United Nations

Advance unedited version

General Assembly

Distr.: General

9 August 2017

Original: English

Seventy-second session
Item 18 (b) of the provisional agenda*
Macroeconomic policy questions

International financial system and development

Report of the Secretary-General**

Summary

The present report, submitted pursuant to General Assembly resolution 71/215, summarises information on trends in international public and private capital flows to developing countries, options to address financial stress in developing countries, and on-going efforts to strengthen the international financial system for the implementation of the 2030 Agenda for Sustainable Development. It highlights progress on commitments and actions in the Addis Ababa Action Agenda of the Third International Conference on Financing for Development related to development finance institutions, financial regulation, the global financial safety net, policy coordination and economic governance reform.

* A/72/150
** This report was prepared with inputs from the major institutional stakeholders involved in the financing for development process. Responsibility for its contents, however, rests solely with the United Nations Secretariat.

I. Introduction

1. The General Assembly, in its resolution 71/215, requested the Secretary-General to submit to the General Assembly at its seventy-second session a report on implementation of the present resolution and to consider including in the report "an analysis of options for an enhanced approach to financial stress in developing countries." The resolution recognized the need to continue to enhance the coherence and consistency of the international monetary, financial and trading systems, and to ensure their openness, fairness and inclusiveness. It also encouraged international financial institutions to align their programmes and policies with the 2030 Agenda for Sustainable Development.

2. The mid-year update of the *World Economic Situation and Prospects 2017* forecasts that world gross product will expand by just 2.7 per cent in 2017.[1] While this marks an acceleration compared to 2016, growth in many regions remains below the levels needed for achieving the Sustainable Development Goals (SDGs), and a high degree of uncertainty in the international policy environment continues to cloud the outlook.

3. The Addis Ababa Action Agenda recognises that the international financial system is critical to enabling sustainable and inclusive growth and development aligned with the SDGs. The financing needs for SDG implementation indicate that the international financial system has not adequately allocated resources towards long-term sustainable development, with insufficient investment in critical areas. In addition, systemic risks threaten financial stability, including in developing countries.

4. To achieve the SDGs, the global financial system will need to allocate long-term public and private resources toward sustainable development in an effective and stable manner. Ultimately, stability and sustainability are mutually reinforcing. Without a stable financial system, achievement of the SDGs will be derailed by future financial crises; and without sustainable investment, we will sow the seeds for future environmental catastrophes and economic crises.

II. Trends in international financial flows to developing countries

5. Theoretically, finance should flow to countries and sectors where capital is scarce and returns are high, thus providing the resources necessary for development. However, capital has not always flowed to areas where needs are greatest, while volatile boom-bust patterns have led to instability in the real economy and made macroeconomic policy management more challenging.

6. In 2016, net international financial flows to developing countries were negative for the third year in a row. Net capital outflows from developing and transition countries were recorded at $498 billion.[2] Net outflows are expected to continue in 2017 ($267 billion) and 2018 ($79 billion), though at a slower pace reflecting the somewhat improved economic

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[1] E/2017/65

[2] Net financial flows are, unless otherwise indicated, based on IMF (2017), *World Economic Outlook*, April database.

situation. These trends are primarily driven by flows to and from China, which moved from a position of large net outflows in 2015 and 2016 to net inflows of $36.8 billion in the first quarter of 2017, in part reflecting policy changes enacted to stabilise flows.[3]

7. Capital flows have three main components: foreign direct investment (FDI), portfolio flows, and other investment. FDI remains the most stable component, and, as noted in the Addis Agenda, can make an important contribution to sustainable development, particularly when projects are aligned with national and regional sustainable development strategies. Global FDI remained steady in 2016, at an estimated $1.75 trillion, with projections for 2017 of continued high levels. However, these levels were driven by inflows to *developed* economies. FDI to developing economies shrunk by 14.1 per cent in 2016 to $646 billion, primarily due to falls in FDI to East Asia and South-East Asia. FDI to the least developed countries (LDCs) declined by 13 per cent to $38 billion, reflecting weak interest in primary sectors given persistently low commodity prices.[4] In net terms, the IMF data projects FDI inflows in all developing regions in 2017 except for South and East Asia.

8. The largest capital outflows from developing countries have been in the 'other investment' category, which is primarily composed of cross-border bank loans.[5] Other investment recorded outflows of $395 billion in 2016 with an expected decline to $283 billion in 2017, with South and East Asia and Latin America and the Caribbean experiencing large outflows. Following broader trends, other investment is expected to remain negative in 2017, though at a lower level than in 2016. Data from the Bank for International Settlements specifically on cross-border bank exposures to emerging markets, show quarterly declines throughout 2016 and a $151 billion increase in the first quarter of 2017.[6]

9. Net portfolio flows to developing countries also remained negative in 2016, at $165 billion in outflows, and are expected to remain so in 2017 ($143 billion) and 2018 ($157 billion). Portfolio investment exhibits strong regional differences, with East, South and West Asia witnessing large net outflows, and Latin America and the Caribbean and Sub-Saharan Africa experiencing net inflows.

10. The boom bust cycle of inflows and outflows is indicative of the high volatility associated with these flows. Analysis of high frequency data on capital flows in select developing countries over the past 12 years has shown that international capital inflows, particularly portfolio flows and cross-border bank loans, remain subject to periodic episodes of high volatility, often triggered by global systemic risks.[7]

11. While large global banks are the main providers of other investment (i.e. cross-border bank loans), institutional investors are generally the main drivers behind portfolio flows.

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[3] Q1 2017 data from national sources: http://www.safe.gov.cn/wps/wcm/connect/6d920c804c296c90a415af4393d9cc2e/The_time-series_data_of_Balance_of_Payments_of_China.xlsx?MOD=AJPERES&CACHEID=6d920c804c296c90a415af4393d9cc2e

[4] UNCTAD (2017) *World Investment Report*.

[5] Other investment includes currency and deposits, loans, trade credits and other financial sector instruments.

[6] BIS (2017), http://www.bis.org/statistics/rppb1707.pdf.

[7] United Nations (2017) *World Economic Situation and Prospects 2017*.

There is increasing interest in the role that these investors, particularly those with long-term liabilities such as pension funds, life insurance companies and sovereign wealth funds, can play in financing long-term sustainable development. These three types of investors were estimated to have assets under management of approximately $79 trillion at end-2014.[8] Nonetheless, the high volatility of portfolio flows in many ways reflects a short-term bias of institutional investors. This bias is also reflected in asset allocation. Most funds, even funds with long-duration liabilities, are generally invested in short-term and/or liquid assets. For example, in 2016, pension funds in the seven largest pension markets invested 76 per cent of their assets in liquid assets, overwhelmingly in developed countries, rather than long-term illiquid assets such as infrastructure.[9] Reallocation of even a small portion of these resources to long-term investments to achieve the SDGs, particularly in developing countries, will remain a challenge, without stronger measures to change incentives.

12. Global gross public and private debt of the non-financial sector reached a record high in 2015, largely due to increases in public debt and continued high levels of private debt. In developing countries, external-debt-to-GDP ratios declined since the early 2000s and until the 2008 world financial and economic crisis, but have risen since, hitting 27.4 per cent for low- and middle-income countries in aggregate in 2016.

13. These average debt ratios mask debt build-ups in certain countries, regions and categories. For example, in small island developing states average debt-to-GDP ratios increased from 27 per cent in 2008 to 45 per cent in 2016. The 20 low- and lower-middle-income countries with the largest increases in debt saw their external-debt-to-GDP ratios increase by almost 27 percentage points on average between 2010 and 2015.[10] The role of private debt in external debt burdens is increasing in some low- and lower-middle-income countries. For low-income countries, the private sector represented less than 2 per cent of external debt burdens before 2010, but 3.6 per cent in 2015; likewise, in lower-middle-income countries the share grew from about 28 per cent before 2010 to 33.5 per cent in 2015.[11]

14. Public finance institutions and systems are also important contributors to efforts to achieve the SDGs. Though public financial flows are much smaller than their private counterparts, they are generally less volatile, and play specific roles in financing sectors or projects with benefits to the whole of society. Preliminary figures for official development assistance (ODA) in 2016 showed an increase to $142.6 billion, representing a rise of 8.9 per cent in real terms from 2015. As a share of gross national income, ODA averaged 0.32 per cent, still significantly below the United Nations target of 0.7 per cent. While donors agreed

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[8] Estimates based on TheCityUK (2016) *Key Facts About the UK as an International Financial Centre*; Sovereign Wealth Fund Institute (2017) "Sovereign Wealth Fund Rankings", http://www.swfinstitute.org/sovereign-wealth-fund-rankings/.
[9] Willis Towers Watson (2017) *Global Pension Assets Study 2017*, https://www.willistowerswatson.com/en/insights/2017/01/global-pensions-asset-study-2017.
[10] See online annex of the Inter-agency Task Force on Financing for Development, http://www.developmentfinance.un.org.
[11] World Bank (2016) International Debt Statistics.

to halt the recent decline in ODA to LDCs in the Addis Agenda, the figures indicate that bilateral aid to LDCs fell by 3.9 per cent in real terms in 2016, amounting to $26 billion.[12]

15. Existing indicative estimates of South-South cooperation, a complement to North-South cooperation, suggest it surpassed $20 billion in 2014.[13] The OECD, which also estimates concessional development finance from developing countries, arrived at comparable figures of $24.6 billion in 2015.[14]

16. The International Monetary Fund (IMF), which provides lending for balance of payments support, approved $8 billion of new non-concessional commitments in fiscal year 2016 and $26.8 billion in 2017, with disbursements for 2016 of $6.6 billion. In 2016, the IMF also committed concessional loans of $1.2 billion to its low-income developing members,[15] and a further $2.8 billion for 2017 and after.[16]

17. Annual commitments of non-concessional lending from seven multilateral development banks (MDBs) fell slightly in 2015-2016 to $74.1 billion, while disbursements grew slightly to $57.3 billion, with a total exposure of $377.4 billion.[17] The New Development Bank (NDB) and Asian Infrastructure Investment Bank (AIIB) completed their first full year of operations in 2016 with commitments of $3.3 billion.[18]

18. The flip side of capital flows is the current account, which largely shows trade in goods and services. In 2016, while some developed countries reported large current account deficits, developed countries as a whole had large surpluses. These are expected to decline in 2017 and 2018. Developing countries as a whole remain in deficit, though with large regional differences.

19. By definition, imbalances in the current (primarily trade flows) and capital accounts (primarily financial flows) must be absorbed through higher or lower levels of international reserves. Overall, reserves in developing economies declined by $443 billion in 2015, and $502 billion in 2016, indicating that developing countries were spending reserves to moderate the impact of capital outflows. As noted above, China experienced large capital outflows in 2015 and 2016, which were offset by drawing down foreign exchange reserves. The IMF predicts declines of reserves in developing countries of $107 billion in 2017, before they start accumulating again from 2018.

20. Central banks typically invest reserves in safe liquid assets. The US dollar portion of reported reserves was 64.5 per cent in the first quarter of 2017, down slightly from 65.8 per cent at end 2015. The holdings of Chinese renminbi as foreign reserves, which make up 1 per

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[12] OECD (2017), http://www.oecd.org/dac/development-aid-rises-again-in-2016-but-flows-to-poorest-countries-dip.htm
[13] E/2016/65.
[14] Estimates of gross flows based on DAC estimates and published national sources. See: http://www.oecd.org/development/stats/non-dac-reporting.htm
[15] IMF (2016) *IMF Annual Report 2016*.
[16] http://www.imf.org/external/np/fin/tad/extarr11.aspx?memberKey1=ZZZZ&date1key=2020-02-28
[17] United Nations (2017), *World Economic Situation and Prospects 2017*.
[18] https://www.aiib.org/en/news-events/news/2016/annual-report/.content/download/Annual_Report_2016.pdf; http://www.ndb.int/projects/list-of-all-projects/

cent of reserves globally, were reported for the first time in 2016. However, the accumulation of safe low-yielding assets has an opportunity cost since reserves could be invested in domestic productive capacity, infrastructure and the SDGs.

III. Strengthening the international financial architecture

21. The Addis Agenda recognises the importance of a stable international financial architecture, while also emphasising the financial system's role in intermediating credit and investment. It also emphasises the role of development banks, and the importance of incorporating sustainability factors into the rules that govern the financial system.

A. Addressing financial stress in developing countries

22. There is no single solution for addressing financial stress;[19] a combination of interventions is necessary. The best approach is prevention through effective policies to manage risks, including national prudential and regulatory policies, international support, and the continued strengthening of the international financial architecture. Once financial stress has developed, international and national systems should help alleviate stress and return countries to stability, while not compromising efforts to achieve the SDGs.

Safety nets and macroeconomic surveillance

23. The Addis Agenda recognizes the need to strengthen the permanent international financial safety net, with a strong and quota-based IMF. The safety net is a network of institutions and financing facilities that can provide liquidity to countries in times of financial stress. The safety nets comprise multilateral lending facilities operated by the IMF at a global level, along with regional facilities (such as the European Stability Mechanism (ESM)), and bilateral lines of credit (frequently through reserve currency swap lines).

24. The January 2016 adoption of IMF governance reforms increased the volume of Fund resources, thus increasing the size of the financial safety net. Further work on the Fund's lending facilities was called for after a March 2016 IMF staff paper noted that while the safety net had grown significantly since the global financial crisis, important gaps remained. Questions include whether the Fund's facilities provide adequate volumes of financing, and whether the requirements for accessing them are overly burdensome. In June and July 2017, the IMF reviewed several of its lending instruments, though the conclusions are not yet available. The Fund also agreed to create a new non-financing Policy Coordination Instrument (PCI) for countries seeking to unlock financing from multiple sources and/or to demonstrate a commitment to a reform agenda.[20] The IMF will conduct a further review of its concessional lending facilities in 2018, which were last comprehensively discussed in July 2015 just before agreement on the Addis Agenda.

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[19] Financial stress can include balance of payments pressures, debt distress, or financial sector crises.
[20] http://www.imf.org/en/News/Articles/2017/07/26/pr17299-imf-executive-board-approves-proposal-for-a-new-policy-coordination-instrument

25. There is considerable scope for the operation of regional financial arrangements, which serve as a form of reserve pooling. Existing regional safety nets vary widely in size, coverage and activity. The notional value of the three largest regional arrangements – Chiang Mai Initiative Multilateralization (CMIM) for ASEAN+3 countries, the North American Framework Agreement (NAFA), and the ESM – is estimated as $1.22 trillion in 2015. The Addis Agenda called for strengthened cooperation between the IMF and regional arrangements, while safeguarding their respective independence, and greater dialogue among regional arrangements. To improve cooperation, in 2016 the ASEAN+3 Macroeconomic Research Office, which services the CMIM, worked with the IMF to conduct a joint test run of the facility.

26. Additionally, the IMF estimates that in 2015 gross value of swap arrangements between central banks were about $600 billion among advanced economies in nominally ‘unlimited’ arrangements, and a further $600 billion in limited swap arrangements. The swap lines are mostly among developed economies or between developed economies and G20 members; of the non-G20 developing countries most swap lines are meant to facilitate the settling of current account/trade transactions.

27. Macroeconomic surveillance is an important global public good provided by regional and multilateral institutions. Risk management and the prevention of crises require timely and accurate knowledge of the status of financial flows, debt levels, risk exposures of financial institutions, the trends for economic growth and other macroeconomic variables. Early warning systems that utilise this information can help manage risks. The IMF continues to cooperate with the FSB on early warning exercises, similar to stress tests that examine unlikely but plausible risks. The United Nations Conference on Trade and Development (UNCTAD) has developed new Financial Conditions Indicators for a heterogenous set of developing countries, using available macroeconomic and financial market indicators, and is working to expand the country coverage. The real-time indicators were constructed with financial vulnerability in developing countries in mind.

28. The 2030 and Addis Agendas stress the interlinkages among the environmental, social and economic dimensions of development. It could be worth exploring whether early warning systems could be strengthened by inclusion of the two-way interaction of risks and outcomes between financial and economic systems and social and environmental systems. To integrate such a complex-systems approach into crisis prevention would require building on the expertise of different international organizations through increased cooperation.

29. Continued strengthening of the international monetary system could contribute to addressing financial stress in developing countries, especially by reducing the likelihood of crises. In July 2016, an IMF staff note for the G20 outlined initial considerations on whether a greater role for the special drawing right (SDR), an international reserve asset managed by the IMF, could contribute to the smooth functioning of the international monetary system. In October 2016, the Chinese renminbi officially became the SDR’s fifth currency, at 10.92 per cent of the SDR basket. Additionally, a high-level external advisory group, consisting of

prominent academics, former policymakers, and market practitioners, was convened to advise the IMF on this issue.[21] The IMF board will discuss the topic in March 2018.

Capital account and macroprudential policies

30. As noted in paragraphs 6-11 above, in recent years, capital has tended to flow from developing to developed countries. In addition, volatile capital flows, particularly short-term flows, can increase macroeconomic volatility and the probability of financial and debt crises. The Addis Agenda underscores the importance of the quality of capital flows. A key challenge for countries is how to harness the benefits of inflows, while managing the risks. The Addis Agenda recognised that when dealing with risks from large and volatile capital flows, necessary macroeconomic policy adjustment could be supported by macroprudential and, as appropriate, capital flow management measures.

31. Macroprudential policies and measures are designed specifically for limiting systemic risk and encompass a wide variety of tools that can help build buffers to shocks, mitigate the pro-cyclicality of financial markets and institutions, and try to limit the structural vulnerabilities in the financial system.[22] The IMF categorizes macroprudential policies into categories of "(i) broad-based tools; (ii) sectoral and asset side tools; and (iii) liquidity tools", along with a place for structural reforms to the financial sector.[23] Examples of tools include dynamic loan loss provisioning requirements, limits on loan-to-value ratios, and liquidity charges or reserve requirements, such as on foreign currency liabilities. An IMF review of the effectiveness of these tools notes that they can help reduce risks and contain pro-cyclical pressures, but that their effectiveness varies based on capital market openness, financial market development and the potential for domestic and cross-border leakage. The IMF also notes that: "Source country policies can also play an important role in increasing global effectiveness of macroprudential policies in containing systemic risks from capital flows."[24] The general indication is that countries with greater financial openness, larger financial markets and more complex instruments, generate more risks that are harder to control. This emphasises the importance of structural policies that shape the financial system to inherently reduce systemic risks, and that can help align the financial system with sustainable development.

32. To help countries better understand and address the impact of cross-border capital flows, in 2016 the IMF reviewed countries' experience with the IMF's institutional view on the liberalization and management of capital flows, which was approved in 2012.[25] The IMF Executive Board considered that the institutional view remained relevant in the current environment, and that there was no need for substantive adjustment at that point, but would

[21] http://www.imf.org/en/News/Articles/2017/07/26/pr17299-imf-executive-board-approves-proposal-for-a-new-policy-coordination-instrument
[22] Clement, Piet (2010) "The term 'macroprudential': origins and evolution", http://www.bis.org/publ/qtrpdf/r_qt1003h.pdf.
[23] IMF (2017) Increasing Resilience to Large and Volatile Capital Flows—The Role of Macroprudential Policies, http://www.imf.org/en/Publications/Policy-Papers/Issues/2017/07/05/pp060217-increasing-resilience-to-large-and-volatile-capital-flows.
[24] Ibid
[25] http://www.imf.org/external/np/pp/eng/2016/110416a.pdf

need to remain flexible and evolve over time. They also agreed that further clarification was warranted in relation to the interaction between macroprudential and capital flow policies, especially the role of macroprudential policy frameworks in addressing systemic financial risks arising from capital flows; on the relevant conditions for the re-imposition of capital flow management measures during liberalization and when countries face particular challenges; and how the institutional view can serve as a framework for greater multilateral consistency in the design of policies for dealing with capital flows.

Restoring debt sustainability

33. Although developing countries' debt ratios remain significantly below their levels in the early 2000s, debt levels have shown a rising trend of late and some individual countries have heightened risks of entering debt distress. The importance of providing "breathing space" to a sovereign at the time of debt distress has been highlighted in the international policy debate, but remains to be fully addressed. There has been insufficient political agreement for a statutory approach, but progress has been made in market-based solutions to sovereign debt distress, for example through incorporating enhanced collective action and *pari passu* clauses in sovereign bond contracts.

34. The Addis Agenda notes the legislative steps taken by certain countries to constrain the "activities of non-cooperative minority bondholders, and encourages all Governments to take action, as appropriate." It notes that support for advisory and legal support can be provided for countries facing litigation. As agreed in the Addis Agenda, a renewed effort to develop global consensus on guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, could be of assistance. Borrowers and lenders may also wish to consider how contractual clauses on restructuring can be introduced into commercial bank loan contracts.

35. There is also renewed interest among policy makers in state-contingent debt instruments, such as GDP-linked bonds, including discussions at the IMF Board on their use.[26] Increased use of such instruments can provide for automatic reduction in debt payments for countries under pre-defined conditions of financial stress. Implementation by public creditors in their lending, building on the existing experiences of some donors, would build greater resilience into debt management. It would also help establishing private investor confidence in these instruments, which has been a challenge to date.

B. International financial regulation

36. Since the 2008 world financial and economic crisis, the international community has also taken steps to reform the international financial regulatory system. These reforms, primarily agreed through the Financial Stability Board (FSB) working with the relevant standard setting bodies, have aimed to address the vulnerabilities that led to the crisis, with the goal of promoting financial stability. Measures to address systemic risks, such as system

[26] IMF (2017) "IMF Discussed State-Contingent Debt Instruments", http://www.imf.org/en/News/Articles/2017/05/22/pr17187-imf-discussed-state-contingent-debt-instruments

wide stress tests, and setting of liquidity coverage ratios, have been important components of the reforms.

37. The ultimate goal of the financial system should be to facilitate the flow of funds from savers to borrowers in a stable and sustainable manner, and to effectively allocate funds throughout the economy. The Addis Agenda emphasises the importance of achieving the right balance between stability, safety and sustainability, and access to finance and financial services. In addition, it stresses that credit intermediated through the financial system should ultimately be aligned with the three dimensions of sustainable development.

Banking regulation

38. International standards for banking regulation are established by the Basel Committee on Banking Supervision (BCBS), with guidance from the FSB, and then adopted into national regulations. The Basel III framework for banking regulation raised the capital adequacy standards for banks. Adoption of the core Basel III elements into national regulation has continued with most jurisdictions meeting deadlines for their implementation. Liquidity rules are fully in force and final rules on higher loss absorbency requirements for global systemically important banks (G-SIBs) are in force in all jurisdictions that have G-SIBs headquartered in them. Jurisdictions continue their efforts to implement the leverage ratio and the Net Stable Funding Ratio (NSFR), which are due to come into force in January 2018. Four jurisdictions have not yet published draft or final rules for the leverage ratio, while 9 have not yet taken action on rules for the NSFR.

39. However, substantial work remains in implementing policies designed to solve “too-big-to-fail.” Supervisory colleges have been established for almost all G-SIBs, though the FSB considers that compliance with the BCBS Principles on risk data aggregation and risk reporting is unsatisfactory. Only a subset of FSB jurisdictions has implemented bank resolution regimes with comprehensive powers broadly in line with the principles previously agreed. For example, only 10 of the 24 jurisdictions have implemented the recommended bail-in powers, with no progress in the last year. Failure to have such rules in place undermines supervisors’ ability to wind-up a failing large bank rather than bail them out, as well as market confidence in their willingness to do so.

40. Over the past year, the BCBS issued for consultation or finalised standards in the following areas: revisions to the securitisation framework, the regulatory treatment of accounting provisions, total loss absorbing capacity holdings, disclosure requirements, a review of the assessment framework for determining which banks are globally systemically important, and a simplified alternative to the standardised approach to market risk capital requirements. The Committee’s priorities for 2017-2018 include completing the review of the regulatory treatment of sovereign exposures, the regulatory treatment of expected loss provisioning, and the identification and measurement of "step-in" risk provided by banks to non-bank entities. A revision to the Basel III framework is also being discussed to deal with the variability of risk-weighted assets as the internal risk models applied by banks differ markedly from the standardised approach.

Shadow banking and derivatives

41. Despite regulatory reform efforts, there remains concern about the effects on financial stability of financial institutions and markets outside the regulatory perimeter, especially as they continue to grow in size. The FSB estimates several different measures of shadow banking.[27] The narrow measure, which focuses on non-bank financial entities that pose financial stability risks, grew 3.2 per cent to $34 trillion in 2015. A broader measure, which includes all "other financial institutions", saw an increase from $89 trillion in 2014 to $92 trillion in 2015.[28] Of the narrow measure, 65 per cent of the assets are in collective investment vehicles with features that make them susceptible to runs. The FSB indicates that the growth of shadow banking has been accompanied by a relatively high degree of credit risk, as well as liquidity and maturity transformation, and, in the case of jurisdictions that reported hedge funds, relatively high levels of leverage. Of the 24 FSB jurisdictions, 13 have not made sufficient progress in implementing agreed rules for money market funds, and 9 have not done so in securitisation practices. The FSB believes that there are no new stability risks from shadow banking that would warrant additional regulatory action at the global level, but that work is needed by FSB jurisdictions to implement agreed policy recommendations and enhance data collection and analysis to capture emerging risks in a timely manner.

42. There has also been agreement on reforms to unregulated derivatives trade, particularly of over-the-counter (OTC) derivatives, which can dramatically increase leverage in the financial system. As of June 2017, all FSB jurisdictions had implemented, or were in the process of implementing, trade reporting, central clearing and platform trading arrangements, however some jurisdictions are behind schedule. The rules on margin requirements for non-centrally cleared derivatives, which are to be phased-in between September 2016 and 2020, are in progress in all but one jurisdiction.[29] Significant work is needed on trade reporting due to a lack of harmonisation of data formats, data quality issues, and legal barriers to full reporting and to authorities' access to data in trade repositories, making the monitoring of systemic risks difficult.

Reform impact

43. The Addis Agenda underscores the importance of monitoring the impact of financial regulation on incentives for financial inclusion and investment in sustainable development. The FSB has proposed a framework for the post-implementation evaluation of effects and unintended consequences of financial regulatory reforms to guide analyses by the FSB and other standard-setting bodies into whether the reforms are achieving their intended outcomes.[30] The framework specifies that evaluations should focus on the a reform's effectiveness in achieving its original objectives, its interaction and coherence with other

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[27] The FSB defines "shadow banking" as credit intermediation involving entities and activities outside of the banking system.

[28] FSB (2017) Global Shadow Banking Monitoring Report 2016, http://www.fsb.org/wp-content/uploads/global-shadow-banking-monitoring-report-2016.pdf

[29] FSB (2017) *Implementation and Effects of the G20 Financial Regulatory Reforms*, 3rd Annual Report.

[30] http://www.fsb.org/2017/04/proposed-framework-for-post-implementation-evaluation-of-the-effects-of-the-g20-financial-regulatory-reforms/

reforms and the overall effects on financial system resilience, the orderly functioning of markets, and the cost and availability of financing to households and nonfinancial businesses.

44. Nonetheless, data on the impacts is currently limited. The FSB conducts outreach to developing countries and has not yet found "major unintended consequences", though developing countries have reported both challenges in implementing reforms and possible effects of regulatory reforms on the activities of global banks in their jurisdictions. The data presented earlier show that cross-border lending to emerging market countries has declined, but the cause is unclear. The FSB has noted the reduction in activities may be due to broader macroeconomic developments and the still-evolving business models of global banks.[31]

45. Efforts to include all dimensions of sustainable development into the financial reform agenda are still in their infancy. One effort to address some of the interlinkages between environmental sustainability and financial governance is the Task Force on Climate-related Financial Disclosures (TCFD), which was set up in April 2015 under the FSB, with members from the private sector. The panel's recommendations[32], published in June 2017, focus on the development of voluntary, consistent standards for disclosures that could help investors, lenders, insurance underwriters and other stakeholders better understand the material risks to organisations from climate change. The recommended disclosures, which should be included with mainstream financial reporting, include a company's governance of climate risks, actual and potential impacts of these risks on its business strategy, mechanisms for managing these risks, and the metrics and targets used in risk assessment and management. The FSB indicated that "more than 100 firms, with market capitalisations of over $3.3 trillion and financial firms responsible for assets of more than $24 trillion, have provided statements of support."[33] This effort is important, not least because it emphasises the importance of measuring long-term performance (though work still needs to be done to measure and benchmark environment, social and governance impacts beyond what may materially affect the company's own long-term profits.)

Financial inclusion and correspondent banking

46. Financial sectors can become deep without delivering access to financial services to large segments of the population. For example, in some countries, where the financial sector exceeds the size of GDP, less than a quarter of adults report having a formal bank account, while in other countries, with a much smaller financial sector, account penetration is over 80 per cent.[34] As of 2014, 62 per cent of the world's adult population has a bank account, up from 53 per cent in 2011. However, while more than 80 per cent of adults in developed countries have accounts, less than 50 per cent in developing countries and 27 per cent in LDCs do. Globally, account ownership among women increased from 47 per cent (versus 54

[31] FSB (2017) *Implementation and Effects of the G20 Financial Regulatory Reforms,* 3rd Annual Report.
[32] http://www.fsb-tcfd.org/publications/
[33] FSB (2017) *Task Force publishes recommendations on climate-related financial disclosures*, 29 June, http://www.fsb.org/2017/06/task-force-publishes-recommendations-on-climate-related-financial-disclosures/.
[34] CGAG (2012). Measuring Financial Exclusion: How Many People Are Unbanked? Available from: http://www.cgap.org/blog/measuring-financial-exclusion-how-many-people-are-unbanked and; World Bank (2014). *Global Findex database*. Available from: http://www.worldbank.org/en/programs/globalfindex

per cent for men) in 2011 to 58 per cent (versus 65 per cent for men) in 2014.[35] Efforts to ensure inclusive finance can be based on a range of interventions, including the use of new technologies, the promotion of credit registries, and involving a range of institutions (such as microfinance, cooperative banks, and development banks).

47. Correspondent banking relationships (CBRs), agreements between two banks in different countries to handle transactions on behalf of each other, are an important part of the international financial system. They enable the provision of domestic and cross-border payments, and are critical for trade finance and facilitating the transfer of remittances from migrant workers. Many CBRs have been terminated since the financial crisis, though the causes are multiple and likely include the costs of complying with anti-money laundering rules and the desire of banks to reduce their risks. The Financial Stability Board (FSB) launched an action plan in November 2015 to assess and address the decline in correspondent banking and established a Correspondent Banking Coordination Group (CBCG) in 2016.

48. The FSB reports that between 2011 and 2016 active corridors and correspondents for international financial transactions each declined by around 6 per cent, with Oceania experiencing the greatest decline in corridors per jurisdiction (15 per cent), followed by Africa (9 per cent) and the Americas excluding North America (7 per cent).[36] FSB survey data, which gives direct evidence on the CBRs of 150 banks, shows that 48 countries and territories are served by three or fewer banks, with the average number of banks serving each country and territory declining by 9.6 per cent to 16 banks between 2011 and 2016, with 5 territories experiencing complete exit of the surveyed banks.[37]

49. The FSB reported progress in implementation of several measures to address the decline in correspondent banking, including through know your customer utilities and the use of legal entity identifiers in payment messages.[38] The decision to end a CBR is a private commercial decision, underscoring the importance of capacity building of respondent banks to improve their risk management and due diligence. Greater financial transparency and a reduction in banking secrecy would also help improve correspondent banks' ability to manage their risks. A recent IMF paper suggested that public financial institutions could also take temporary measures in the event of a comprehensive loss of CBRs (though only as a last resort option.)[39] Both the IMF paper and the FSB action plan emphasise clarification of regulatory expectations by international standard setting bodies, but not changes to the actual standards themselves.

Credit rating agencies (CRAs)

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[35] World Bank (2014). *Global Findex database*. Available from: http://www.worldbank.org/en/programs/globalfindex

[36] FSB (2017) *FSB Correspondent Banking Data Report*, July, http://www.fsb.org/2017/07/fsb-correspondent-banking-data-report/

[37] Non-surveyed banks may still be providing services.

[38] FSB (2017) FSB action plan to assess and address the decline in correspondent banking: Progress report to G20 Summit of July 2017, http://www.fsb.org/wp-content/uploads/P040717-3.pdf

[39] IMF (2017) Recent Trends in Correspondent Banking Relationships—Further Considerations, http://www.imf.org/~/media/Files/Publications/PP/031617.ashx

50. By providing creditors with information on the creditworthiness of borrowers, CRAs play an important role in the functioning of capital markets and influence the flow of finance towards countries, companies and projects. However, the financial crisis demonstrated the impact inaccurate ratings can have on the stability of the international financial system. The FSB set out a roadmap to reduce mechanistic reliance on CRA ratings in standards in 2012, which was largely successful, though reliance on CRA ratings is still present in some regulatory environments. Reviews of the operation of CRAs are currently conducted on the national level in some countries. A 2016 United States Securities and Exchange Commission report found continued weaknesses of practices and violations of policies, procedures and regulatory rules by CRAs.[40]

51. Nine CRAs, including two of the three biggest, signed up to a May 2016 statement on the inclusion of environmental, social and governance (ESG) factors in credit ratings.[41] In September 2016, Standard & Poors proposed ESG Assessments, though not as part of their credit rating methodology. However, the assessments focus on the financial impact of ESG risks to long term profitability, rather than viewing social and environmental goals as ends of their own. The Inter-agency Task Force on Financing for Development will give further consideration to the issue of ESG inclusion in CRA assessments as part of its requested work on mapping of financial system incentives.

C. International public finance institutions

52. International public finance institutions play an important and unique role in the international financial system, as they intermediate credit to both the public and private sectors in developing countries. They have the ability to finance sectors that provide public goods and can also leverage private resources for public purposes.

53. The Addis Agenda stresses that MDBs should update and develop their policies in support of the 2030 Agenda and also encourages multilateral development finance institutions to examine their roles, scale and functioning to be fully responsive to the sustainable development agenda. In 2016, the World Bank conducted a Forward Look exercise, which sought to shape a common view among shareholders on how the World Bank Group can best support the development agenda for 2030 and implementation of the Addis Ababa Action Agenda while staying focused on its own goals. The Bank reported on its progress and challenges in March 2017.[42] One of the tools the World Bank Group proposes to use to target resources is called the "Cascade" which prioritises private sector involvement. Under this approach – which is primarily used for infrastructure finance, but will be expanded to finance, education, health and agribusiness sectors – the World Bank Group "first seeks to mobilize commercial finance, enabled by upstream reforms where necessary… Only where market solutions are not possible through sector reform and risk mitigation would official and public resources be applied." The Cascade approach introduces market mechanisms in the identified sectors as the first priority for reform efforts. Other

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[40] US SEC (2016) https://www.sec.gov/ocr/reportspubs/special-studies/nrsro-summary-report-2016.pdf.
[41] https://www.unpri.org/download_report/20983
[42] http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23745169/DC2017-0002.pdf

MDBs are also conducting strategic exercises to seek to align with the 2030 Agenda. All these efforts should be consistent with relevant development effectiveness principles, including that of country ownership.

54. Additionally, the MDBs are working together to increase their use of leverage and engage the private sector in their projects. In this context, nine MDBs including the new institutions have produced both a set of six principles for crowding-in private sector finance for growth and sustainable development and joint ambitions[43] for crowding in private finance. In the joint ambitions, the "MDBs commit to increasing overall private sector mobilization by 25-35 per cent over the next three years". Using a uniform methodology agreed among the MDBs, they report that in 2016 they directly mobilized $50 billion from private and other institutional investors, and a further $114 billion in direct mobilisation. Infrastructure investment represented 14 per cent of the direct mobilisation and 54 per cent of the indirect mobilisation.[44]

55. The Addis Agenda states that MDBs should make optimal use of their resources and balance sheets, consistent with maintaining their financial integrity, and doing so in alignment with sustainable development. In response to a G20 request, in June 2017, the MDBs issued a second annual report on balance optimization.[45] To ensure that the increased leverage does not impact their credit ratings negatively, the MDBs have engaged CRAs on their methodology, and have also undertaken measures at individual banks. An additional item on the balance sheet optimisation agenda has been portfolio diversification. In 2015, the MDBs engaged in some exposure swaps to try to diversify risks and thus reduce loss provisioning, though no such swaps were done in 2016. Such efforts could be developed in the areas of currency and other risks, which could theoretically allow greater lending in local currencies.

56. Capital increases are also on the agendas for a few institutions. The World Bank Group last had a capital increase, agreed along with a reform of voting rights, in 2010. In October 2015, World Bank governors agreed to consider a general capital increase alongside further governance reform, aiming to reach a decision by the 2017 annual meetings. The World Bank's senior management indicated that without increases at both the IBRD and IFC, the Group's private sector lending arm, the institutions would have to shrink their activities despite the large needs associated with SDG financing.[46] The President of the African Development Bank has also clearly stated his belief that the AfDB needs a capital increase if it is to meet the rapidly rising needs of the continent.[47]

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[43] http://www.bundesfinanzministerium.de/Content/DE/Downloads/G20-Dokumente/Hamburg_Genannte_Berichte/Joint-MDB-Statement-of-Ambitions.pdf
[44] http://www.worldbank.org/mdbmob
[45] http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Featured/G20/G20-Documents/Hamburg_reports-mentioned/Second-Report-on-MDB-Action-Plan.pdf?__blob=publicationFile&v=2
[46] Development Committee Spring 2017 communique.
[47] http://www.afdb.org/fileadmin/uploads/afdb/Documents/Generic-Documents/Keynote_speech_delivered_by_Akinwumi_A._Adesina__President_of_the_African_Development_

57. The Addis Agenda also stresses that development banks should establish or maintain social and environmental safeguard systems, including on human rights, gender equality and women's empowerment, that are transparent, effective, efficient and time-sensitive. In August 2016, the World Bank's executive board adopted a new Environmental and Social Framework,[48] which adds new provisions on labour and non-discrimination. Nonetheless, some civil society groups see the new framework as a "set-back to key environmental and social protections," due to its heavier reliance on the accountability systems of borrower countries and greater flexibility in application of rules.[49]

58. The New Development Banks (NDB) Articles of Agreement list the purposes of the bank as supporting "sustainable development projects". The NDB agreed its environmental and social framework in April 2016, which relies on project-level or national grievance mechanisms.[50] It does not include an independent accountability mechanism to oversee compliance or accept complaints. With the exception of the Inter-American Development Bank, whose safeguard systems were agreed in 2006, the other MDBs have all revised their safeguard systems in 2009 or later.

59. Member States have repeatedly emphasised the importance of women's rights and gender equality, including in the Financing for Development outcomes, and encouraged international financial institutions to include gender equality in their investment decisions. The World Bank monitors the gender components of its lending in its reporting. According to its April 2017 scorecard, 62 per cent of projects were gender-informed in the three dimensions of analysis, action and monitoring. Additionally, 70 per cent of projects were reporting on gender results during implementation, somewhat below the target of 75 per cent. All country strategies had incorporated gender. The IFC has been collecting gender-disaggregated indicators on employment creation by IFC investments since 2009, and reports that 673,437 women were collectively employed by IFC clients in 2014, about 27 per cent of the report employment. The IFC's nominations for positions of the boards of directors of its clients were 29 per cent female.[51] According to the African Development Bank Group's Annual Development Effectiveness Review, in 2016, 70 per cent of its new projects had gender-informed design.[52] While the most recent review no longer contains information on gender-equality outcomes, the latest data available shows that 61 per cent of projects had

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Bank_Group__at_the_Annual_Meeting_of_the_African_Development_Bank_Group__Ahmedabad__India__May_22-25__2017_.pdf

[48] http://www.worldbank.org/en/programs/environmental-and-social-policies-for-projects/brief/the-environmental-and-social-framework-esf

[49] http://www.ciel.org/news/safeguard-policy-endangers-rights/

[50] http://www.ndb.int/wp-content/uploads/2017/02/ndb-environment-social-framework-20160330.pdf

[51] IFC (2017) "Gender at the IFC", http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Gender+at+IFC, accessed 24 July 2017.

[52] AfDB (2017) *Annual Development Effectiveness Review 2017*, https://www.afdb.org/fileadmin/uploads/afdb/Documents/Development_Effectiveness_Review_2017/ADER__2017_EN.pdf

satisfactory gender-equality outcomes in 2015, down from 78 per cent in 2014.[53] The Asian Development Bank reported that for 2014-2016 50 per cent of its operations, representing 41 per cent of financing, supported gender mainstreaming.

60. Grants and concessional lending by MDBs are an important source of resources for many of the LDCs. The World Bank's concessional arm, the International Development Association (IDA), concluded its 18th replenishment round in December 2016 with donor contributions declining in nominal terms from $26.1 billion for IDA17 in 2013 to $23.1 billion for IDA18. However, a reform to allow IDA to borrow on capital markets will allow an increased commitment authority of $75 billion for IDA18, up from $52.1 billion for IDA17.[54]

61. Similar reforms have taken place at some of the regional development banks. In 2016, the Asian Development Bank restructured its capital base to enable an increase in concessional lending to eligible countries from $23 billion to $28 billion for 2017-2020. Similarly, the Inter-American Development Bank also restructured its concessional fund to better leverage resources. In December 2016, donors agreed to contribute $4.7 billion towards a replenishment to the African Development Fund, the African Development Bank's concessional window, though this was down from $5.7 billion contributed by donors in 2013.

D. Other international economic issues

Women's participation in the economy

62. Member States have repeatedly emphasised that women's equal access to and opportunities for participation and leadership in the economy are crucial to the realization of women's human rights and to sustainable development. The World Bank estimates that across all countries around 35 per cent of firms have female participation in ownership, with 14 per cent having majority female ownership, and 18.8 per cent have females as a top manager.[55] Women hold around 15.8 per cent of seats on corporate boards globally, and 9 per cent of board seats at major corporations in emerging markets in 2016.[56] The International Labour Organisation (ILO) has estimated that there is increasing gender gaps along sectoral and occupational lines, and that women are more likely than men to be in vulnerable employment, but that this gap is declining. Globally, only 1.5 per cent of women in work are classified as 'employers', compared to 3.9 per cent of men, marking a gap of 2.4 percentage points. This gap is largest in developed countries, where it hits 3.8 percentage points. Of women participating in the labour force, almost 16 per cent of them in emerging countries

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[53] AfDB (2016) *Annual Development Effectiveness Review 2016*, https://www.afdb.org/fileadmin/uploads/afdb/Documents/Development_Effectiveness_Review_2016/ADER__2016_EN.pdf
[54] http://ida.worldbank.org/financing/replenishments/ida18-replenishment
[55] http://www.enterprisesurveys.org/
[56] MSCI (2016) *The Tipping Point: Women on Boards and Financial Performance*, https://www.msci.com/www/research-paper/the-tipping-point-women-on/0538947986

work as managers, professionals or technicians; for working women in developed countries, nearly 40 per cent work in these occupations.[57]

Illicit financial flows (IFFs)

63. Tackling tax evasion and avoidance as well as other IFFs, remains one of the biggest challenges in mobilizing revenues for sustainable development. Measuring and tracking IFFs is extremely challenging because of the clandestine nature of the underlying activity, as well as the lack of an agreed definition. There is no single tool or process capable of effectively measuring or estimating all elements of IFFs. Component-by-component and channel-by-channel analysis and estimation of IFFs will allow further methodological work and proposals for relevant policy tools and options. Following the lead of the Economic Commission for Africa's work, in September 2016, the Economic Commission for Latin America and the Caribbean published estimates of goods trade mis-invoicing for its region, showing the amount of mis-invoicing ranging between $50 billion and $100 billion annually.[58] The majority of the United Nations Regional Commissions are planning to coordinate production of estimates of goods trade mis-invoicing in the future.

64. Tackling IFFs will require strengthening of existing institutions, enforcement of the law as well as the development of new policies and practices. Innovative uses of new technologies can also be helpful. Risk and vulnerability assessments can help countries focus their data, monitoring and enforcement efforts to the channels most relevant to their country contexts. Capacity building to fight IFFs should promote whole of government approaches to tackling financial crimes, encouraging inter-agency and international co-operation. At the international level, strengthened financial transparency standards, the publication of beneficial ownership information, and improved regional and international exchange of financial information will also assist in enforcement.

International investment agreements and facilitation

65. International investment agreement (IIA) reform has made significant progress. Consolidating the first phase of IIA reform, most new treaties follow UNCTAD's Road Map for IIA Reform, which sets out five action areas: safeguarding the right to regulate, while providing protection; reforming investment dispute settlement; promoting and facilitating investment; ensuring responsible investment; and enhancing systemic consistency. Approximately 100 countries have so far used UNCTAD's policy instruments to review their IIA networks and an estimated 60 countries have used them to design treaty clauses. Global progress on sustainable-development-oriented IIA reform will be reviewed at the 2017 International Investment Agreement Conference in October 2017.[59]

66. In December 2016, UNCTAD's Trade and Development Board (TDB) endorsed UNCTAD's Global Action Menu for Investment Facilitation.[60] UNCTAD has so far

[57] ILO (2017) *World Employment Social Outlook: Trends for Women 2017*.
[58] ECLAC (2016) Economic Survey of Latin America and the Caribbean 2016, LC/G.2684-P
[59] http://unctad.org/en/pages/MeetingDetails.aspx?meetingid=1541
[60] TD/B/63/7

conducted Investment Policy Reviews for 45 countries – half of which are LDCs – with the aim of helping beneficiary countries align their investment frameworks with development objectives, and enhancing the benefits from FDI. So far in 2017, work has started on three more national and one regional review, while three national implementation reports will be presented for intergovernmental review in November 2017.

Global economic governance

67. The Addis Agenda recommits to broadening and strengthening the voice and participation of developing countries in international economic decision-making and norm-setting and global economic governance. Countries also reiterated their commitment to further governance reform in both the IMF and the World Bank to adapt to changes in the global economy.

68. With the 2010 IMF quota and governance reforms nearly fully implemented and only five countries have not yet consented to their proposed quota increases, attention is turning to the 15th General Review of Quotas and a new quota formula. IMF governors agreed, in October 2016, to set back the timetable for completion from the 2017 annual meetings to the 2019 annual meetings "to provide adequate time to build the necessary broad consensus".[61]

69. The World Bank's shareholding review agreed in 2010 was due to be fully phased in by March 2017. The shareholding of developing countries in the Bank's main lending arm grew from 38.06 per cent in 2010 to 38.78 per cent as of end June 2017.[62] A 2015 review of shareholding decided that an agreement on a further reform should be reached by the 2017 annual meetings of the World Bank Group scheduled for October. A spring 2017 progress report on the shareholding review indicated that "there is scope for a potential selective increase" but stressed that "at this stage of discussion the options remain open … the discussions are proceeding on the basis that nothing is agreed until everything is agreed."[63]

Role of the United Nations

70. In the Addis Agenda, Member States recognised the importance of addressing inconsistencies in the international system and committed to taking better advantage of relevant United Nations forums for promoting universal and holistic coherence and international commitments to sustainable development. In 2017, the first substantive report and the creation of an online annex of the Inter-agency Task Force on Financing for Development[64] – which includes the five major institutional stakeholders and over 50 UN agencies, international organization and other relevant actors, such as the FSB and OECD – as well as the second ECOSOC Forum on Financing for Development follow-up made major contributions to improving system coherence. Using the guidance provided by the Task

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[61] https://www.imf.org/en/News/Articles/2016/10/08/AM16-cm100816-Communique-of-the-Thirty-Fourth-Meeting-of-the-IMFC
[62] http://siteresources.worldbank.org/BODINT/Resources/278027-1215524804501/IBRDCountryVotingTable.pdf
[63] World Bank and IMF (2017) *Shareholding Review: Progress Report to Governors at the 2017 Spring Meetings*, DC2017-003.
[64] Available at http://developmentfinance.un.org

Force's report, the substantive agreement on the outcome of the Forum[65] sent a strong signal that the international community remains deeply committed to multilateralism and the global partnership for sustainable development, despite a challenging global environment. Member States and other stakeholders agreed to accelerate national and international efforts in all areas of the Addis Agenda and the means of implementation of the SDGs. The Forum's successful outcome provided an important input to the High-level Political Forum on Sustainable Development in July 2017.

[65] E/FFDF/2017/3