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## International financial system and development

### Report of the Secretary-General**

*Summary*

The present report, submitted pursuant to General Assembly resolution 73/220, summarizes ongoing efforts to implement the commitments in the Addis Ababa Action Agenda of the Third International Conference on Financing for Development with regard to the international financial and monetary architecture, financial regulation, financial safety nets, international public finance institutions and global economic governance. The report contains three main sections. The first focuses on trends in international private and public capital flows to developing countries, the second on reforms to financial regulation and the third on strengthening macroeconomic stability and the international financial architecture in support of the 2030 Agenda for Sustainable Development.

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** The present report was prepared with input from the major institutional stakeholders involved in the financing for development process. Responsibility for its contents, however, rests solely with the United Nations.

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# I. Introduction

1. In its resolution 73/220, the General Assembly 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 the international financial institutions to align their programmes and policies with the 2030 Agenda for Sustainable Development and stressed the critical importance of a stable global economic environment for the implementation of the 2030 Agenda.

2. The world is being reshaped by rapid shifts in geopolitics, globalization, geoeconomics, technological advancement, the climate and other factors. Global systemic risks have been rising, raising doubts as to whether the multilateral financial and economic architecture is equipped to address current global challenges.

3. To implement the 2030 Agenda, the financial system needs to intermediate credit towards sustainable development in an inclusive and stable manner. Since the financial crisis of 2008, financial sector reforms have reduced important systemic risks, while access to financial services has increased in many countries, owing, in part, to the growth of financial technology. Yet, the implementation of the reforms is incomplete and new risks have emerged, including risks arising from the fact that financial technology operating outside traditional regulatory boundaries has grown. At the same time, the financial system fails, as before, to allocate adequate resources to meeting long-term sustainable development needs. In many areas critical to the Sustainable Development Goals, investment is insufficient.

4. In a period of political uncertainty, achieving the required transformation of the financial system will require domestic actions and strengthened international cooperation, both of which are necessary to ensure that adequate resources are available and that the financial safety nets designed to protect countries from instability provide comprehensive coverage. Ultimately, stability and sustainability are mutually reinforcing; longer-term investment in sustainable development can reduce short-term financial volatility, while the absence of a stable financial system makes it impossible to attain the Sustainable Development Goals.

# II. Economic and financial trends

5. In its midyear update of the world economic situation and prospects for 2019 (E/2019/70), the Economic and Social Council forecasts that world gross product growth will be 2.7 per cent in 2019 and 2.9 per cent in 2020, a slight downgrade from year-end forecasts. Economic growth remains highly uneven across regions and countries. Per capita growth in Africa, Western Asia, and Latin America and the Caribbean is, on average, significantly below 1.5 per cent. Together those regions are home to half of the world's people living in extreme poverty.

6. Debt sustainability remains a concern. As of May 2019, of the 46 least developed countries covered by the Debt Sustainability Framework for Low-Income Countries of the World Bank and the International Monetary Fund (IMF), 5 were in debt distress, and 13 more were classified as being at high risk. In the period of low interest rates between 2007 and 2017, the total external debt of the least developed countries more than doubled, jumping from $146 billion to $313 billion. Of that amount, around 60 per cent was concessional. In 2017, the debt service burden of the least developed countries as a group exceeded 6 per cent of exports (and in some individual cases exceeded 10 per cent), approaching levels last seen before the debt relief initiatives of the early 2000s. In a context of heightened uncertainty and persistent financial stability risks, the growing debt levels in least developed countries

may undermine their ability to make sufficient investments to achieve the Sustainable Development Goals.

7. The evolving global outlook is reflected in policy responses. In developed economies, central banks had been indicating for many years that they would gradually tighten monetary policy from the historic low interest rates set in the wake of the 2008 financial crisis. However, because of economic uncertainty and policy risks compounded by weaker-than-expected inflation and growth, they have placed that tighter monetary policy on hold. Monetary policy may even become looser in some cases; in the United States of America, early in 2019, the treasury yield curve inverted, meaning that longer-term bonds provided lower returns than very short-term bonds. This indicates that investors were pricing in an easing of monetary policy.

8. The volatility that affected the exchange rates in a number of emerging markets in the first half of 2018 did not lead to a depreciation of developing countries' currencies. The rise in dispersion of currency volatility affecting emerging markets in 2018 to levels not seen since the financial crisis indicates that financial markets have been differentiating between countries, with capital outflows and pressures on exchange rates more acute in countries with weaker fundamentals or higher political risk. Nonetheless, IMF has assessed that medium-term risks to broader financial stability remain elevated and that a prolonged period of "easy money" could result in a more severe downturn later.

9. Recent progress on gender equality has been marginal at best. Globally, the labour force participation rate of women, at 48 per cent in 2018, was 27 percentage points below the rate for men. The gap between wages earned by women and men lies between 16 and 22 per cent, depending on the estimation technique. In developed countries, the gender pay gap is largest at the top of the income distribution scale, while in poorer countries the gap is largest at the low end.[1]

## A. Global trends in capital flows

10. Developing countries are estimated to have recorded net capital inflows of \$72 billion in 2018, down from \$254 billion in 2017.[2] Net capital inflows were strong in Latin America and the Caribbean, and in some countries in Asia. For example, India saw \$68 billion in inflows. China, which saw large net outflows in 2015 and 2016, saw net inflows of \$131 billion in 2018.[3] Looking to the future, with expectations of an easing of monetary policy, some financial market actors may again seek higher returns in developing countries.

## B. Private flows

11. Private capital flows have three main components: foreign direct investment, portfolio flows, and other investment. Foreign direct investment is generally more stable and oriented towards the long term than other investment flows, although it can be motivated by tax and regulatory arbitrage rather than underlying business opportunities. Bank lending and portfolio flows tend to reflect global financial conditions and are subject to greater volatility and procyclicality. Residents and

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[1] International Labour Organization, *Global Wage Report 2018/19: What Lies behind Gender Pay Gaps* (Geneva, 2018).

[2] International Monetary Fund (IMF), *World Economic Outlook: Growth Slowdown, Precarious Recovery* (Washington, D.C., 2019), table A13. Aggregates have been recalculated based on the United Nations working definition of the term "developing country".

[3] China, State Administration of Foreign Exchange, "Time series data of balance of payments of China", available at http://www.safe.gov.cn/en/BalanceofPayments/index.html.

non-residents in a given country also exhibit different investment behaviour and different degrees of risk aversion.

12. In 2018, global foreign direct investment flows fell by 13 per cent to $1.3 trillion.[4] The decline – the third in as many years – was mainly due to large-scale repatriations of accumulated foreign earnings by United States multinational enterprises, following tax reforms in the United States at the end of 2017. However, it also reflects broader anaemic growth in foreign direct investment since the 2008 global economic and financial crisis. Foreign direct investment net of one-off factors such as tax reforms, megadeals and short-term financial flows has undergone an average annual growth of only 1 per cent for a decade, compared to 8 per cent between 2000 and 2007, and more than 20 per cent before 2000. Explanations include declining rates of return on foreign direct investment, exhaustion of opportunities for creating global value chains, increasingly asset-light forms of investment and a less favourable investment policy climate.

13. In contrast to the global trend, foreign direct investment flows to developing countries rose 2 per cent in 2018, with the share of developing countries in global foreign direct investment increasing to a record 54 per cent. Following a decline in 2017, foreign direct investment flows to the least developed countries recovered slightly to $24 billion but still accounted for less than 3 per cent of the global total.

14. Net portfolio flows to developing countries remained volatile, with net outflows of $79 billion in 2018.[5] South and East Asia accounted for the largest portion of net outflows, at $111 billion driven primarily by outflows of residents. Inflows to the region from non-residents remained positive, at $222 billion in 2018.

15. The category “other investment” primarily consists of cross-border bank loans.[6] Net outflows from developing countries in this category increased to $248 billion in 2019,[7] reflecting $701 billion in outflows from resident investors in developing countries. Regionally South and East Asia also saw the biggest net outflows in this category. Looking specifically at cross-border bank exposure, most regions saw a slowdown in credit growth. The exception was Latin America and the Caribbean, which returned to annual growth in cross-border loans (1 per cent) in 2018, after experiencing contractions in 2016 and 2017.[8]

## C. Official flows

16. Capital flow data include official lending from bilateral and multilateral lenders. In 2017, annual disbursements of non-grant subsidized finance from traditional multilateral development banks was $63 billion, a very small nominal decline from 2016, and the second year in a row that lending growth has been negligible. IMF, which provides lending for balance-of-payments support, approved $79 billion in new non-concessional commitments in the fiscal year 2019, as well as concessional loans of $172 million to its low-income developing members.[9]

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[4] *World Investment Report 2019* (United Nations publication, Sales No: E.19.II.D.12).

[5] IMF, *World Economic Outlook*, table A13. Aggregates have been recalculated based on the United Nations working definition of the term “developing country”.

[6] The category “other investment” includes currency and deposits, loans, trade credits and other financial sector instruments.

[7] IMF, *World Economic Outlook*, table A13. Aggregates have been recalculated based on the United Nations working definition of the term “developing country”.

[8] Bank for International Settlements, “BIS international banking statistics at end-December 2018” (18 April 2019).

[9] IMF, “IMF lending arrangements as of May 31, 2019”, IMF Lending Arrangements database, available at https://www.imf.org/external/np/fin/tad/extarr1.aspx.

17. The Asian Infrastructure Investment Bank and the New Development Bank completed their third full year of operations in 2018. The Asian Infrastructure Investment Bank approved 11 projects worth $3.3 billion in 2018, an increase from the $2.5 billion approved for 15 projects in 2017.[10] The New Development Bank nearly trebled its pace of commitments, with almost $5.7 billion approved in lending for 21 projects; over 40 per cent of commitments were in the transportation sector.[11]

# III. Strengthening macroeconomic stability and the international architecture

## A. International financial and monetary architecture

*Managing capital flow volatility*

18. International capital inflows can be of substantial benefit to countries by supplementing domestic savings and investment. However, short-term and volatile capital flows give rise to macroeconomic and financial stability risks that often impact the real economy. The short-term orientation that sometimes characterizes capital markets is reflected in the volatility of cross-border capital flows that was discussed above. It is also reflected in the holding period of stocks in some developed markets, which has shortened from an average of eight years in the 1960s to eight months today. Given the differences in investment horizon and other drivers of various types of investment flows, policymakers can aim to maximize the benefit of inflows while managing risks and enhancing macroeconomic stability.

19. In the Addis Ababa Action Agenda, Member States recognized 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. Macroprudential policies and measures, which are designed to limit systemic risk, encompass a wide variety of tools that can help to build buffers to shocks, mitigate the procyclicality of financial markets and institutions, and limit structural vulnerabilities in the financial system. Certain capital account management techniques, including macroprudential regulations, have proved particularly effective in shifting the maturity profile of investment.

20. It is not yet fully understood how source countries, i.e., countries from which capital flows originate, can appropriately combine macroeconomic, macroprudential and regulatory policies to meet their domestic macroeconomic objectives while at the same time avoiding excessive leverage and large international spillovers in the form of capital flow volatility. Incentivizing international investors to adopt longer time investment horizons would help to achieve not only sustainable development, it could have the added benefit of helping to reduce volatility. The international community could work to develop guidelines or good practices indicating how source countries can adopt such policies most effectively. Greater macroeconomic coordination among systemically important economies can also help to address global financial market volatility.

21. Capital account policies in both source and destination countries need to be consistent with macroeconomic and macroprudential policies. For the Sustainable Development Goals to be achieved, measures also need to be consistent with the full range of policies in the action areas of the Addis Ababa Action Agenda, such as international investment agreements, financial sector strategies and capital market

[10] Asian Infrastructure Investment Bank, “Approved projects” (accessed on 15 July 2019).
[11] New Development Bank, “Project procurement” (accessed on 15 July 2019).

development policies. To be at their most effective, capital account policies should therefore be incorporated into integrated national financing frameworks.

22. Many developing countries hold international reserves as a form of "self-insurance" against capital flow volatility, as a drawdown in reserves can help to manage exchange rate instability. However, for those developing countries able to accumulate international reserves, storing them in safe but low-yielding assets has an opportunity cost. Reserves are mostly invested in bills and bonds of the United States Treasury, which implies that resources of developing countries are being lent to developed countries at relatively low interest rates. Furthermore, the precautionary accumulation of reserves, while sensible at the national level, increases the amount of systemic risk at the international level by adding to global imbalances. Although there are many reasons for countries to hold reserves, containing global volatility could enable developing countries to free up some of their reserves for investment in domestic productive capacity, infrastructure or other projects related to the Sustainable Development Goals, while further reducing systemic risks.

*Addressing global imbalances and the international monetary system*

23. International reserves are the balancing factor between current account surpluses (or deficits) and corresponding capital account deficits (or surpluses). Global imbalances in the current and capital accounts have continued to diminish from their peaks from before the financial crisis, even though they are estimated to have increased slightly in 2018, with major imbalances, including both deficits and surpluses, now concentrated in developed countries. This broadly mirrors the trend that reserves as a share of global gross domestic product have fallen since 2013, even though in 2018, global reserve accumulation saw a small nominal decline to \$11.2 trillion, with approximately \$7.4 trillion held in developing countries.[12]

24. The share of international reserves held in United States dollars has been falling steadily. Dollar-denominated reserves accounted for 61.7 per cent of the global total at the end of 2018, down from a peak of 71.5 per cent in 2001. This represents a relatively constant decline, despite a small jump in 2014. Euro-denominated assets accounted for 20.7 per cent, and Chinese renminbi-denominated assets, which were reported for the first time in 2016, rose to 1.9 per cent of the total.[13]

25. The decline in the share of reserves held in dollars is seen by some economists as the beginning of a shift from the current system, based primarily on the dollar, to a multi-currency reserve system. There is a risk that such a system could lead to more volatility, because it entails greater uncertainty and fluctuations between major reserve currencies. Weak macroeconomic coordination among systemically important economies could exacerbate that volatility.

26. The design of the international monetary system sets the backdrop against which capital flows and macroeconomic stability play out. Some analysts and researchers have proposed giving more prominence to an internationally created reserve asset to help to manage volatility. However, proposals to that effect have lacked political support. In 2018, the IMF executive board discussed whether special drawing rights could be used for that purpose, but did not come to a consensus. At the same time, the

[12] Calculations by the Department of Economic and Social Affairs based on IMF international financial statistics.

[13] IMF, "Currency composition of official foreign exchange reserves (COFER)", IMF Data (accessed on 15 July 2019).

growth of cryptoassets issued by private parties[14] has added uncertainty to the landscape, potentially creating macroeconomic risks and challenges.

27. The IMF executive board has requested research into how economic and technological transitions, such as a potential move towards a multipolar global economy and the adoption of financial technologies, could reshape the international monetary system in the future. The challenges posed by cryptoassets and the impact of proposed digital currencies issued by central banks will be central to the analysis of IMF and to its recommendations.

*Cryptoassets*

28. Cryptoassets are an emerging innovation in financial technology that has grown rapidly since the bitcoin network was first launched in January 2009. With time, the growth of cryptoassets could have systemic implications. Cryptoassets could bring decentralized payment processing and greater access to digital financial services (see para. 61), but not without systemic risks or risks to consumers (see also the discussion on financial inclusion in sect. IV.D).

29. In June 2019, two major payments processors, Visa and Mastercard, together with digital businesses such as Uber and Lyft, and the world's largest social media network, Facebook, announced a joint initiative to create a new global cryptoasset that could be used like a currency and whose volatility, they hope, will be low. The digital currency, named Libra, is meant to promote financial inclusion, make it easier to move money around the world and secure digital financial assets on mobile devices with distributed ledger technology.[15] The potential scale of this cryptoasset – given its major backers – has broad implications for macroeconomic policies, as would the development of any large cryptoasset for that matter.

30. It is also unclear how Libra or other global currencies will comply with capital account restrictions or currency exchange rules in those countries that have them in place. The widespread adoption of a digital currency would also affect monetary policy and financial stability, and could entail severe complications for developing countries. The Libra Association intends to stabilize the value of the Libra by tying its value to a basket of currencies and keeping a reserve of liquid assets for every Libra unit (or token) created. In doing so, it could retain large volumes of the conventional money supply, which might not be sustainable in an environment of negative interest rates or high volatility among the reserve currencies. If residents of developing countries are able to store, with relative ease, their financial assets in the Libra network rather than in the local banking system, central banks will find their ability to effectively transmit their monetary policies to the economy severely hampered. Likewise, the solvency of the domestic banking sector could be impacted significantly and the availability of lending capital for productive investment could be reduced.

31. While the Libra Association aims to promote financial inclusion and have its currency used for payments in ordinary transactions, the history of other cryptoassets suggests that there may also be interest in Libra tokens as a speculative asset. Speculation based on the value of cryptoassets, including, potentially, in new derivative markets, could exacerbate the volatility of valuations.

32. The anonymity and cross-border reach of all cryptoassets raises concerns about illicit financial flows. Currently, transactions in cryptoassets cannot be traced to real identities in any authoritative way because they are anonymized by service providers.

[14] Cryptoassets are private virtual assets that rely primarily on cryptography and distributed-ledger or similar technology. Examples of existing cryptoassets are bitcoin, Litecoin and Ethereum.

[15] Libra Association, "An introduction to Libra: white paper" (accessed on 15 July 2019).

There is evidence that cryptoassets have been fertile ground for financial crime.[16] In October 2018, the Financial Action Task Force updated its standards and recommendations regarding virtual assets. It defined the term "virtual asset service providers" to include virtual asset exchanges, digital wallet providers and providers of financial services for initial coin offerings. The Financial Action Task Force called on jurisdictions to include virtual asset service providers in their regulations to counter money-laundering and the financing of terrorism.[17] It is unclear if or how the Libra Association intends to comply with the rules to counter money-laundering and the financing of terrorism. Its potential to facilitate illicit financial flows (see sect. V.D below) merits attention from regulatory agencies.

## B. Financial safety nets

33. In the Addis Ababa Action Agenda, States recognized the need to strengthen the permanent international financial safety net, with a strong and quota-based IMF at its centre. They urged IMF to continue its efforts to provide more comprehensive and flexible financial responses to the needs of developing countries. At present, issues for consideration by the Member States include the size and coverage of the safety net, the conditions placed on countries that access parts of the safety net, and coordination between different layers of the safety net.

34. The size of the global financial safety net is determined by a combination of IMF quota and its arrangements for temporary borrowing from its members. At the end of May 2019, IMF maintained a forward commitment capacity of $257 billion based on quota resources and potential resources from borrowing of $518 billion if the borrowing lines were activated.[18]

35. The board of governors of IMF agreed in December 2016 to work towards completing the fifteenth general review of quotas, including a new quota formula, by the 2019 annual meetings.

36. In 2018, IMF conducted the first comprehensive stock-taking of its lending operations since the 2008 global financial crisis in the form of a review of programme design and conditionality.[19] In parallel, it created a strategy for IMF engagement on social spending.[20] In the conditionality review, IMF found that the number of structural conditions in its programmes had increased over time, with the IMF executive board noting the importance of further prioritizing reforms. At the same time, under the social spending strategy IMF programmes are to put greater emphasis on mitigating the adverse impact of fiscal adjustment on the vulnerable, such as through social protection, thus better aligning IMF programmes with the 2030 Agenda. The strategy does not commit IMF to supporting the aims of the 2030 Agenda of universal social protection floors or expanded social spending in all countries and instead indicated that an appropriate mix of universal and targeted transfers depended on country preferences and circumstances, including administrative, financing, social and political constraints.

[16] See Izabella Kaminska, "Fintech as a gateway for criminal enterprise", *Financial Times*, 12 January 2018.

[17] Financial Action Task Force, "Regulation of virtual assets", 19 October 2018.

[18] IMF, "Weekly report on key financial statistics", 30 May 2019.

[19] IMF, *2018 Review of Program Design and Conditionality*, IMF Policy Paper, No. 19/012 (Washington, D.C., 2019).

[20] IMF *A Strategy for IMF Engagement on Social Spending*, IMF Policy Paper, No. 19/016 (Washington, D.C., 2019).

*Regional financial safety nets*

37. Additional options for strengthening the global financial safety net include regional reserve pooling arrangements and bilateral swap lines. The biggest regional arrangement, with resources of $240 billion, is the Chiang Mai Initiative Multilateralization, which involves financial cooperation between the Association of Southeast Asian Nations, China, Japan and the Republic of Korea. In May 2019, the first periodic review of the Chiang Mai Initiative Multilateralization was completed and the partners agreed to begin allowing contributions and borrowing in local currencies instead of only in United States dollars[21] in response to increasing cross-border trade and investment activity denominated in local Asian currencies. Asian countries continue to renew their bilateral swap lines, which provide for emergency liquidity support between central banks. For example, China has 35 such arrangements with countries in every region for a total value of almost $500 billion.[22]

38. The Latin American Reserve Fund, which has eight members in the Latin American region, is another regional reserve pooling arrangement. It has been used actively by six of its members. In 2018, it provided new credits worth $1.3 billion in three loans as its members faced balance-of-payments challenges. A regional reserve fund with a larger membership and more capital could contribute even more to regional financial stability.

39. The three largest regional pooling arrangements – the Chiang Mai Initiative Multilateralization, the Latin American Reserve Fund and the European Stability Mechanism – hosted their third annual research seminar for all regional financial arrangements in May 2019. They focused on strengthening their capacity to detect sovereign risk and on ways to coordinate different layers of the global financial safety net.

## IV. Reforms of financial regulation

40. Achieving the Sustainable Development Goals will require shifting the central concern of investment decisions towards long-term investment and sustainability. Doing so requires aligning private and public incentives with sustainable development.

41. Traditionally, financial regulation focused on the safety and soundness of the banking sector. However, all regulation affects incentives, and growing attention has been paid to the impact of financial regulation on incentives for investment in sustainable development. On the other hand, in conjunction with coherent policy frameworks, regulation can encourage positive changes in behaviour, such as when it promotes financial inclusion. In the Addis Ababa Action Agenda, Member States agreed to work to ensure that our policy and regulatory environment supported financial market stability and promoted financial inclusion in a balanced manner.

42. At the same time, an increasing portion of credit intermediation is taking place outside the regulated banking sector. Regulatory boundaries are being blurred by financial technology. Financial technology is helping the financial system to reach those left behind, but its spread does have both stability and sustainability implications.

[21] See joint statement of the twenty-second "ASEAN+3" finance ministers' and central bank governors' meeting, 2 May 2019. Available at https://asean.org.

[22] Daniel McDowell "The (ineffective) financial statecraft of China's bilateral swap agreements", *Development and Change*, vol. 50, No. 1, p. 122.

## A. Banking and insurance regulation

43. Banking regulations are intended to ensure that commercial banks hold sufficient capital and liquidity to cover potential losses in their portfolios, and are thus able to withstand financial and economic stress. The Basel Committee on Banking Supervision reformed the international standards for banking regulation in several rounds, which together formed the international regulatory framework for banks, also known as Basel III. The reforms included boosting the capital of banks to ensure that they had sufficient high-quality liquid assets, and requiring banks to maintain a sustainable funding profile.

44. All 24 Financial Stability Board jurisdictions have risk-based capital rules and regulations regarding the liquidity coverage ratio in force. The leverage ratio is in force in 16 jurisdictions and the net stable funding ratio in 11 jurisdictions, meaning that a number of jurisdictions have yet to adopt those rules, even though the January 2018 implementation deadline has passed. Despite another deadline of January 2019, only 9 jurisdictions have to date implemented the large exposures framework, which is intended to constrain the maximum loss a bank could face in the event of a sudden failure of a single counterparty or a group of connected counterparties.

45. Questions have been raised about the way in which the Basel III framework will affect lending in sectors that are important for achieving the Sustainable Development Goals. Areas of concern include for the financing of long-term projects such as infrastructure, small and medium-sized enterprises, and lending to developing countries in a broader sense.

46. The Financial Stability Board has also launched an effort to evaluate the impact of financial regulatory reforms in various thematic areas. In November 2018, it completed an evaluation of the effects that financial regulatory reforms have on infrastructure finance.[23] A broad range of factors has the potential to affect infrastructure finance, including regulations, monetary and financial conditions and the business models of large financial institutions operating around the world. The Board found that, overall, private infrastructure finance had grown in recent years after a temporary drop during the 2008 financial crisis. This growth had mainly been due to a growth in non-bank finance, with infrastructure finance by banks having been relatively flat after falling in the wake of the crisis. Infrastructure finance provided by the financial sector accounted for a relatively small share of the global spending on infrastructure investments (about 5 to 10 per cent), while the bulk was provided by the public sector.

47. It is difficult to single out the changes to infrastructure finance that are due specifically to regulatory reforms. Nonetheless, infrastructure finance provided by banks does not seem to have been affected disproportionately compared to other types of bank lending. However, the Financial Stability Board did find that regulatory reforms had contributed to shorter average maturities of infrastructure loans by global systemically important banks, which was in line with the goal of the reforms to reduce maturity mismatch on bank balance sheets.

48. In June 2019, the Financial Stability Board launched a public consultation on the effects of reforms on the financing of small and medium-sized enterprises. As concerns lending to developing countries, total cross-border bank lending to borrowers in emerging markets has grown since 2009, despite volatility over the years. However, much of that increase has been the result of short-term lending. Long-term lending (maturities longer than one year) has grown more slowly, underscoring

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[23] Financial Stability Board, *Evaluation of the effects of financial regulatory reforms on infrastructure finance* (Basel, Switzerland, 2018).

the challenges policymakers in developing countries face in ensuring the quality of borrowing and in managing debt and capital account risks.

49. Members of the Financial Stability Board have agreed to some reforms to address the problem of "too-big-to-fail" financial institutions, in other words, those institutions that were so large and integral to the financial system that they had implicit bailout guarantees from Governments. Almost all of the Board's members have adopted requirements for global and domestic systemically important banks, along with the core reform, namely the requirement that those banks hold additional capital. However, substantial work remains to be done to arrive at effective regimes for resolving, or winding down and liquidating, insolvent large financial institutions. The implementation of resolution powers and of resolution planning requirements is still incomplete in many jurisdictions. The least progress has been made in relation to powers for resolving insurance companies, with only eight jurisdictions having such regimes in place. An evaluation on the effects of the "too-big-to-fail" reforms will be launched in 2019 and completed in 2020.

## B. Correspondent banking

50. There are widely shared concerns about a decline in the number of active correspondent banking relationships, agreements between two banks in different countries to handle transactions on behalf of each other. Correspondent banking relationships enable the provision of domestic and cross-border payments. A decline in correspondent banking relationships can hamper efforts to reduce the costs of trade finance and sending remittances. The decline is, in large part, driven by the cost of maintaining anti-money-laundering and related standards (which are important for combating illicit financial flows), along with other risk considerations.

51. The decline in the number of active correspondent banking relationships continued in 2018, with a year-on-year reduction of 3.5 per cent, a slight slowdown.[24] Overall, since 2011 correspondent banking relationships have fallen by about 20 per cent, a decline that has affected all regions. Even though the overall volume of payments has increased, the number of active corridors fell by about 10 per cent over the same period.[25]

52. In 2015, the Financial Stability Board established an action plan to address the decline in correspondent banking relationships that comprised four focus areas: research and analysis; clarification of regulatory expectations; capacity-building; and strengthening tools for due diligence by banks.

53. Well-managed technological solutions and standardization have the potential to reduce the costs and risks of operating correspondent banking relationships. Member States would need to work together to agree to implement a standard solution so that financial institutions in any one country are not disadvantaged by set-up costs of new technologies. For example, Member States can work together to incentivize or require the adoption of know-your-customer utilities and the legal entity identifier. As the issuance of a legal entity identifier is accompanied by due diligence, the use of such identifiers in payment messages would facilitate the unambiguous identification of the originator and beneficiary of payments, without having to undertake due diligence for each payment.

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[24] Committee on Payments and Market Infrastructures, "New correspondent banking data – the decline continues", 27 May 2019. Available at www.bis.org.

[25] An active corridor is a country pair that saw at least one transaction in a given period.

## C. Non-bank financial institutions and derivatives

54. Effective financial regulation needs to address systemic risks from financial intermediation, whether by banks or other entities, as well as the full spectrum of other risks, such as settlement risk and fraud. In developing countries, much of the growth in intermediation outside the banking sector has come from the growth of financial technology and other non-bank financial instruments or institutions aimed at promoting financial inclusion (as discussed in the following section). The challenge for regulators is to create a framework that manages systemic risks and protects consumers without stifling innovation and access to financial services. To date, international standards have not yet fully addressed the growth in those activities.

55. Regulations must vary by the type of risk. For example, consumer protection is not likely to be addressed effectively with the help of capital requirements. In that vein, the international community has agreed that the focus of the regulatory framework needs to shift from the type of financial institution that provides a given financial service to the risks underlying that financial service. International regulatory standards also need to adapt to the new landscape. Such an approach is consistent with the efforts of the Financial Stability Board to set regulatory norms that address the financial stability risks associated with non-bank financial intermediation (often referred to as shadow banking) that were highlighted in the 2008 crisis.

56. Monitoring of non-bank financial intermediation involves aggregating data from different jurisdictions on all the different types of institutions. A narrow measure of non-bank financial intermediation, which includes non-bank financial entities that may pose financial stability risks, grew to $51.6 trillion in 2017, an expansion of 8.5 per cent.[26] A broader measure comprising other non-bank financial intermediaries grew 7.6 per cent to $116.6 trillion globally in 2017.

57. Reforms to the regulatory treatment of non-bank financial intermediation have been adopted and implemented by members of the Financial Stability Board. In almost all jurisdictions, regulations have been introduced on money market funds, repurchase agreements and other instruments that contributed to the 2008 crisis. Eight jurisdictions have not yet published draft liquidity management rules for money market funds, although the two largest jurisdictions for such funds, the United States and China, have. Meanwhile, nine jurisdictions do not yet have draft rules for incentivizing simplicity, transparency and comparability in securitization.

58. Derivatives are an example of financial instruments that can pose systemic risks but were previously outside regulatory boundaries. Countries hosting the largest derivatives markets have implemented stronger reporting, clearing, trading and margin requirements for over-the-counter derivatives. However, a number of member jurisdictions of the Financial Stability Board still have not implemented agreed rules for central clearing (6 jurisdictions), platform trading (10) and margin requirements for non-centrally cleared derivatives (8).[27]

## D. Financial inclusion and financial technology

59. Access to finance is essential for achieving the Sustainable Development Goals. The good news is that access to financial services has improved in recent years, often because of institutions or instruments outside the traditionally regulatory boundary,

[26] Financial Stability Board, *Global Monitoring Report on Non-Bank Financial Intermediation 2018* (Basel, Switzerland, 2019).

[27] Financial Stability Board “Progress in implementation of G20 financial regulatory reforms: summary progress report of the G20 as of June 2019” (Basel, Switzerland, 2019).

including financial technology. However, significant gaps remain in financial inclusion in most countries and for specific market segments.

60. In a recent survey on financial access, which was based on administrative data,[28] researchers found that from 2010 to 2017, the number of automated teller machines per 100,000 adults had grown by close to 50 per cent around the world, from 44 to 66. In least developed countries, the number per 100,000 adults doubled between 2010 and 2017, from 2.34 to 5.80. The growth of commercial bank branches per 100,000 adults relative to that of automated teller machines has been more moderate: only 2 per cent between 2010 to 2017. This lower growth rate is a result of more customers using digital banking solutions rather than visiting their local bank branches, as well as banks cutting costs. In the Latin America and Caribbean region, parity between women and men was reached in the use of deposit services at banks, but all regions still had gender gaps on borrowing from banks.

61. Digitalization can help the financial system to reach populations that do not yet have access to financial services, including women. Mobile money services have grown into major payment service providers, especially in Africa. In 2017, in low-income countries, mobile money accounts were more than twice as prevalent as bank accounts, whereas in middle-income countries, bank accounts remained about four times more prevalent than mobile money accounts. Sub-Saharan Africa had the highest penetration of mobile money accounts, nearly 600 per 1,000 adults in 2017, a doubling from the 300 accounts per 1,000 adults found in 2013. South Asia recorded a massive growth in mobile money accounts, resulting in the second-highest density of almost 450 accounts per 1,000 adults in 2017, compared to less than 50 per 1,000 adults in 2013. The Middle East and North Africa had the lowest penetration at less than 100 accounts per 1,000 adults in 2017.[29]

62. However, many new financial technology actors and products are not covered by existing regulatory frameworks. Financial technology is also blurring the lines between software, settlement and financial intermediation. If not appropriately regulated, financial technology services can pose risks to customers. Central banks and regulators should look carefully at the potential implications and address the risks that widespread adoption poses to macroeconomic stability, financial stability and consumers.

63. For example, the proposed digital currency, the Libra, is meant to promote financial inclusion, allow easier movement of money around the world and secure digital financial assets on mobile devices with distributed ledger technology. However, cryptoassets carry widely reported risks for consumers and investors. In addition to high price volatility, bankruptcies and fraud have caused major losses for consumers. There have also been many reports of market manipulation on cryptoasset exchanges, which are generally not covered by the regulations that protect traders in other financial markets. For example, initial coin offerings are transactions in which companies raise capital by creating digital assets related to a specific product or business model. Initial coin offerings have gained in popularity, with about $7 billion raised in the first half of 2018. However, in an often-cited study, researchers found that more than 80 per cent of initial coin offerings launched to date were ultimately identified as scams.[30] In response, regulators in several countries have started to apply investor protections to initial coin offerings.

[28] IMF, "Financial access survey 2018" (Washington, D.C., 2018).
[29] IMF, "Mobile money note 2019" (Washington, D.C., 2019).
[30] Satis Group, "Cryptoasset market coverage initiation: network creation", 11 July 2018.

## E. Credit rating agencies

64. Credit rating agencies continue to play an important role in both domestic and international capital markets. Their opinions on the creditworthiness of borrowers influence the availability and cost of finance for countries, companies and projects. In 2018, in the United States, despite continued national monitoring and supervision by credit rating agencies, regulators continued to find instances of agencies not properly applying methodologies and policies for determining ratings and violations of conflict-of-interest policies.[31]

65. No fundamental changes were witnessed in the market structure regarding the provision of credit ratings, with the three largest credit rating agencies still holding a 95 per cent share of business in the largest financial markets.[32] However, there are increasing numbers of smaller agencies operating in some market niches.

66. The time horizon for ratings remains relatively short – between two and five years for corporate debt. A longer-term outlook would likely increase the impact of sustainability considerations on performance, since many environmental and social risks are relevant only for time horizons longer than five years. Rating agencies could, as a first step, publish longer-term ratings alongside traditional ratings.

67. Credit rating agencies are also paying more attention to environmental, social and governance factors. To date, integration of such factors into credit analysis has meant that analysts focus on how environmental, social and governance factors affect financial return, rather than measuring the sustainability impact of an investment. In January 2019, Fitch Ratings, one of the three large credit rating agencies, launched a new integrated scoring system that is to show how environmental, social and governance factors impacted individual credit rating decisions. The agency plans to publish these scores for all asset classes. In April 2019, another of the three largest credit rating agencies, S&P Global, published an analysis titled "Environmental, social, and governance evaluation analytical approach", in which the agency outlined how it planned to look at environmental, social and governance factors to analyse an entity's capacity to operate successfully in the future. S&P Global stresses that the approach is not a component of its credit rating methodology, but that the information gathered for the evaluation can inform its credit analysis.

68. In contrast, some new firms have emerged that issue sustainability ratings. They do not relate those ratings to a financial return analysis, but to the direct impact the rated entity has on sustainability. The firms in question use a range of methodologies, which can result in the same entities being given contradictory ratings. As with efforts to understand the impact of investment on sustainable development, there is a need to take stock of these methodologies, analyse their underlying assumptions, find similarities and differences, and identify potential gaps and possible ways forward for standardization.

[31] United States of America, Securities and Exchange Commission, "2018 summary report of Commission staff's examinations of each nationally recognized statistical rating organization" (Washington, D.C., 2018).

[32] United States, Securities and Exchange Commission, "Annual report on nationally recognized statistical rating organizations" (Washington, D.C., 2018).

# V. Other issues related to the financial system

## A. Governance reform at international financial institutions

69. In the Addis Ababa Action Agenda, Heads of State and Government and High Representatives recommitted to broadening and strengthening the voice and participation of developing countries in international economic decision-making and reiterated their commitment to further governance reform in both IMF and the World Bank. Shareholders of the World Bank Group recently agreed on a capital increase and the shareholders of IMF are in the midst of the fifteenth general review of quotas, which could affect the voting rights of the Fund's members. In 2018, developing countries constituted 74.6 per cent of the membership of the World Bank and their voting rights in the Bank's main public-sector lending arm amounted to 39.7 per cent of the total, although that percentage will increase once the recent capital increase is completed and members subscribe to their new shares. At IMF, developing countries also make up 74.6 per cent of the membership, while holding 37.7 per cent of the voting rights.

70. In the Addis Ababa Action Agenda, Member States also committed to open and transparent, gender-balanced and merit-based selection of the heads of the international financial institutions. In January 2019, then World Bank Group President Jim Yong Kim announced that he would step down from his position. The World Bank board accepted nominations from any shareholder in February and March, but only one nomination was received. The board shortlisted and interviewed David Malpass, who was duly selected as president in early April. In early July, IMF Managing Director Christine Lagarde relinquished her responsibilities at IMF after being nominated to lead the European Central Bank. At the time of publication, the IMF board had not yet announced any replacement process. Ms. Lagarde is the first female managing director of IMF.

## B. International public finance institutions

71. Development banks play a key role in financing sustainable development, as recognized in the Addis Ababa Action Agenda. In the Agenda, Heads of State and Government and High Representatives stressed that development banks should make optimal use of their resources and balance sheets, consistent with maintaining their financial integrity, with the aim of raising their contributions in support of the 2030 Agenda.

72. World Bank shareholders agreed on a capital increase for two parts of the bank in 2018. While the capital increase for the public-sector lending arm was formally approved in October, there was insufficient support for an increase for the International Finance Corporation, which lends to the private sector.[33] Approval of the reform requires agreement by members holding 80 per cent of the voting power, whereas one country has not yet received authorization from its Congress.

73. The African Development Bank continues to negotiate about its seventh general capital increase, which is expected to be approved in October 2019.[34] To temporarily alleviate the lack of resources experienced by the Bank and make new loans, and to

[33] World Bank and IMF, "Update: the forward look and IBRD-IFC capital package implementation" (Washington, D.C., April 2019).

[34] African Development Bank, "Final communiqué of the fifty-fourth annual meeting of the board of governors of the African Development Bank and the forty-fifth annual meeting of the board of governors of the African Development Fund", 14 June 2019.

help to protect the AAA rating of the Bank, Canada provided temporary callable capital of up to $1.1 billion.

74. Many development banks are working to align their operations with the Sustainable Development Goals, although the impact is not always clear. The World Bank has stopped investing in new fossil fuel energy generation projects, and, from 2019, will phase out upstream projects in fossil fuel exploration or extraction. However, infrastructure related to fossil fuel, such as storage facilities, pipelines and shipping are still being financed by many multilateral development banks. Further changes could include a further alignment of internal staff incentives with metrics relevant to achieving the Sustainable Development Goals, rather than with, primarily, the volume of lending. Doing so will require an effective measurement of sustainable development impact.

75. Increasing the effectiveness of financing by multilateral development banks and bilateral development banks was a point raised by the Group of 20 Eminent Persons Group on Global Financial Governance. In its report of November 2018, the Group recommended that multilateral development banks overcome fragmentation by working together within country platforms. The Group of 20 worked on principles for the operation of such country platforms, but no consensus had been achieved by the middle of 2019, when the Group of 20 held its summit.

76. In the Addis Ababa Action Agenda, Heads of State and Government and High Representatives also encouraged all development banks to 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. The World Bank began implementation of its new environmental and social framework in October 2018. In December 2018, the evaluation office of the Inter-American Development Bank recommended that the Bank revise its system of safeguards to address weaknesses by means of a new, integrated environmental and social policy framework and that it work to strengthen the capacity of Inter-American Development Bank Group staff and clients.

77. Member States continue to emphasize the importance of women's rights and encourage international financial institutions to include gender equality in their investment decisions. Each multilateral development bank has a different system for measuring performance and impact related to gender, making comparison and benchmarking difficult. Updated World Bank Group data on gender integration and results have not been published due to an imminent update to its corporate results framework, which in turn resulted from the Bank's capital increase package. As part of the package, Member States asked the International Finance Corporation to (a) flag all its projects with a gender component by 2020; (b) expand investment in and advisory services provided to financial institutions specifically targeting women; (c) double the share of female directors that the Corporation nominates to boards of companies where it has an equity investment, to 50 percent by 2030; and (d) quadruple the amount of annual financing dedicated to women and small and medium-sized enterprises led by women by 2030.[35] The latest figures of the African Development Bank show that 87 per cent of new operations have a gender-informed design.[36] The Asian Development Bank reports that in 2018, 52 per cent of operations supported gender mainstreaming, above the Bank's target of 50 per cent.[37] The

[35] International Finance Corporation, *Strategy and Business Outlook Update FY20–FY22: Gearing up to Deliver IFC 3.0 at Scale* (Washington, D.C., 2019).

[36] African Development Bank Group, *Annual Development Effectiveness Review 2019: Integrating Africa, Connecting People* (Abidjan, Côte d'Ivoire, 2019).

[37] Asian Development Bank, *2018 Development Effectiveness Review* (Manila, 2019).

Inter-American Development Bank recently introduced loan incentives based on gender and climate performance.[38]

## C. Women's leadership in the economy

78. Enterprise surveys indicate that just over one third of the world's formal sector enterprises have female participation in their ownership, marking no significant change from 2017. The data are updated in only a handful of countries each year, making global trends difficult to detect. In 2018, women held 17.9 per cent of seats on corporate boards globally, a marginal increase from 17.3 per cent in 2017.[39] According to one global index of over 2,500 publicly listed companies, only 1.6 per cent of boards had achieved gender balance, while the highest percentage of boards with at least three women was found in Europe. Models of the International Labour Organization showed no change in the likelihood that women were classified as employers in 2018, with the figure remaining at only 1.7 per cent of total female employment in 2018, compared to 3.8 per cent among men.[40]

## D. Illicit financial flows

79. Illicit financial flows represent a major obstacle to the mobilization of domestic resources for sustainable development. There is no universally agreed definition, although there are some parameters for identifying illicit financial flows. The three main components are corruption, the transfer of proceeds of crime and tax-related illicit financial flows. Different components are not directly comparable and an aggregation of estimates across channels and components could result in double counting. The scope and complexity of illicit financial flows necessitates component-by-component action plans at the national and international levels.

80. For each component, different policy responses are relevant. Tax transparency reforms, in particular beneficial ownership registries and the exchange of tax information, are relevant for tracking and stopping tax-related flows. Technology can help authorities to use tax information to more effectively enforce the law. Changes to international tax norms to address the digitalization of the economy, which are still under discussion in several international forums, will also affect enforcement regarding tax-related illicit financial flows.

81. The United Nations Convention against Corruption remains an essential tool for enhancing cooperation in the fight against corruption and bribery. Work on anti-money-laundering, combating the financing of terrorism and tackling predicate offences continues to be addressed by many international organizations, including the Financial Action Task Force, the United Nations Office on Drugs and Crime (UNODC), IMF, and the World Bank. Examination of suspicious transactions and stronger enforcement of know-your-customer rules are critical, but solutions are also needed to prevent the costs associated with enforcement from damaging access to finance (see sect. IV.B above on correspondent banking).

82. Efforts to recover stolen assets are part of the effort to combat illicit financial flows. The term "stolen assets" refers to the proceeds of corruption that have been transferred abroad. The recovery and return of stolen assets is provided for in the

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[38] Inter-American Development Bank, *Development Effectiveness Overview 2018* (Washington, D.C., 2018).

[39] Morgan Ellis and Meggin Thwing Eastman, *Women on boards: Progress report 2018* (MSCI, Inc., n.p., 2018).

[40] ILO (2019), *World Employment Social Outlook: Trends 2019*.

Convention against Corruption, as the recovery and return of stolen assets necessitates international cooperation. States need to step up cooperation, sharing information more proactively, making greater use of legal tools such as non-conviction-based forfeiture and dedicating greater resources to asset recovery and return efforts.

83. The United Nations Conference on Trade and Development (UNCTAD) and UNODC are the custodians of target 16.4 of the Sustainable Development Goals (By 2030, significantly reduce illicit financial and arms flows, strengthen the recovery and return of stolen assets and combat all forms of organized crime). Both organizations continue their joint work on developing a methodology for the statistical measurement of illicit financial flows. Pilot testing with national statistical offices is planned in five countries in Latin America and nine countries in Africa. An UNCTAD/UNODC task force on the statistical measurement of illicit financial flows started work in January 2019 and will continue to work on the conceptual and measurement challenges until October 2021.

## VI. Conclusions

84. **Systemic financial risks are rising and parts of the multilateral system are under strain. Achieving sustainable development requires: multilateral action to address global challenges; revisiting the global institutional architecture; strengthened regional cooperation; and national action, including adjusting policies to the changing global landscape.**

85. **Reforms of the international financial system are critical to creating a stable and sustainable system that will contribute to the transformation that the world needs to implement the 2030 Agenda for Sustainable Development. Changes will have to be made to public policies and the regulation that shape the activities of private finance.**

86. **Developing countries remain exposed to sudden changes in financial market sentiment and volatility of capital flows, although the expectation of looser monetary policies in systemically important economies reduces the risks of short-term capital outflows, while also possibly heightening the build-up of medium-term vulnerabilities. Countries at risk should design complementary suites of macroeconomic policies, financial regulation, macroprudential measures and capital account management policies, which should be coherent with wider sustainable development strategies and integrated national financing frameworks.**

87. **Incentivizing longer time horizons for international investors would not only help to achieve sustainable development, it has the added benefit of potentially reducing capital market volatility. The international community could work to develop guidelines for how countries can undertake such policies effectively.**

88. **Ultimately, to achieve sustainable development, the international community should also continuously examine whether its institutions are sufficient and remain fit for purpose. Wider, open and inclusive discussions can be used to find ways to increase the coherence of the global system and improve the inclusivity of global economic governance.**



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