome effective and predictable tax administrations. Effective tax policy and administration with few or minimal tax holidays and incentives—and which are transparent, carefully considered beforehand and kept under review—can ensure an even playing field for investors, both foreign and domestic.

The international community has started to address the problems of raising sufficient tax revenue with more concerted efforts to enhance international cooperation on tax matters. Existing initiatives, such as the OECD/G20 base erosion and profit-shifting project, have tried to improve international tax cooperation through the development of a 15-point action plan.[56] The G20, in its Brisbane Summit held in November 2014, committed to finalizing this work in 2015, including transparency of taxpayer-specific rulings that constitute harmful tax practices. At the United Nations, the Committee of Experts on International Tax Cooperation[57] continues to address ways of ensuring a revenue return for countries where economic activities occur, such as through limited but practicably enforceable withholding taxes, and by recognizing the practical differences between goods-based and increasingly services-based economies. IMF has also contributed important expertise on tax policies and spillovers.[58] Additionally, there are existing multilateral instruments, such as the OECD-hosted Convention on Mutual Administrative Assistance in Tax Matters. While the convention was opened to non-OECD countries for signature in 2010, it was negotiated within the OECD and the Council of Europe, and all G20 countries agreed to sign the convention. In some regions, such as in Europe, there are discussions on harmonizing corporate tax bases. Ireland recently announced a change in tax residency rules that is intended to make it more difficult for multinational enterprise (MNE) profits to remain untaxed through complex financial structures set up in the country. However, many areas of international tax policy require improvements and effective cooperation to enhance the ability of developing countries to raise revenue for sustainable development investment.

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54 Philipp Genschel, and Peter Schwarz, "Tax competition: a literature review", *Socio-economic Rev*, vol. 9, No. 2, pp. 339–370.

55 See, for example, World Bank , "Does *Doing Business* matter for foreign direct investment?", available from http://documents.worldbank.org/curated/en/2013/01/18142493/doing-business-2013-doing-business-matter-foreign-direct-investment; Era Dable-Norris, and others, "FDI flows to low-income countries: global drivers and growth implications", IMF Working Paper, No. WP/10/132 (June 2010). Washington, D.C.

56 For more information, see http://www.oecd.org/ctp/beps.htm.

57 For more information, see http://www.un.org/esa/ffd/ffd-follow-up/tax-committee.html.

58 IMF, "Spillovers in international corporate taxation", IMF Policy Paper, 9 May 2014.

Key issues

ODA can play a critical role in strengthening capacities of tax administration in developing countries

Skills and capacity gaps are large in the tax authorities of many developing countries, although not uniformly so.[59] International assistance, such as through ODA, could help overcome these problems. Researchers estimate that investment in tax administration and enforcement capacity offers high returns on investment. In the United States, the Department of Treasury estimates that $1 of investment in enforcement yields $6 in direct revenue, plus additional indirect revenue from deterrence. Technical assistance for tax capacity-building in El Salvador, for example, helped raise the tax-to-GDP ratio from 11 per cent in 2004 to 14.1 per cent in 2007.[60] Based on past experience, well targeted international assistance to enhance the capacities of tax administration is likely to have a strong positive impact on domestic resource mobilization efforts. Yet it is estimated that only $120 million of ODA from OECD/DAC donors in 2012 was targeted at tax-related activities, less than 0.07 per cent of the total.[61]

A key issue is how to determine the location of multinational enterprise value added for the purposes of taxation. In September 2013, the G20 endorsed the statement that "profits should be taxed where economic activities are performed to derive the profits and where value is created".[62] Multinational enterprises often transact across borders through multiple subsidiaries, which are expected to apply the principle of arm's-length transfer pricing.[63] There is a debate about whether the best way to prevent transfer mispricing is through better implementation of the arm's-length pricing mechanism, including through capacity-building of tax administrations, or through a change towards formulary apportionment, wherein the global profits of a multinational enterprise would be divided up by jurisdiction according to a fixed formula agreed in advance and intended as a proxy for the level of economic activity in each jurisdiction.

The proposals for formulary apportionment, which are supported by many civil society organizations, would see MNE profit taxes divided up between jurisdictions based on some metrics such as sales volume, turnover or even employee headcount. Other similar proposals include the idea of unitary taxation of multinational enterprises.[64] Switching from arm's-length pricing to an apportionment formula would affect the corporate tax base of all countries in the world, as the current incidence of taxation does not align with the

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59 See "Supporting the development of more effective tax systems", Report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank.

60 Organization for Economic Cooperation and Development, "Tax and development: aid modalities for strengthening tax systems", DCD/DAC(2012)34, available from http://www.oecd.org/official-documents/publicdisplaydocumentpdf/?cote=DCD/DAC(2012)34&docLanguage=En.

61 Organization for Economic Cooperation and Development, *Development Co-operation Report 2014: Mobilising Resources for Sustainable Development*. Paris.

62 G20 Leaders' Declaration, Saint Petersburg, September 2013.

63 According to the arm's-length principle, transfer prices charged between associated enterprises reflect prices charged between independent entities at arm's length, taking into account the circumstances specific to the transaction at hand. See United Nations, "Practical manual on transfer pricing for developing countries" ST/ESA/347, p. 11.

64 Sol Picciotto, "Towards unitary taxation of transnational corporations", Tax Justice Network, 9 December 2012; and United Nations, *Global Governance and Global Rules for Development in the Post-2015 Era*. Policy Note of the Committee for Development Policy (United Nations publication, Sales No. E.14.II.A.1).

factors being proposed for inclusion in a fixed formula to apply in unitary taxation.[65] It is as yet unclear what effect this would have on tax revenues in individual countries or on different groups of countries, such as the LDCs. There are also distinct problems of political will in moving in this direction, as well as serious concerns about auditing consolidated MNE profit statements and potential abuse of the system. Some proposals have included implementing unitary taxation on regional bases.[66]

On the other hand, many Governments and the United Nations Committee of Experts on International Tax Cooperation have argued for the more effective implementation of the arm's-length pricing mechanism. The Committee developed and published a practical manual on transfer pricing in 2013, "recognizing the practical reality of the widespread support for, and reliance on, the arm's-length standard among both developing and developed countries".[67] The level of complexity and the information, knowledge and resources required in administering transfer pricing legislation can put a tremendous strain on national tax authorities, especially in countries where tax administrations tend to lack human and other resources. Tax administrations are also confronted with information asymmetry vis-à-vis multinational enterprises. These are areas for further policy development concerning the implementation of the arm's-length pricing standards.

While the G20 has improved information sharing in tax matters, a global standard would be preferred

Third, another important debate is the role of tax information. While the need for reliable information for effective and efficient tax administration is well recognized, tax administrators and decisions makers are asking what information should be public, what information should be shared among tax authorities, and how that information should be shared. The G20 has explicitly "committed to automatic exchange of [tax] information as the new global standard, which must ensure confidentiality and the proper use of information exchanged".[68] The G20 countries and other members of the OECD Global Forum expect to automatically exchange tax information among themselves by the end of 2017, and have committed to making sure that developing countries benefit from these new initiatives.[69] In 2013, civil society campaigners worked with the Government of the United Kingdom to ask both the Group of Eight (G8) and the G20 to introduce public beneficial ownership registries[70] so that anyone could access information on corporate and trust ownership.[71] However, the G8 and G20 countries could not agree on this point, although the G8 did agree to make general information on beneficial ownership of all

65 Alex Cobham, and Simon Loretz, "International distribution of the corporate tax base: impact of different apportionment factors under unitary taxation", February 2014.

66 Alex Cobham, "The impacts of illicit financial flows on peace and security in Africa", available from http://www.tanaforum.org/index.php?option=com_docman&task=doc_download&gid=44&Itemid=219.

67 United Nations, "Practical manual on transfer pricing for developing countries" ST/ESA/347, available from http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Manual_TransferPricing.pdf.

68 G20 Leaders' Declaration, Saint Petersburg, September 2013.

69 Organization for Economic Cooperation and Development, "Global forum on transparency and exchange of information for tax purposes: statement of outcomes", October 2014, available from http://www.oecd.org/tax/transparency/statement-of-outcomes-gfberlin.pdf.

70 See "PM letter to the EU on tax evasion", 25 April 2013, available from https://www.gov.uk/government/news/pm-letter-to-the-eu-on-tax-evasion.

71 See, for example, work by Global Witness, available from http://www.globalwitness.org/campaigns/corruption/anonymous-companies.

entities available to law enforcement officials.[72] At the Summit meeting in November 2014, the G20 reaffirmed its commitment to improve the transparency of public and private sector entities and of beneficial ownership by implementing the G20 High-Level Principles on Beneficial Ownership Transparency. Public transparency is supposed to help track and deter tax avoidance and evasion, but if introduced unilaterally may prove a competitive disadvantage to any individual country. A global standard and common introduction would mitigate the negative competitive effects of such a measure. While exchange of information is an important factor in the fight against tax evasion, the rules of information exchange may not adequately reflect the reality of developing countries in terms of their capacity to administer such rules. Developing countries also may not have the capacity to obtain the most relevant information or the analytical capacity to make the best use of information received. Capacity-building in this area can address these problems, but designing rules or norms in a forum that includes developing countries can ensure that information exchange will benefit all countries.

Considerations for reform

A better understanding of the distributional consequences of international tax reforms could contribute to global discussions

There are important distributional implications among Member States, depending on the design and implementation of reforms in international tax cooperation. Potential changes in the global distribution of tax revenues will have implications on the level of domestic resources across countries, with important consequences for financing sustainable development. For example, implementing unitary taxation on multinational enterprises and then distributing the tax revenue according to MNE payroll levels would likely result in high gains in taxation in rich countries, where most multinational enterprises maintain their headquarters and senior staff, and potential losses for developing countries. There is insufficient research on the impact of different types of tax reform on the distribution of tax revenues, particularly the implications of reforms on low-income and least developed countries as groups. Further research in this area would make an important contribution to tax reform discussions, but is constrained by insufficient public information about the distribution of MNE profit reporting and tax payments.

There are also political economy concerns. MNEs often exert influence on their home Governments and attempt to influence the direction of public policies. This may influence decision makers in countries with many MNEs to prefer certain reforms over others, or no reforms at all. Thus a key impediment to international tax reform would be the incentives of decision makers, who may not agree to reforms that are perceived as harming the competitiveness of some of their strong interest groups. Other interest groups, however, which may make less use of tax avoidance strategies, may see stronger rule enforcement as being in their interest and can be potential partners in improving tax systems. The balance of interests in each political environment will be important for policymakers and stakeholders to understand. If tax reforms proceed on a voluntary basis, then countries that do not accept or participate in new frameworks may distort the distribution of gains and losses. This should also be a priority area for future study.

The United Nations can provide a universal platform for reaching agreement on reforms in international tax cooperation

Reforms to the international framework for tax cooperation, which do not properly assess or address distributional impacts, will carry the risk of being counterproductive.

72 G8 Leaders' Communiqué, Lough Erne, 2013, available from https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207771/Lough_Erne_2013_G8_Leaders_Communique.pdf.

Forums for discussion of these reforms in which developing countries are not well represented will lack legitimacy. While intergovernmental cooperation on tax matters occurs in many forums, there is no current forum where all developing countries participate on equal terms with developed countries. For example, there was limited representation from developing countries, and no representation from special categories such as the LDCs, small island developing States, or even for small economies, in the negotiation of the OECD Convention on Mutual Administrative Assistance in Tax Matters.[73] Without equal representation, developing-country priorities, such as source-country taxation mechanisms, are less likely to be prioritized. Additionally, new rules, such as those being proposed on beneficial ownership registries, are less likely to consider administrative complexity and the cost of compliance issues. Intergovernmental tax cooperation at the United Nations, which has a universal membership and strong legitimacy, could play a key role in such efforts, building on the intergovernmental cooperation model that has worked at the OECD. It could also facilitate enhanced cooperation among international organizations, including regional institutions.

Improving financial safety nets and surveillance

The global financial safety net comprises global, regional and bilateral arrangements that provide resources to prevent a financial crisis or mitigate the adverse effects of a crisis when it unfolds. Reliable financial safety nets continue to play an important role in ensuring global financial stability. They provide liquidity in times of systemic crisis and reduce incentives for countries to accumulate excess reserves as a protection against external shocks. At the meeting of the G20 Finance Ministers and Central Bank Governors in Cairns in September 2014, the G20 Finance Ministers committed to ensuring the continued effectiveness of global financial safety nets.[74]

Financial safety nets are stronger than before, but remain inadequate and fragmented

Progress at the global level includes the quadrupling of the lending resources of the IMF since 2008 and reforming its lending toolkit. Importantly, a number of regional mechanisms have also considerably improved their ability to respond to a crisis (table III.4). In July 2014, BRICS member countries established the Contingent Reserve Arrangement (CRA) with an initial size of $100 billion.[75] This arrangement—which allows member countries to draw on each other's reserves—is likely to have a positive precautionary effect, help countries forestall short-term liquidity pressures, strengthen the global financial safety nets and complement existing international arrangements. The regional financial safety net for South-East Asia, the Chiang Mai Initiative Multilateralization (CMIM), was boosted in October 2014 when the member countries upgraded the ASEAN+3 Macroeconomic

73 Organization for Economic Cooperation and Development, "Convention on mutual administrative assistance in tax matters", October 2014, available from http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm (accessed 14 November 2014).

74 Communiqué meeting of G20 Finance Ministers and Central Bank Governors, Cairns, 20–21 September 2014, available from https://www.g20.org/sites/default/files/g20_resources/library/Communique%20G20%20Finance%20Ministers%20and%20Central%20Bank%20Governors%20Cairns.pdf (accessed 23 October 2014).

75 See "Treaty for the establishment of a BRICS contingent reserve arrangement", VI BRICS Summit, 15 July 2014, available from http://brics6.itamaraty.gov.br/media2/press-releases/220-treaty-for-the-establishment-of-a-brics-contingent-reserve-arrangement-fortaleza-july-15 (accessed 23 October 2014).

Research Office (AMRO) into an international organization that will be responsible for surveillance of systemic risks in the member countries. This will complement the lending activities of the CMIM.[76]

Despite these improvements, the safety net mechanisms are still inadequately equipped (table III.4) given the structure of the world economy, where crises are increasingly generated or transmitted on capital and financial accounts. Compared to the magnitude of international capital flows (table III.1)—which still remain below their peak in 2007—the resources of global and regional financial safety nets remain inadequate. When the establishment of the European Stability Mechanism did not sufficiently calm market reactions to the euro area debt crisis in 2012, it required the European Central Bank President's announcement that the institution would do whatever it takes to reduce interest rate spreads and avert a full-blown crisis in the euro area.

Expanding its financial safety nets, the IMF has enhanced the flexibility of its existing instruments for low-income countries. This includes easing timing restrictions on access under the Standby Credit Facility, providing options for Extended Credit Facility arrangements with longer initial durations, offering more flexibility in the phasing of disbursements, and relaxing the requirements for poverty reduction strategy documentation. The IMF can now disburse with reduced conditionalities and at a zero interest rate under the Rapid Credit Facility, although the interest rate is scheduled for review by the end of 2014.

Swap arrangements among central banks can strengthen financial safety nets

Improved coordination of swap arrangements can also improve the predictability of the current ad hoc arrangements in bilateral financial safety nets, while still respecting the

Table III.4

Fund size and paid-in capital for global and regional financial agreements

In billions of United States dollars and percentage

	Fund size	Paid-in capital	Paid-in ratio
Arab Monetary Fund	2.7	2.6	96%
Latin American Reserve Fund (Fundo Latino Americano de Reservas, FLAR)	3.3	2.3	70%
EURASEC Anti-Crisis Fund (Central Asia)	8.5	8.5	100%
European Union Balance of Payments Facility	63.5	63.5	100%
European Financial Stabilization Mechanism (European Union)[a]	76.2		
BRICS Contingency Reserve Agreement	100.0		
Chiang Mai Initiative Multilateralization (ASEAN+3)	240.0		
European Financial Stability Facility (euro area)[a]	558.8		
European Stability Mechanism (euro area)[a]	635.0	101.6	16%
International Monetary Fund (IMF)	1,362.0	362.0	27%

Source: IMF; Rhee, Changyong, Lea Sumulong and Shahin Vallée (2013). Global and regional financial safety nets: lessons from Europe and Asia. Bruegel Working Paper, 2013/06. Brussels: Bruegel. November, available from http://www.bruegel.org/publications/publication-detail/publication/801-global-and-regional-financial-safety-nets-lessons-from-europe-and-asia/.

a Since September 2012, all loans for euro area members are under the European Stability Mechanism. The European Financial Stability Facility and the European Financial Stabilization Mechanism will continue to manage the previously approved loans to Greece, Ireland and Portugal.

76 ASEAN+3 Macroeconomic Research Office, "AMRO Director's statement regarding the completion of the signing of the agreement establishing ASEAN+3 Macroeconomic Research Office", 10 October 2014, available from http://www.amro-asia.org/wp-content/uploads//2014/10/141010-Press-release-AMRO-Directors-statement-on-signing-of-the-AMRO-Agreement.pdf (accessed 23 October 2014).

unique roles of central banks. The Fed has set up a number of permanent swap arrangements; however, they are limited to a few high-income countries such as with Canada and Japan, and the European Central Bank. China has established more than 25 bilateral currency swap arrangements, including with a number of ASEAN countries and Australia, Switzerland and the United Kingdom.

Regional mechanisms will need to enhance their precautionary and lending capacities as well as their surveillance efforts. Proposals for strengthening the linkages between the IMF and regional arrangements include a review of IMF options to lend directly to regional structures that are in the position to contribute significantly to surveillance. Another suggestion is for regional arrangements to look beyond their regional interest and facilitate cooperation with the IMF, especially in terms of programme design, surveillance and monitoring. While improving cooperation between global and regional financial safety nets will be important, each structure will also have to be strengthened individually.

Stronger coordination in multilateral surveillance is needed

The multilateral surveillance framework comprises the IMF and the G20 along with several standard-setting bodies such as the World Bank, the BCBS or the Financial Action Task Force. In 2009, the G20 introduced the Mutual Assessment Process (MAP)—a new approach to policy collaboration—to identify objectives for the global economy, the policies needed to reach them, and their spillover effects on other countries and the global economy. MAP envisaged an in-depth analysis of the nature and causes of countries' imbalances to identify impediments to adjustment and recommend appropriate policy actions. Compared to IMF surveillance under Article 4, MAP presented stronger country ownership as it is directly under the leadership of the G20 member states. However, the MAP process lost traction because major deficit and surplus countries could not agree on how to manage the imbalances.

The IMF has significantly improved its surveillance mechanisms

The IMF strengthened its surveillance mechanisms in the past years to address shortcomings in its pre-crisis surveillance framework. This has included a stronger focus on interconnections within and between economies; improved integration of bilateral and multilateral surveillance; strengthening analysis beyond exchange-rate movements when assessing spillovers; improved risk assessments; building expertise in financial stability analysis; stronger awareness of the comprehensiveness of external stability measures; and stronger cooperation with Member States. In the 2014 Spillover Report, the IMF extended country coverage by analysing spillovers resulting from the withdrawal of unconventional monetary policies in advanced economies and the declining growth rates in emerging markets.[77] A review of the Financial Sector Assessment Program (FSAP), which assesses the stability of countries with systemically important financial sectors, was released in September 2014.[78] As many as 144 member countries have undergone assessments under the programme since 1999, most of them more than once. The review found that since 2009 FSAP reports improved in all dimensions, including stress tests that covered a broader set of risks, and an increasing analysis of spillovers and macroprudential policy frameworks.

77 IMF, "IMF multilateral policy issues report: IMF Spillover report", IMF Policy Paper, 29 July 2014, available from http://www.imf.org/external/np/pp/eng/2014/062514.pdf (accessed 23 October 2014).

78 IMF, "Review of the financial sector assessment program: further adaptation to the post crisis era", September 2014, available from http://www.imf.org/external/np/pp/eng/2014/081814.pdf (accessed 23 October 2014).

In October 2014, the IMF completed its latest Triennial Surveillance Review (TSR).[79] The review analysed the consistency and focus of the IMF policy advice and found that the IMF had not taken full advantage of the synergies between and among bilateral and multilateral surveillance. In particular, it found that stronger efforts are required to identify how risks map across countries and how domestic vulnerabilities are exacerbated by rapid spillovers across sectors. The TSR also raised the question whether the IMF mandate is sufficient to support a stronger role of the Fund in global cooperation. Concerns remain that IMF surveillance is too strongly focused on overall comprehensiveness instead of identifying risks that bear the biggest threats to the global economy. A better understanding of individual country situations and risks will help the IMF offer customized advice to its 188 member states.

Greater representation of developing countries can further strengthen multilateral surveillance

The efficacy of multilateral institutional arrangements for both safety nets and surveillance is still constrained by the underrepresentation of developing countries. The fragmentation of the international financial system further undermines policy coordination and causes time delays. Therefore, reforms that allow for more inclusiveness and efficiency gains will have to be explored.

Governance reform

Governance reforms are urgently needed to foster an enabling financing framework for sustainable development

The governing bodies of both the IMF and the World Bank Group agreed to governance reforms in 2010 with a view to improving representation, responsiveness, and accountability in these two organizations. The FSB, created in 2009, has a more inclusive governance structure compared to its predecessor, the Financial Stability Forum, and recently reviewed its structure of representation.[80] Still, the need for governance reform leading to strengthened global coordination remains urgent. FSB remains an exclusive body without universal representation and without clear rules for membership in its various subsidiary bodies. The World Bank Group reforms would result in an increase in voting power for developing and transitional countries in the International Bank for Reconstruction and Development and the International Finance Corporation for Part II members, but have so far not been fully implemented. The proposed reforms of the IMF executive board, which require an amendment of the IMF Articles of Agreement, have also not entered into force because they have not yet been ratified by the United States. This has stalled the implementation of the IMF quota increases and voting rights reforms that were agreed in 2010.

The underrepresentation of developing countries in global economic decision-making bodies needs to be addressed to enhance the effectiveness of global partnership for sustainable development. While member states have asked the IMF to explore other options for reforms given the impasse over implementation of the 2010 reforms, more can be done to reform the global economic decision-making processes. Building on the current momentum created by the preparations for the upcoming third International Conference on Financing for Development in July 2015, the United Nations, by providing an inclusive forum for policy dialogues and coordination, can play an increasingly critical role in strengthening global economic cooperation, enhancing global financial stability and creating a financial architecture that enables sustainable development.

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79 IMF, “2014 Triennial Surveillance Review”, 15 October 2014, available from https://www.imf.org/external/np/spr/triennial/2014/index.htm (accessed 23 October 2014).

80 Financial Stability Board, “Report to the G20 Brisbane Summit on the FSB’s review of the structure of its representation”, 6 November 2014.