

Financing for Sustainable Development Report 2019

Inter-agency Task Force on Financing for Development



United Nations

This report is a joint product of the members of the Inter-agency Task Force on Financing for Development (a full list of members can be found on page x). The Financing for Sustainable Development Office of the United Nations Department of Economic and Social Affairs serves as the coordinator and substantive editor of the Financing for Sustainable Development report.

The online annex of the Task Force (<http://developmentfinance.un.org>) comprehensively monitors progress in implementation of the Financing for Development outcomes, including the Addis Ababa Action Agenda and relevant means of implementation targets of the Sustainable Development Goals. It provides the complete evidence base for the Task Force's annual report on progress in the seven action areas of the Addis Agenda (chapters III.A–III.G). The report is by necessity more concise and selective and should thus be read in conjunction with the online annex.

The online annex also covers several key cross-cutting initiatives that build on the synergies of the Sustainable Development Goals:

- Delivering social protection and essential public services
- Ending hunger and malnutrition
- Closing the infrastructure gap
- Promoting inclusive and sustainable industrialization
- Generating full and productive employment for all
- Protecting ecosystems
- Promoting peaceful and inclusive societies
- Gender equality
- Investing in children and youth
- Addressing the diverse needs and challenges faced by countries in special situations
- Global partnership

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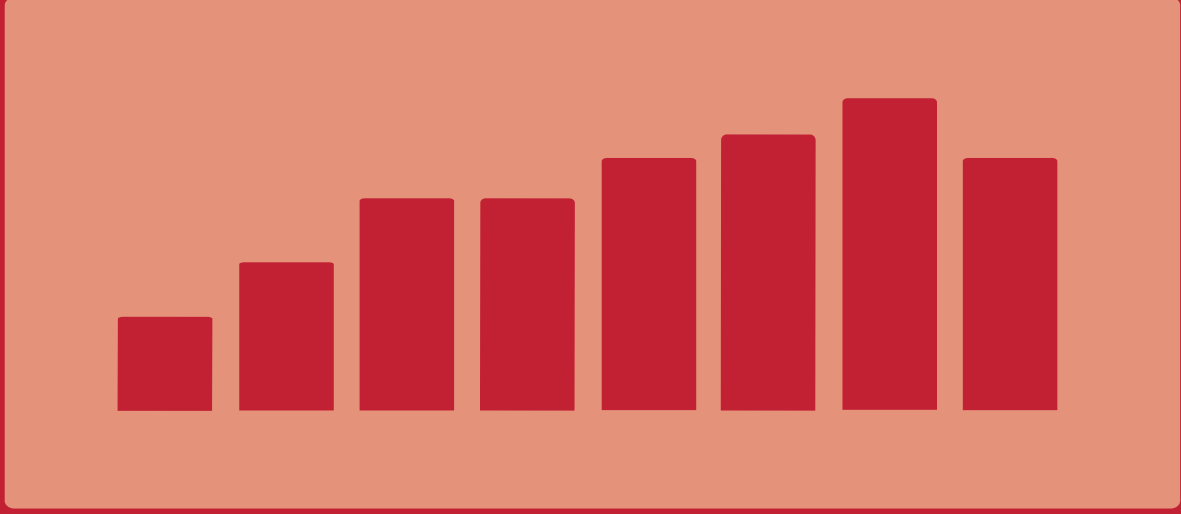
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DOMESTIC AND INTERNATIONAL PRIVATE
BUSINESS AND FINANCE





Chapter III.B



Domestic and international private business and finance

1. Key messages and recommendations

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The private sector represents the largest part of the economy in most countries. It is thus promising that a growing number of investors have expressed interest in taking social and environmental issues into account in their investment decisions. Yet, the impact of this growing interest in sustainable development is unclear, in part because of confusion regarding what sustainable investment means and a lack of consensus on how to measure its impact. *Through its analytical work, the Inter-agency Task Force on Financing for Development could help create greater global consensus on the definition of sustainable investment and the measurement of investment impacts, building on both public and private efforts.*

Policymakers should capitalize on the growing interest in sustainable investing. Capital markets are a powerful vehicle for promoting alignment with sustainable development, provided the right incentives are in place for all market participants. The Addis Ababa Action Agenda underscores the role of capital markets and calls on Governments to design policies that “promote incentives along the investment chain that are aligned with long-term performance and sustainability indicators, and that reduce excess volatility”.¹

Many countries are making strides towards building sustainable financial systems; lessons learned can be shared through international platforms to find synergies and strengthen policy frameworks. *Governments can help create incentives to foster greater sustainable investing, including by pricing externalities, requiring more meaningful disclosure by corporations on social and environmental issues, and clarifying fiduciary duty and asset-owner preferences (e.g., through incorporating sustainability preferences into required investor profiles). They can also promote long-term investing by supporting efforts to build*

longer-term indices or encouraging longer-term investment horizons in credit ratings, as well as through regulatory frameworks.

The Addis Agenda also recognizes that public policy is needed to create an enabling environment that encourages entrepreneurship and a vibrant domestic business sector. Investments in sustainable and resilient infrastructure can further facilitate private sector development by providing essential services for the functioning of the economy. *Governments should continue to strengthen the enabling environment, including by considering appropriate financing sources, assessing bottlenecks to investment, and prioritizing policy actions* (see chapter II). For example, in infrastructure, this would help identify where private or public delivery and financing of sustainable infrastructure is the most cost-effective solution, and what type of infrastructure is most likely to deliver desired impacts.

The achievement of the Sustainable Development Goals (SDGs) is also dependent on investments in least developed countries (LDCs) and other vulnerable countries where capital markets are less developed and investment profiles riskier. *Deliberate policy efforts are required to promote and facilitate investments that are linked to sustainable development. This also highlights the importance of international support to spur investment, for instance through carefully structured risk-sharing instruments, or through a greater role for development banks* (see also chapter III.C).

The question of access to finance is central to private sector development. While access to financial services has improved in recent years, significant gaps remain across countries and for specific market segments. *Financial sector strategies are instrumental to addressing financing*

gaps and tackling market failures in an integrated manner. As a first step, Governments can aim to build inclusive financial systems, for instance by supporting diversified types of financial institutions, depending on national contexts, and making greater use of financial technologies (fintech). They can also seek to further develop capital markets by first ensuring that the right conditions are in place. In addition, they can consider complementary solutions such as private equity markets, which deserve further research to better understand the associated benefits and risks.

Financial development has, however, its own limits and should not be pursued blindly. Over-financialization can harm growth and contribute to rising inequality. *Policy frameworks can help incentivize finance for productive investments, and effective regulatory environments can help minimize risks of financial volatility and maximize the benefits of financial sector development.*

Policies that promote private sector development also need to take into account impacts on income distribution. Over the last three decades, the share of wages in total income has declined versus the share of capital. Market concentration in certain sectors raises concerns for its role in worsening income distribution and *calls for competition policies that reflect the changing global environment and the growing role of technology, both at the national and the international levels, and for better monitoring market concentration trends.*

2. Advance sustainable capital markets

Mainstream investors, such as pension funds and insurance companies, are often looked to for investment in the SDGs due to the amount of their assets under management. These investors generally seek to maximize profits. Investment aligned with sustainable development is thus attractive to them to the extent that such investment enhances financial performance. At the same time, although it is difficult to quantify, there appears to be growing interest by individuals, especially among millennials, in how their savings impact the world. There are also investors (impact investors) who aim to maximize environmental and social impacts alongside financial returns, though while growing, these investors remain a small fraction of global capital markets.

Together, this has created interest in sustainable investing. Signatories to the Principles for Responsible Investing (PRI)—now over 2,100—represent \$81 trillion of assets under management in 2018. The finance industry is also creating instruments to tap sustainability investing, as seen in the development of sustainability indices and the exponential growth of the green bond market (although this also remains a small portion of the bond market, at less than one per cent).

Nonetheless, the impact of such interest on investment behaviour and ultimately on sustainable

development is unclear, in part because of confusion regarding what sustainable investment means and a lack of consensus on how to measure impact, as well as lingering questions of whether there is a trade-off between financial returns and sustainability impacts.

2.1 Unpacking the relationship between ESG and financial performance

There is a growing recognition in the finance community that the way corporates manage environmental, social and governance (ESG) factors—such as carbon emissions, standards on labour, and internal procedures to fight corruption—impacts financial returns.

Numerous studies have tried to assess the material impact of these factors on long-term financial performance of investments. While the lack of a harmonized definition of ESG factors or sustainability indicators makes comparing studies difficult, the majority of studies find a positive relation between ESG factors and profitability,² or that at worst, these factors have not had a negative impact on returns. Both aggregate levels and changes in ESG ratings are linked to future performance.³ This implies that investors do not necessarily have to choose between profits and positive impact. They can use sustainability information to better manage long-term risks, and potentially enhance returns. Studies have also assessed bond performance in relation to ESG practices and found positive correlations, implying that ESG factors should be part of the overall credit risk analysis.⁴

There is a compelling case as to why companies with “sustainable” business practices may outperform those without. First, sustainable companies might be incorporating a wider range of risks into their business strategy, thus strengthening risk management, including by reducing exposures to natural hazards or anticipating regulatory changes. The latter is salient in the climate space, where it appears that potential policy measures to limit carbon emissions are being priced into some markets. Other factors could include operational performance (e.g., more efficient resource management and capacity to attract talent)⁵ and market opportunities (e.g., a 2015 survey indicated that more than half of the respondents are willing to pay more for sustainable goods).⁶

However, the impact of ESG factors on financial performance depends on the time horizon of investors. Many of the studies referred above examine returns over a period (e.g., ten years) that is greater than the investment horizon of some investors, as well as that of most credit rating agencies. Most ESG elements do not have an immediate visible impact. For example, climate change and water scarcity related-risks may require several years to materialize. Likewise, poor labour practices could remain unnoticed for several years before leading to local unrest and negative brand reputation. Further incorporating these risks into investment decision-making requires a shift to a long-term investment horizon.

Empirical studies have also shown that the material impact of ESG or sustainability factors on long-term performance may depend on sector and industry specificities. While certain factors may affect all industries (e.g., processes to avoid conflicts of interest in corporate boards), the material impact of others varies across industries. For example, greenhouse gas emissions, if priced, are more likely to impact returns of airlines than fast food companies. Firms with good materiality ratings, based on the Sustainability Accounting Standards Board (SASB) materiality map, have significantly outperformed firms with poor ratings.⁷

In addition, different ESG strategies have distinct characteristics that affect their risk/return profiles and development impact. It is therefore important to clarify what sustainable investment means.

2.2 Clarifying what sustainable investment means

There are a wide range of investment strategies used by portfolio managers, with different impacts and levels of sustainability, under the heading of “sustainable investments”. While there is some overlap, these strategies can be broadly divided into three categories: (i) do no harm; (ii) use sustainability factors to maximize long-term value, with positive externalities; and (iii) do good as an explicit investment objective. Individual investment strategies include the following:

- **Exclusion/negative screening** excludes activities or industries with clearly defined negative impacts from an investment portfolio, such as tobacco, arms, or coal;

- **Norms-based screening** excludes companies that don’t meet minimum standards of business practice based on international norms, such as the United Nations Guiding Principles for Business and Human Rights and the Organization for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises;

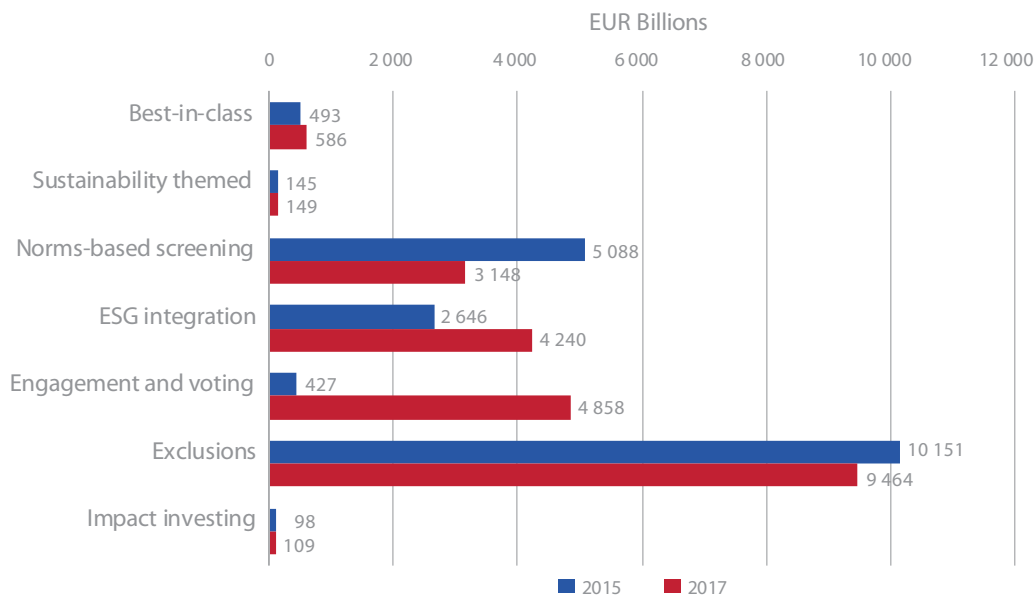
- **Positive screening/“best-in-class” selection** involves selecting best performing companies across industries in terms of sustainability performance, for example by selecting companies ranked among the top 20 per cent in each industry;

- **ESG integration** entails incorporating ESG material factors into the core investment analysis and decision-making processes to lower risk and/or enhance returns. For example, investors may adjust company valuation models to include expected ESG risks, such as risks of stranded assets;⁸

- **Engagement** involves active ownerships through dialogue and/or voting rights to influence corporate behaviour on sustainability issues. For example, the 2018 voting guideline of Blackrock asks companies to review their reporting beyond regulatory disclosure requirements on environmental and social factors that influence companies’ prospects over long horizons;⁹

- **Sustainability themed investment** aims to support the SDGs through buying instruments, such as green bonds or exchange-traded funds (ETFs), constructed around specific SDGs (e.g., water and gender).¹⁰ One example is the ETF launched by the United Nations Capital Development Fund and Impact Shares in 2018

Figure 1
Overview of sustainable, responsible and impact investing (SRI) strategies in Europe
(Billions of Euros)



Source: Eurosif, “2018 SRI Study”. Available from <http://www.eurosif.org/>.

Note: Strategies are not all mutually exclusive as investors could do both ESG integration and corporate engagement for instance.

that targets companies performing well on selected sustainability indicators while overweighting companies with a higher share of revenues generated in LDCs;

- **Impact investing** aims to achieve measurable social and environmental targets that are generally considered on equal weighting with financial returns.¹¹

While sustainable investments historically started with exclusions, the latest data shows that ESG integration and engagement are gaining strong traction in some countries, while norm-based and exclusionary screening are on a declining trend, although the latter remains a dominant strategy in terms of assets (figure 1). The growing popularity of ESG integration is confirmed by a recent survey where 84 per cent of asset owners reported they were pursuing or actively considering pursuing ESG integration in their investment process.¹² The other strategies (i.e., best-in-class, sustainability-themed, and impact investing) are more limited in size although they are the ones with possibly the strongest impact on sustainable development. For example, impact investing remains relatively small, although the amount has been growing. Respondents to the annual survey of the Global Impact Investing Network (GIIN) manage \$228 billion in impact investing assets, or 0.2 per cent of the assets under management by PRI signatories.¹³

These different investment strategies have distinct characteristics that influence their financial performance. For example, in general, **ESG integration** and **best-in-class** strategies appear to have lowered risks, as measured by volatility, and generated excess returns¹⁴ in both developed and emerging markets.¹⁵ One explanation could be that investors have been able to exploit information that is not yet fully incorporated into market prices. The outperformance could suggest that the market is beginning to price in some sustainability risks. On the other hand, some studies have found that **negative screening** has underperformed, with evidence that excluding stocks reduces financial performance.¹⁶ For example, excluding so-called sin stocks may hurt performance because these are steady earners that pay dividends and hold up well during economic downturns. This supports traditional portfolio theory, which suggests that reducing the investment universe should lead to underperformance.¹⁷

The investment strategies also have distinct development impacts. For example, exclusions only affect companies in targeted sectors, while the realization of SDGs requires introducing changes in all industries. ESG integration is likely to help investors better pick stocks and reduce portfolio risks, but there are questions as to its impact on achieving sustainable development, for example: Does ESG integration create sufficient incentives for investee companies to change their business practices? How much weight is given in ESG integration to ESG elements compared to other factors? Likewise, can we quantify the influence that engagement has on companies? The high proportion of investors claiming to do ESG integration and engagement might imply that

there is a relatively limited impact, given that corporate behavior still has not changed significantly. In terms of sustainability themed investments, questions include whether managers are simply tagging existing activities or creating new streams of funds for financing sustainable development needs.

Bundling these strategies together under “sustainable investment” can be misleading and creates the impression that capital markets are solving development issues on their own. For example, a recent report claimed that “sustainable, responsible and impact investing represents 1 in 4 dollars of the total US assets under professional management in 2018.”¹⁸ However, this raises the question of why trillions of dollars invested this way have not had a greater impact on corporate behaviour. A globally agreed definition of sustainable investments should help bring more clarity as well as a better understanding of investment impacts.

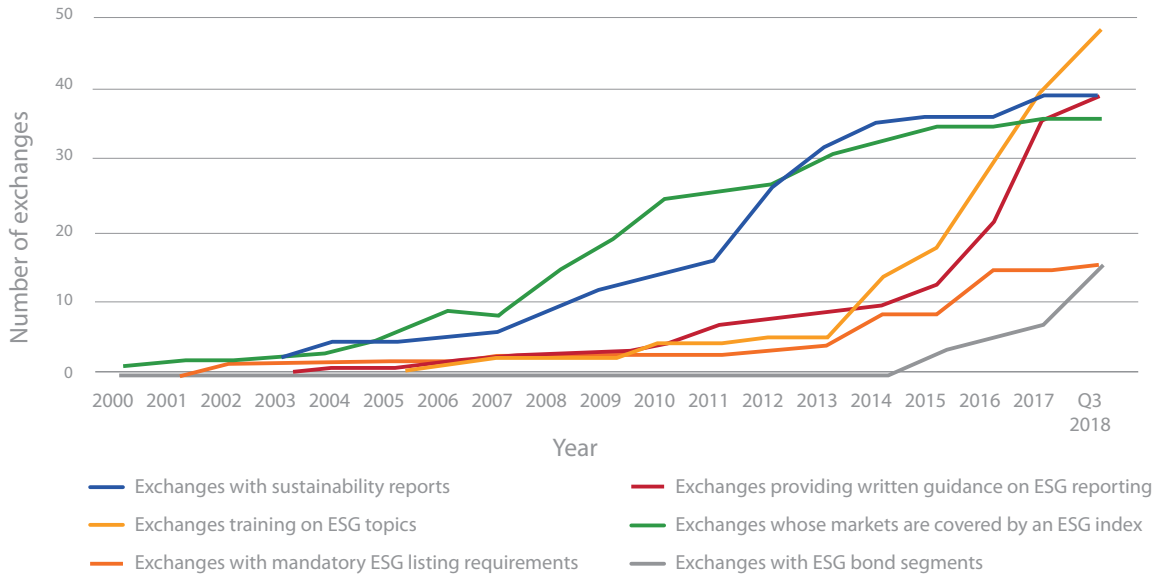
2.3 Making sustainability reporting more meaningful

Corporations have progressively incorporated sustainability elements into their reporting. According to a survey of about 5000 companies from 49 countries, 75 per cent now publish corporate responsibility reports and 60 per cent include some sustainability information in their financial filings.¹⁹ Such wide adoption reflects a range of policy measures and regulations across countries.²⁰ Stock exchanges encourage ESG disclosure through a variety of incentives (figure 2), as promoted by the Sustainable Stock Exchanges Initiative, in which 75 exchanges have become official partners.

However, there is a lack of consistency in reporting metrics, reflecting the lack of internationally recognized standards in sustainability reporting. This is in part because, unlike financial reporting, which uses a common unit (i.e., money), many factors included in sustainability reporting (e.g., tons of recycled waste, use of natural resources, gender balance) are difficult to express in monetary terms. Sustainability reporting is largely voluntary. Companies can choose from a variety of different frameworks, which results in different information being disclosed. These inconsistencies create challenges (and costs) for investors and other stakeholders in interpreting and comparing data. A 2016 study found that 92 per cent of investors surveyed reported that ESG data disclosed by companies in which they invest is not comparable.²¹

Several agencies have developed guidelines to bring more coherence to corporate reporting, including the United Nations Conference on Trade and Development (UNCTAD) Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR),²² the Global Reporting Initiative (GRI), and SASB. Private companies also analyse sustainability data and provide ratings and rankings of firms based on their sustainability performance. However, each sustainability rating company has its own proprietary methodology and data sources, and their

Figure 2
Stock exchange-related sustainability activities
 (Number of exchanges)



Source: Sustainable Stock Exchanges (SSE) Initiative Database.

results do not necessarily converge, adding to the confusion. For example, Tesla is ranked at the top of the automobile industry by MSCI, due to low carbon emissions and green technologies, while FTSE ranks them as zero on the environment because of weak disclosure on emissions from its factories.²³

Box 1

Women’s Empowerment Principles

The Women’s Empowerment Principles (WEPs), launched in 2010 by UN-Women and the United Nations Global Compact, guide businesses in promoting gender equality and empower women in the workplace, marketplace and community. The WEPs provide a gender lens through which businesses can analyse their current initiatives and tailor or establish policies and practices to realize gender equality and women’s empowerment. Today, over 2,000 chief executive officers have committed to implementing the WEPs—twice the number in 2015. Women’s Empowerment Principle 7 on corporate transparency and public reporting offers investors a tool to assess companies based on their performance against gender equality and women’s empowerment criteria.

Source: UN Women.

Policymakers should consider whether there is a need to revise accounting and reporting rules to include key sustainability metrics per industry in mainstream corporate reporting. There are two elements to such reporting. The first is incorporation of those sustain-

ability factors that have material impacts on financial performance. Information on these factors is critical to informing investors’ risk and return analysis. The second is to also incorporate non-material sustainability factors to inform the public about the impact of companies on global goals. Defining key metrics internationally would bring benefits in terms of coherence and comparability.

2.4 Building consensus around impact measurement

To understand the impact of investment on sustainable development there needs to be more of a consensus around principles and norms to measure impact, not just at the corporate level, but also at the security and portfolio levels. There are a host of nascent initiatives within and outside the United Nations system to measure impacts of companies, securities, and investment portfolios:

- **For companies:** several methodologies are being developed to assess to what extent individual corporates contribute to the SDGs, as discussed in the previous section.
- **For securities:** several private firms have begun to offer services on branding investments as SDG compliant, but the methodologies are often not fully transparent and there is a risk that financial products are presented as sustainable when in reality they are not. Industry-led norms are also emerging to attest of the sustainability of investment products but often lack impact measurement elements.
- **For investment portfolios:** some asset managers have begun to link their portfolios to the SDGs. For exam-

ple, APG and PGGM in the Netherlands have target figures for what they call Sustainable Development Investments. However, to date, these are firm-specific mappings, without agreed-on principles or guidelines.

Task-Force members have been active on this front. The International Finance Corporation (IFC) has recently worked on principles to create an impact management system for institutions managing investment portfolios for impact.²⁴ The United Nations Development Programme's SDG Impact initiative aims to develop standards for impact measurement across all asset classes together with a seal to authenticate adherence to the standards. The Positive Impact Initiative of the United Nations Environment Programme Finance Initiative (UNEP FI) explores solutions to the financing gap for sustainable development. The PRI Market Map gives a common definition of 10 thematic sustainability investments, with basic criteria to check compliance. The OECD is also working to establish a common lexicon and framework for measuring the impact of investments targeting sustainable development.

Private actors, sometimes in collaboration with public organizations, also work on impact measurement. For example, several sustainability rating companies provide SDG alignment scores for companies; the Impact Management Project aims to coordinate efforts on impact measurement; and the World Benchmarking Alliance intends to measure corporate SDG performance.

Regulations are also emerging. For example, in 2018 the European Commission presented legislative proposals that aim to establish a unified EU classification system of sustainable economic activities ("taxonomy"), requiring disclosures by institutional investors relating to ESG factors in their decision-making and advisory processes, and the creation of low carbon and positive carbon impact benchmarks.²⁵

There is a need to take stock of these public and private initiatives and analyze their underlying assumptions, identify similarities and differences across methodologies, and lay out potential gaps.

2.5 Clarifying fiduciary duty and asset owner preferences

The growing evidence regarding the materiality of environmental and social factors on financial performance should encourage countries to make clear in their regulations that institutional investors need to take them into consideration as part of their fiduciary duties.²⁶ A 2016 study found that 23 of the 50 largest economies have, or are developing, some kind of rules regarding pension funds and ESG criteria (e.g., requiring funds to disclose their ESG policy), while 14 countries have, or are developing, guidelines on investor stewardship—for example to encourage asset owners to make formal commitments to active ownership in the pursuit of long-term, sustainable growth.²⁷ In this respect, a consultation was launched in 2019 in the United Kingdom of Great Britain and Northern Ireland on a draft Stewardship Code that makes explicit reference to ESG factors.²⁸

It would also be important to ask what asset owners really want for their money. In a 2017 Morgan Stanley survey, 75 per cent of individual investors indicated an interest in sustainable investing, compared to 71 per cent in 2015 (with interest particularly strong among millennials and women, 86 and 84 per cent, respectively).²⁹ It would be interesting to know whether these investors are willing to give up return for sustainability impact. However, looking at the bond market, it does not seem that investors are yet willing to pay a premium for a more sustainable use of proceeds. To date, green bonds do not appear to be priced differently than conventional bonds issued by the same company. Pricing reflects issuer credit risk, which is the same for both sets of bonds (even though the proceeds are used for more sustainable activities in the case of green bonds).

Formal requirements to ask asset owners about their sustainability preferences (as part of know-your-customer rules) would foster more sustainable investment and raise interest in related financial products. Some countries are starting to implement this idea and others could follow. For example, the European Union sought feedback in 2018 on regulatory changes that call for including sustainability considerations in the advice offered to individual clients of investment firms and insurance distributors. Additional technical work may be needed to clarify how to practically ask these questions to customers (e.g., what, how and when to ask). The United Nations, through the Task Force, might help in sharing lessons learned from ongoing experiments at the global level.

2.6 Supporting sustainability relevance through policy measures

There are, however, sustainability issues/externalities that do not have a material impact on corporate profitability but do impact the public good, for instance the intensive use of plastic packaging. The market is unlikely to address these sustainability issues on its own without appropriate policies in place. Policymakers can encourage the use of sustainability factors and explore ways to make all ESG factors material through

- **Pricing externalities:** Most companies remain profit maximizers, and are not going to internalize costs if they are not the ones suffering from negative impacts. "Naming and shaming" and reputational risks can be used to put pressure on companies to change their actions, as can active voting by large investors. Nonetheless, even large investors who include board engagement as part of their sustainability process, generally do so in support of long-term valuations, not usually in support of the public good. Policies can thus complement voluntary actions. Pricing externalities—for example, through carbon pricing—can help address market failures. To date, Governments have implemented or are scheduled to implement 51 carbon-pricing initiatives, covering about 20 per cent of global greenhouse gas emissions. Most of these initiatives saw increases in carbon prices in 2018,³⁰ notably the European Union Allowance price that tripled.³¹

Yet, carbon prices remain significantly below international recommendations;

- **Long-term horizon:** Regulators can encourage asset managers to take a long-term approach. This is necessary as certain sustainability factors only impact financial performance in the long-run. While shifting capital markets to a long-term horizon is challenging, certain steps can be taken, including calling for long-term horizons for asset owners with long-term liabilities, such as pension funds; demanding the disclosure of longer-term climate-related risks; developing long-term indices; and exploring whether credit rating agencies could publish ratings based on a longer period. This also calls for moving away from compensation packages in the finance industry that are disproportionately tied to short-term performance;
- **Regulation:** Companies are likely to modify their practices (for instance, using resilient construction, reducing waste production and improving energy efficiency) if they are convinced that Governments will introduce and enforce regulation to realize their national sustainability objectives. By the same token, markets are likely to reward companies anticipating these regulatory changes;
- **Procurement:** Governments and municipalities can challenge the private sector for proposals to deliver cost-efficient solutions to sustainable issues.³² Pay-for-success approaches also have the potential to promote measurable development results, as do social impact incentives, which directly reward high-impact enterprises with premium payments for achieving social results. Ex-post evaluation of public initiatives is essential for Governments to assess what works and what doesn't.

If the positive impact of sustainable investment products can be demonstrated, then Governments should also consider how they could support these products, possibly through financial incentives such as tax breaks and subsidies to cover certification costs as well as via prudential regulation.

3. Build domestic enabling environment

To support private business's contribution to economic development and employment, public policy needs to set the enabling environment to encourage entrepreneurship and investment. Many developing countries have embarked on numerous reforms to make it easier for companies to do business. In 2017/18, 128 economies undertook 314 reforms—a record number.³³

While not all reforms have the same impact (due, for instance, to inefficient design, poor implementation, or the quality of implementing institutions),³⁴ they do improve the business environment overall. For example, since 2005, LDCs have cut the time and cost of starting a business by

factors of 2 and 4, respectively, with the absolute gap between developed and developing countries shrinking slowly but consistently over the years.³⁵ There is also empirical evidence that countries with better business regulations experience higher entrepreneurial activity (measured as new businesses per 1,000 adults).³⁶ Other elements of the enabling environment are infrastructure, political stability, and the macroeconomic environment. The IFC and the World Bank have jointly produced Country Private Sector Diagnostics to more systematically identify binding constraints to investments, as well as opportunities to create or expand markets, which can be helpful in prioritizing policy reforms (see chapter II). An enabling environment should support both domestic and foreign investment.

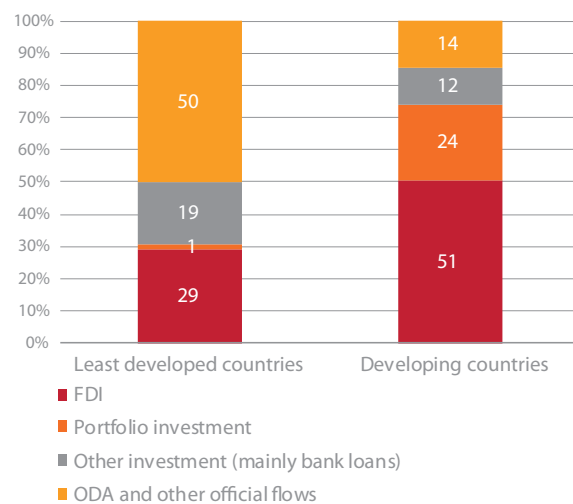
4. Facilitate direct investment in support of the SDGs

Stable long-term investment is necessary to support the long-term needs of sustainable development, such as investments in productive activity as well as resilient and sustainable infrastructure.

4.1 Foreign direct investment

Foreign direct investment (FDI) quadrupled over the last two decades, making economies increasingly interconnected. For many developing economies, FDI is the largest source of external finance (figure 3). It is also more stable than other cross-border financial flows, such as portfolio investment and cross-border bank loans. FDI can enhance productive capacity, transfer know-how and generate employment, particularly when it creates linkages with domestic suppliers and help local companies integrate into international value chains.

Figure 3
Selected sources of external finance, developing economies and LDCs, 2013-2017
(Percentage)



Source: Adapted from UNCTAD World Investment Report 2018.

FDI has been on a weak trajectory globally since peaking in 2015 at \$1.9 trillion. By 2018, it had fallen to \$1.2 trillion (figure 4), back to the low point reached after the global financial crisis. The drop in 2018 was concentrated in developed countries where FDI inflows fell by 40 per cent, mainly due to repatriation of profits held overseas by US companies following the 2017 corporate tax reform.

There are also structural factors behind this negative cycle, including a decline in rates of return on FDI³⁷ and the transformation introduced by the digital economy, which enables companies to operate with limited local investments—for example, digital multinational enterprises make about 70 per cent of the sales abroad with only 40 per cent of their assets based outside their home countries.³⁸ While a rebound is likely in 2019, as suggested by the 29 per cent increase in greenfield project announcements, the underlying trend remains weak. Policy uncertainties, lower growth prospects and trade tensions could cause multinational enterprises to cancel or delay investment decisions.

Flows to developing economies have been more resilient than to developed countries over the past several years, increasing slightly in 2018 to \$694 billion, or 58 per cent of global FDI. Yet, flows within this subgroup remain uneven. Asia received about 66 per cent of the inflows, with Latin America and the Caribbean receiving 25 per cent in 2010–2017. Africa, LDCs, landlocked developing countries and small island developing States received small or negligible levels of FDI (LDCs as a group represented less than 2 per cent of global FDI flows in 2017).³⁹ Within each sub-region, there was also unevenness, with resource-rich, large market or more developed economies attracting higher FDI than others.

Countries have been actively promoting FDI, including through national laws, and bilateral and regional investment treaties. Most of the national measures in the last 15 years have been towards supporting liberalization and pro-

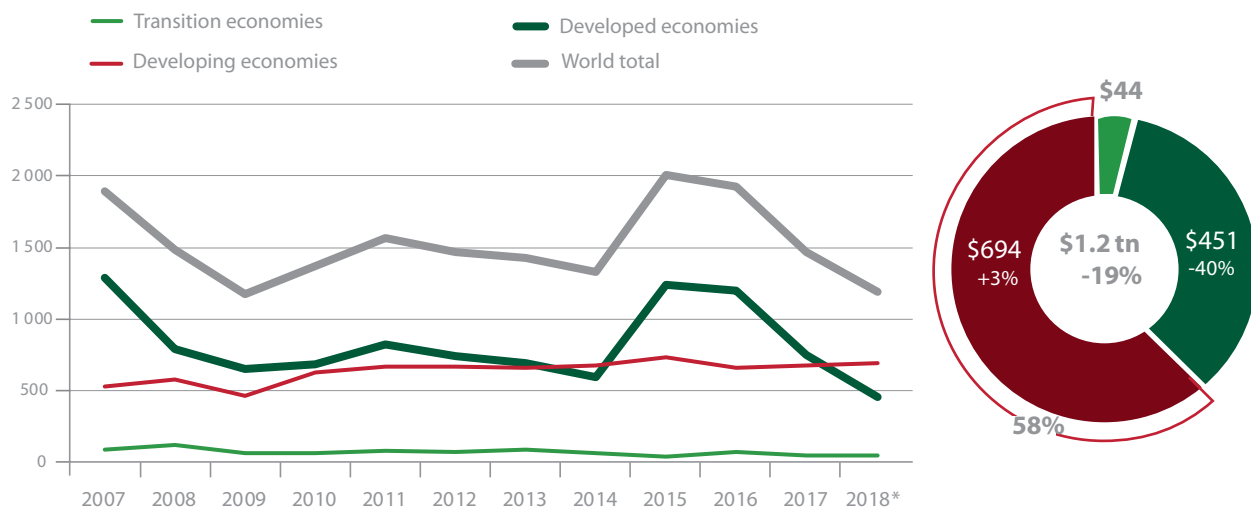
motion of foreign investments—for instance, by opening up industries for investment, relaxing foreign ownership restriction, and granting incentives. Figure 5 highlights that, in 2018 (up to October), about 70 per cent of all investment-related policies were favourable to FDI.⁴⁰

At the same time, there has been an increase in investment restriction measures introduced by countries in more recent years (particularly since 2017), manifested primarily by national security-related policies and review mechanisms, which have included regulations aimed at controlling acquisitions of local businesses. There has also been a decline in investment treaty making, despite some negotiations of megaregional agreements (e.g., the Regional Comprehensive Economic Partnership and African Continental Free Trade Area). This echoes a more protectionist trend observed in trade, but also reflects some policies that aim to better align foreign investments with national sustainable development objectives (see chapter III.D).

Not all investments have the same impact on sustainable development. Historically, FDI has often supported industrial development in labour-intensive sectors (e.g., the garment industry). However, over the last five years investment in greenfield manufacturing projects in developing regions has been lower than in the preceding period, in part due to transformations induced by the digital economy as noted above (see also chapter III.G).

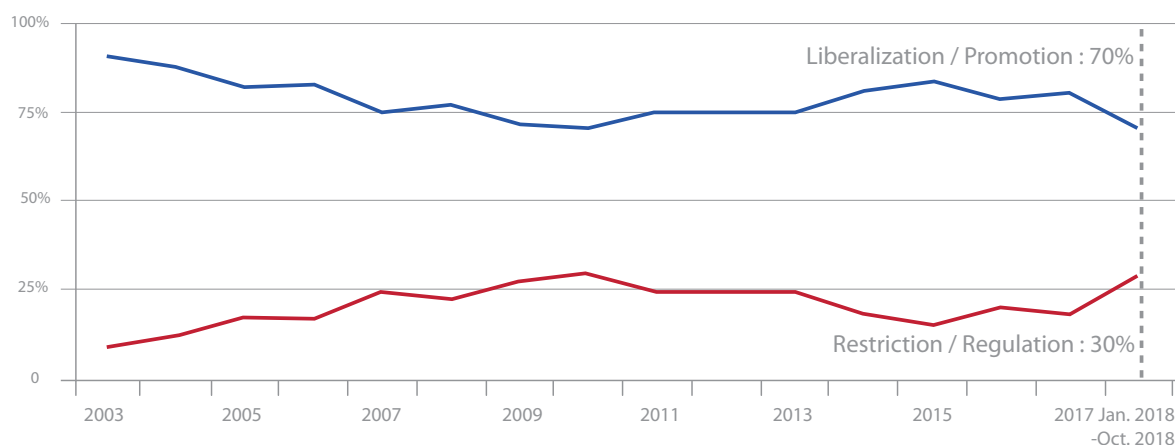
To align FDI with national sustainable development strategies, national investment promotion agencies, established in most countries to facilitate foreign investment, could (i) promote investment in sectors with high sustainable development potential, including through adjusting investment incentives; (ii) work with government partners to build a pipeline of SDG-related projects; and (iii) identify companies likely to be interested in these projects through, for instance, public-private dialogue platforms.⁴¹

Figure 4
FDI flows, by region, 2010-2018
(Billions of United States dollars)



Source: UNCTAD FDI database.

Figure 5

Changes in national investment policies, 2003 – October 2018*(Percentage of investment policies)*

Source: UNCTAD.

4.2 Private investment in infrastructure

Well-functioning sustainable and resilient transport, water, energy and telecommunication services are key to business development, international competitiveness and the realization of the SDGs. Yet, in many countries, weak infrastructure impedes development. A majority of the world's population still lacks safe sanitation, 3 in 10 lack safe drinking water, and almost 1 billion people lack access to electricity.⁴² Closing these gaps requires investment of trillions of dollars as well as more effective spending.⁴³

In the context of constrained public finances and limited borrowing capacity for developing countries, there has been a growing narrative around the role of private investments in infrastructure. Development partners have launched several initiatives to address hurdles that prevent private investment in infrastructure through public-private partnerships (PPP). For example, the Global Infrastructure Hub and the PPP Knowledge Lab were created to disseminate tools and knowledge resources. Technical assistance facilities, such as the Global Infrastructure Facility, and an online infrastructure project preparation platform (SOURCE) have been set up to support the development of well-prepared investable projects.

The Global Infrastructure Forum, established by the Addis Agenda, has been particularly effective in bringing together multilateral development banks, which are engaging in joint work on infrastructure issues, including data, standard contractual provisions, project preparation and credit enhancement. In addition, collaborative platforms, such as the PPP and Infrastructure Financing Network of Asia and the Pacific launched by the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) in 2018,⁴⁴ bring together expertise from various countries to leverage individual efforts.

G20 leaders also endorsed a roadmap to infrastructure as an asset class, which includes useful steps for greater

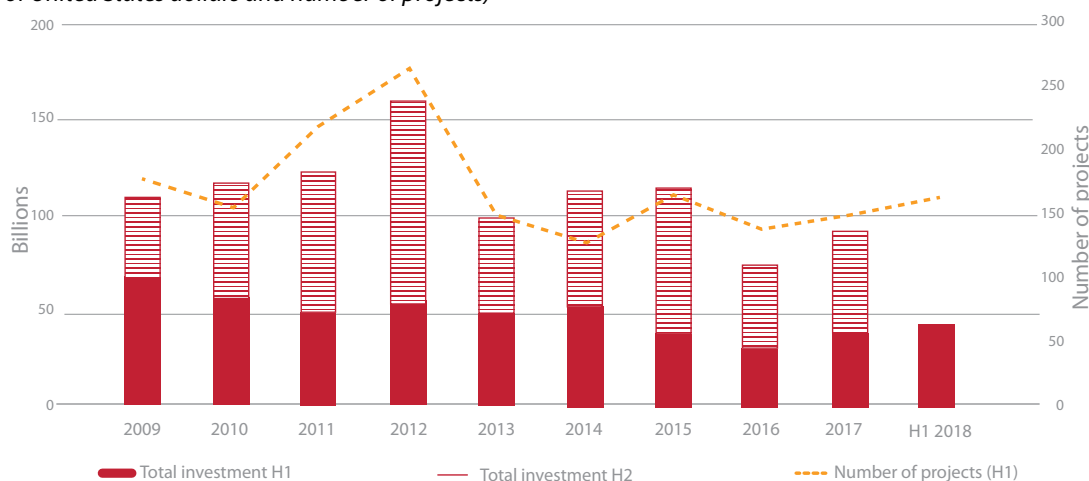
project standardization—although care needs to be taken in the next steps, particularly as such asset class would entail creating liquid instruments on illiquid assets, which could attract investors with short-term investment horizons, with the potential of creating short-term bubbles.

Despite these many initiatives, there has been no major uptake in private investment levels. In the first half of 2018, private commitments to developing countries in energy, transport, information and communications technology, and water amounted to \$43.5 billion across 164 projects. While this represents a 7 per cent increase compared to the same period of 2017, these figures are well below the peak reached in 2012 and remain low in comparison with estimated infrastructure needs (figure 6).⁴⁵

This relatively flat trend provides a reality check on expectations for private investments. To date, the public sector largely dominates infrastructure spending in low- and middle-income countries, accounting for 87 to 91 per cent of infrastructure investments.⁴⁶ To entice private investment, projects need to be sufficiently profitable to compensate investors for the risks they bear. Guarantees and subsidies can make more projects “investable,” but policymakers need to consider when privately-delivered infrastructure services are likely to offer better value for people than the public alternative, as well as the appropriate role for the private sector—as an owner or lessee, service provider, or as a creditor through project finance (see the 2018 report of the Task Force).

There is also a need to ensure that private investments in infrastructure projects contribute to sustainable development and incorporate sustainability issues. While there is no agreed definition of sustainable infrastructure, there are certain elements that need to be incorporated, including both low carbon investment and resilience (box 2). In addition, investment in infrastructure should not exclude vulnerable users from basic services. In this respect, the United Nations Economic Commission for Europe has established Guiding

Figure 6

Investment commitments in infrastructure projects with private participation in emerging market and developing economies, 2009–H1 2018*(Billions of United States dollars and number of projects)*

Source: World Bank Private Participation in Infrastructure (PPI) project database.

principles on People-first PPPs⁴⁷ to set the institutional requirements for a new model of PPPs aligned with the SDGs. The international community has a responsibility to better understand in which circumstances and conditions PPP mechanisms are most effective and only promote them in those cases.

Box 2**Mobilizing private sector financing for disaster risk reduction: a case study from Italy**

The General Confederation of Italian Industry (Confindustria), identified disasters, including the impacts of climate change, as significant risks to private sector activities and proposed a National Resilience Plan to facilitate a transition from a focus on disaster response and recovery to a culture of prevention and resilience across the private sector. To implement this plan, Confindustria will engage (i) the Government to secure tax breaks for companies investing in resilient infrastructure; (ii) the insurance sector to create incentive mechanisms for companies investing in prevention; and (iii) the banking system to attribute value to investments in resilience during credit assessment. This approach demonstrates the importance of integrating disaster risk reduction into business models beyond business continuity and, more broadly, confirms the strategic relevance of disaster risk reduction as a business opportunity that reduces uncertainty and generates value. This approach could be tailored and replicated in different contexts.

Source: United Nations Office for Disaster Risk Reduction.

5. Support remittances

An important cross-border flow is remittances from migrant workers. Remittances are wages earned by migrants in their host countries transferred to families in their countries of origin, helping millions of people meet their basic needs and serving as a social safety net for the families who receive them.

In 2017, there were about 164 million migrant workers worldwide, 41 per cent of whom were women.⁴⁸ Money transferred by these workers to individuals in their home country grew by about 10 per cent from 2017 to 2018, reaching close to \$690 billion worldwide, with \$528 billion to developing countries. Remittances can be a large part of a country's economy: they represent more than 10 per cent of gross domestic product (GDP) in more than 30 countries.⁴⁹

There is no consensus on whether remittances add to a country's long-term GDP growth (and whether this impact would be greater or less than the impact of domestic wages).⁵⁰ The impact most likely depends on characteristics unique to each country, including the poverty level of those receiving the remittances and the country's level of development.

There are several channels through which remittances could impact growth. For example, remittances are often spent on consumption, either for basic needs or for other purposes. These should have a multiplier effect on the economy, although to the extent that inflows are spent on imported goods, the impact could be limited. Remittances have a stronger impact when used for investments, generally in small businesses or entrepreneurship. Government policies to incentivize business formation could help stimulate such activity.⁵¹ Promoting financial inclusion, which could increase the intermediation of savings throughout the economy and

increase access to credit, can strengthen the positive impact of remittances on the economy. Remittances are also often spent on education and contribute to building human capital. However, on the negative side, the lack of attractive job opportunities in the domestic market may foster young people to emigrate, thereby creating a vicious cycle.⁵² And while remittances have a positive impact on the balance of payments, given the stable foreign exchange earnings they provide, in some countries, especially those where remittances are proportionally large, they have also caused the exchange rate to appreciate. This affects a country's international competitiveness, and can reduce opportunities for domestic production and lead to a cycle of more emigration.⁵³

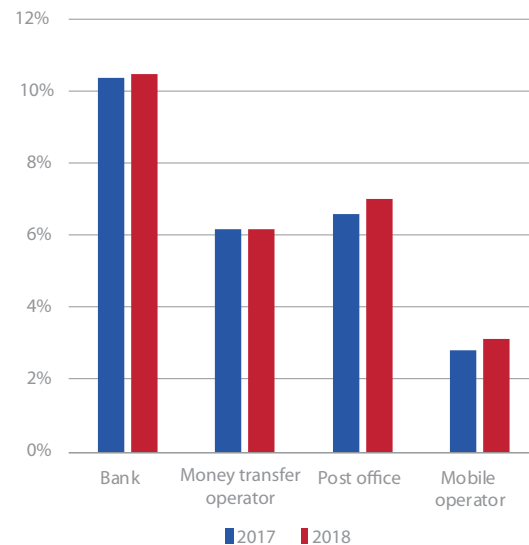
Remittances could have a greater positive impact if the transaction costs were reduced in line with the 3 percent target set by the SDG and Addis Agenda. This would result in savings of about \$27 billion a year.⁵⁴ While the average cost of remittance transfer has declined by 2.7 percentage points over the last decade, there was no improvement in 2018, with the global average still about 7 per cent. Forty-one per cent of corridors surveyed do not have any services available for 5 per cent or less.⁵⁵ Bank and money transfer operator costs are significantly higher than services provided by mobile operators when they are available (figure 7). This highlights the role of fintech to accelerate progress. The latter can also help address the loss of correspondent banking, which impedes remittance flows (see chapter III.F and III.G).

6. Design financial sector strategies

The primary role of the financial sector is to intermediate funds from savers to investors, so resources can be allocated where they are needed. By allowing savers to diversify risk, financial systems facilitate productive investment, which can boost growth prospects.

Figure 7

Average cost by remittance service provider type (Percentage)



Source: World Bank Remittances Prices Worldwide.

6.1 Trends

Considerable progress has been achieved regarding both financial sector depth (i.e., the size of the financial sector relative to the economy) and breadth (i.e., access of the population to financial services). However, significant gaps remain across countries and specific market segments, such as micro, small and medium-sized enterprises (MSMEs).

6.1.1 Financial sector depth

The relative size of the financial sector in the economy has increased significantly since 2000 across country groups. Financial sector depth more than doubled in LDCs and increased significantly in middle-income countries over the period, although it is still at relatively low levels, particularly in sub-Saharan Africa (figure 8).

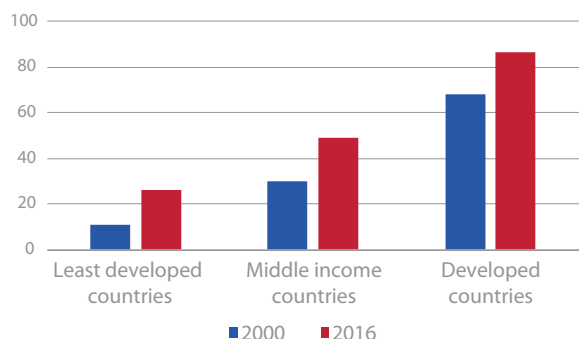
Box 3

Financial literacy, migration and remittances

There are a range of impediments to the use of financial services by migrants, pushing up remittance costs. Migrants may be unfamiliar with financial terms and features of financial products, and may not trust financial institutions. Undocumented migrants often worry that the information requested for access to financial services will be used to identify them and lead to deportation. Such mistrust is often the result of a lack of peer networks for advice on access to financial services. Lack of appropriate complaint channels is another key deterrent for migrants who may simply have no recourse if money is transferred incorrectly. A growing number of financial education initiatives are targeting migrants and their families at home, with the aim of improving their understanding of remittance channels and costs, including exchange rates and fees. These initiatives can also incorporate information on risk of fraud and privacy issues. Yet, to date, only one quarter to one third of adults are financially literate in the top remittance-receiving countries.

Source: UNESCO.

Figure 8
Domestic credit to private sector
 (Percentage of GDP)



Source: World Bank, Global Financial Development database.

There has also been progress in capital market development, with local currency debt growing 70 per cent between 2011 and 2017,⁵⁶ along with a substantial increase in stock market capitalization, which rose from 33 to 58 per cent of GDP on average for a sample of 25 middle-income countries between 2000 and 2017.⁵⁷ However, progress has not been distributed evenly across countries. Beyond a limited number of large developing countries, capital markets remain underdeveloped in terms of size, liquidity and maturity, while more developed markets are often accessible only by a few large and reputable companies (figure 9).

6.1.2 Financial sector breadth

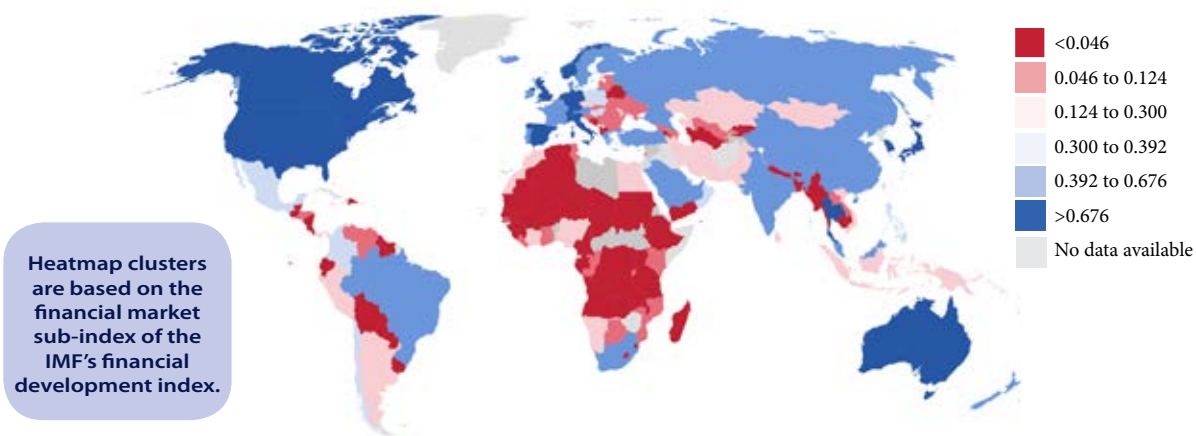
Since 2011, about 1.2 billion adults have obtained a bank account. Yet, there are still about 1.7 billion adults unbanked, 56 per cent of whom are women.⁵⁸ In many developing countries, people continue to borrow primarily from friends and family, while only half of savings are held in formal financial institutions (figure 10).

Financial services do not reach all market segments equally. For example, just over 45 per cent of small businesses are able to access credit provided by formal financial institutions in Latin America and the Caribbean compared to 68 per cent of large companies.⁵⁹ The MSME financing gap is estimated to be at more than \$5.2 trillion⁶⁰ and, despite improvements, these enterprises continue to rank their lack of adequate financing as the biggest obstacle to growing their business (figure 11). Female-owned businesses (typically smaller than male-owned) account for an outsized share of the financing gap. They represent 28 per cent of business establishments and account for 32 per cent of the MSME financing gap.⁶¹

6.2 Financial sector strategies

Financial sector strategies provide a mechanism for Governments to reflect on how to further develop the financial sector and come up with implementation plans and policies adapted to the local context. These strategies, which are an integral part of Integrated National Financing Frameworks (see chapter II), bring together all aspects of the financial sector, including both tradi-

Figure 9
World Map of Financial Market Development, 2016
 (Financial Markets score)

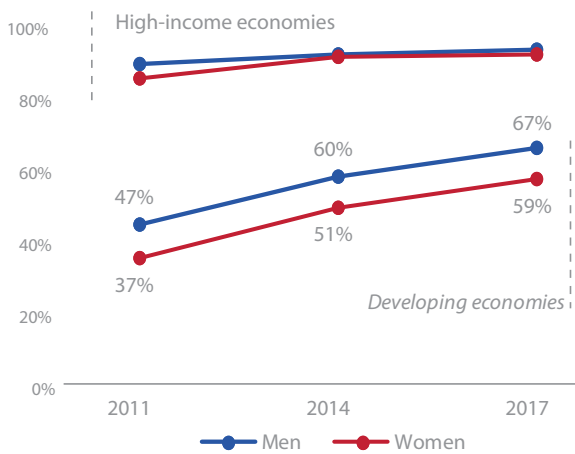


	Nascent	Basic	Intermediate	Advanced
	78 Countries	54 Countries	36 Countries	15 Countries
Depth	VERY SHALLOW	SHALLOW	LESS DEEP	VERY DEEP
Access	INACCESSIBLE	LESS ACCESSIBLE	ACCESSIBLE	VERY ACCESSIBLE
Efficiency	INEFFICIENT		LESS EFFICIENT	VERY EFFICIENT

Source: World Bank based on IMF's Financial Development Index database.

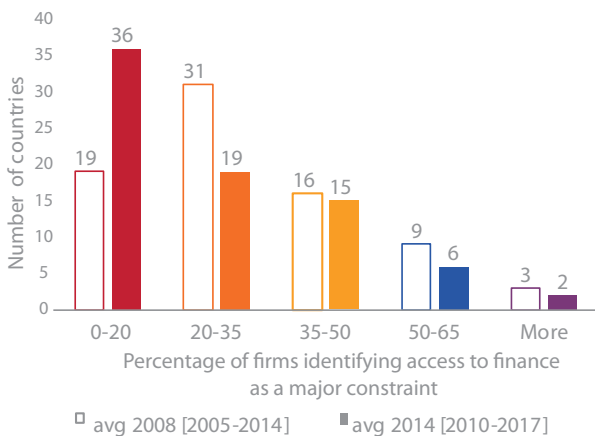
Note: The boundaries and names shown and the designations used on the maps do not imply official endorsement or acceptance by the United Nations.

Figure 10
Account Ownership (2011-2017)
 (Percentage of adults age 15 and above with an account)



Source: World Bank, Global Findex Database 2017.

Figure 11
Distribution of countries based on access to finance constraints for firms
 (Number of countries)



Source: AUN/DESA based on World Bank Enterprise Surveys.

Note: The chart is based on 78 developing countries for which at least two surveys have been conducted. The latest year for which data were available was used for each country (ranging from 2010 to 2017) as well as the preceding one (ranging from 2005 to 2014).

tional financial institutions and new instruments, such as fintech, to enhance the contribution of the financial system to the realization of national sustainable development objectives—for instance, by promoting inclusive finance or by better aligning private sector activities with sustainable objectives as presented in the first part of the chapter.

Financial sector strategies are not new but also not widespread. From 1985 to 2014, roughly three fourths of countries surveyed did not have even one financial sector development strategy, which could be a stand-alone

document or a dedicated section in a national development strategy document.⁶² There has, however, been greater focus on financial inclusion, with another study finding that at least 58 developing countries have adopted or are in the process of developing financial inclusion strategies.⁶³ Countries have also developed financing plans targeting sustainability issues. In 2017, China approved the Guidelines for Establishing the Green Financial System; in 2016, Morocco launched a national road map for aligning its financial sector with sustainable development.⁶⁴ Policymakers are also increasingly using policy tools to promote impact investment, with an estimated 590 policies across 45 countries.⁶⁵

There is evidence that financial sector strategies can be effective in supporting financial deepening, inclusion and stability. This could result from their influence on developing an effective regulatory framework, as well as from the dialogue they generate among the main institutions involved (including development partners).⁶⁶

Overall, financial sector strategies try to answer a set of questions, such as

- What types of financial institutions are active in the country and do they fulfil their purpose?
- How could capital markets be further developed and better serve the economy?
- How can financial infrastructure be improved in a way that supports sector effectiveness?
- How can the benefits of technology be maximized in the financial sector while mitigating the associated risks?
- How can regulations balance development and stability goals, while protecting consumers?
- What is the best means for building adequate capacity within the sector?
- What tools could be used by policymakers to address market failures and development goals?

6.2.1 Institutions

In the Addis Agenda, countries made the commitment to encourage their commercial banking systems to serve all, and to support a wide range of financial institutions, including microfinance institutions, cooperatives, development banks, mobile operators and saving banks, where appropriate.

Different types of institutions bring different benefits and risks. For example, small firms have a better chance of building trust and a long-term relationship with a local banking partner.⁶⁷ Some local institutions—such as savings, cooperatives and development banks—also include a development mandate. Experience has shown it is possible to develop an economically viable decentralized system of financial institutions with a mission to support local development (box 4). However, in some countries, local financial institutions may suffer from a lack of economies of scale or technical capacity.

Box 4

Sparkassen (savings banks) in Germany

The institutional model of the German Sparkassen, while somewhat unique today, offers lessons for building national financial systems in other countries. Their business model, based on savings mobilization, is characterized by social as well as business objectives, with a goal of profitability but not profit maximization. Sparkassen have successfully followed a self-sustaining business model over two centuries in a highly competitive banking sector, and have the largest market share in both deposit and credit markets in Germany. The local government serves as its formal trustee. The Sparkasse conducts its business as an independent economic entity, subject to parameters set by related legislation. Sparkassen are authorized to operate only in their local region, which creates commonalities of interests between the Sparkassen and the local authorities as well as with the communities and economies they serve.

Of course, the operating methods of such large and sophisticated organizations cannot simply be adopted as a blueprint for developing countries, but there are several important constitutive elements of this model that could be suitable for adaptation in financial sector development. In particular, as public banks, the Sparkassen mandate is to serve the economy and people in the local region. Their mandate also includes pursuing economic viability rather than profit maximization. Similar to development banks, this mandate allows Sparkassen to align their business operations more closely with sustainable development. Other lessons learned include the importance both of local communities' knowledge and of dedication to making skilled and professional financial banking services and advice available at the local level to everyone, in particular small and medium-sized enterprises and startups.

Source: Axel Bertuch-Samuels, "The role of effective local banking structures" (2018), paper for the expert group meeting of the Inter-agency Task Force on Financing for Development on Financial Sector Development, October 2018, UN/DESA.

International banks bring capital, expertise and innovative ways to improve financial intermediation. They represented 39 per cent of banks in developing countries in 2013 compared to 19 per cent in 1995.⁶⁸ Yet, they have raised concerns as to whether they primarily serve large companies. In addition, they can sometimes create instability by transmitting crisis from abroad. There is evidence that foreign banks experiencing crisis in their home countries scaled back their lending by between 13 and 42 per cent.⁶⁹ However, the impacts depend on the bank characteristics, such as whether banks operate in foreign countries through local affiliates or cross-border lending. Indeed, since the 2008 financial crises, cross-border lending (which is more volatile) has declined, while lending by local affiliates has been more resilient. Larger international banks with deposit-taking activities, and those banks that are culturally closer to the community they serve, also seem to provide better access to households and SMEs and be less likely to serve only larger companies, relative to others.⁷⁰

Financial sector strategies should help countries consider what types of financial institutions are more likely to meet their development needs, given the local circumstances and existing market structure, and whether they need to adjust regulatory frameworks (e.g., entry conditions, licensing policies and minimum capital requirements). However, encouraging the right type of institutions without causing distortions remains challenging.

6.2.2 Capital markets

Capital markets, including stock exchanges and bond markets, channel funds directly from savers to firms and governments seeking financing. Capital markets

help match investment risk with those most able to manage it. They contribute to

- Increasing the availability of long-term and possibly cheaper financing than bank loans in local currency;
- Financing for risky activities that are necessary to firms' innovation and growth;
- Providing access to a wider investor base, since companies can directly access savings from retail, asset managers and institutional investors, both domestically (if an investor base exists) and internationally;
- Allowing investors to diversify their risks by spreading investments across different assets.

However, while countries have tried to harness these benefits, they have not always succeeded. In several countries where stock exchanges have been created, there are only a few companies listed. For example, a study of 20 middle-income countries found that the 10 largest companies represent more than half of the market capitalization in almost half the countries.⁷¹

Countries face multiple challenges in developing capital markets, such as inadequate market infrastructure, weak or inappropriate regulation and supervision, and the lack of reliable information on issuers. In addition, they also often face both limited demand and supply. To function, capital markets need a critical mass of investors, such as pension funds and insurance companies. These investors play a catalytic role in market development and add liquidity to the system. However, such an investor base remains limited in many developing countries. One study found that while pension assets account for about 50 per cent of GDP on average in developed countries, they account

for only 20 per cent on average in many developing countries, as of 2017.⁷² At the same time, there is often limited supply of issuers. The number of issuers willing and capable of accessing markets is limited in many developing countries, with the cost and complexity of issuing securities restraining interest. Extremely low liquidity from insufficient supply and demand tends to lead to extremely high volatility, as there could be no demand when someone tries to sell a position, causing the price to collapse.

A financial sector strategy should take stock of existing challenges and map out actions to address them. This could include efforts to minimize the cost and obstacles for issuers without undermining trust in the market, as well as longer-term goals of supporting the emergence of a larger base of domestic investors (e.g., through developing pension funds or sovereign wealth funds). Solutions will differ depending on whether capital markets are expected to support the financing of, for example, large corporations, SMEs or infrastructure projects.

A strategy also has to consider the country-specific context and initial conditions, and adjust expectations accordingly. For example, certain preconditions are necessary for capital market development, such as a stable macroeconomic and political environment that reduces investment risk. Having a short-term interbank market and a government securities market developed first can facilitate corporate bond and equity market development. In addition, the size of the economy matters since a critical mass of investors and issuers is required for capital markets to function. While regional markets could provide a solution, previous experiences have shown the difficulties of capital market integration at the regional level.

A financial sector strategy could ponder other possibilities, such as offshore issuances, to mobilize international investors and leverage already developed markets. It could also explore whether private equity funds could be further developed as a complement to raising risk capital through public markets. The Task Force could conduct more research on these alternatives to provide further guidance in this area.

6.2.3 Financial infrastructure

Financial infrastructure provides the backbone of financial systems and includes credit information systems, collateral registries, corporate reporting rules, rating agencies, central securities depositories, and payment, clearing and settlement systems. Gaps or inefficiencies in these areas hinder financial services delivery.

For example, the Addis Agenda notes the importance of credit bureaus to strengthen the capacity of financial institutions to undertake cost-effective credit evaluation. These bureaus help address information asymmetries, which are particularly large for individuals and smaller companies active in the informal sector. However, coverage remains limited in many countries. While the percentage of adults covered either by credit

registry or bureau exceed 75 per cent in developed countries, it falls under 10 per cent in LDCs.⁷³ Limited credit information could raise borrowing costs and hinder access to credit.

Financial sector strategies could investigate how to reduce information asymmetries through innovative means such as fintech or big data to speed up credit assessment (see chapter III.G). Improved corporate reporting could also reduce information asymmetries. However, maintaining proper accounts and financial statements is challenging, particularly for MSMEs. Regulators may need to develop simplified reporting guidelines tailored to these enterprises, such as those developed by UNCTAD-ISAR.⁷⁴

Financial sector strategies could similarly review other components of the financial infrastructure and plan actions to address issues identified.

6.2.4 Fintech as new instruments

The relevance of financial sector strategies is heightened by the growing importance of non-traditional fintech players. Technology advancements disrupt the way financial services are provided and enable new actors, instruments and platforms. For example, mobile banking has enabled access to financial services to millions of people. Peer-to-peer platforms, such as crowdfunding, provide a channel for smaller companies to raise risk capital. They have experienced robust growth. For example, the transactions volume on these platforms across Europe (excluding the United Kingdom) more than doubled between 2015 and 2016 to reach €1.1 billion.⁷⁵ However, fintech requires adjusting legal and regulatory frameworks to cope with the risks and maximize the benefits associated with these new players (for an in-depth discussion, see chapter III.G).

6.2.5 Financial regulation and standards

Financial regulation is a core element of any financial sector strategy and underpins the functioning of financial systems. Robust regulatory frameworks for all institutions involved in financial intermediation and deposit taking are necessary to ensure the stability of the financial sector and protect consumers. For example, the exponential growth of microfinance without appropriate regulation and oversight led to major repayment crises in some countries in the 2000s.

Overall, the legal, policy, regulatory and supervisory frameworks need to balance the objectives of development with consumer protection, integrity and stability. Aligning regulation with international standards helps build confidence in capital markets, but must be proportionate, especially in the nascent phase of capital market development. There is also a need to better understand how social and environmental risks influence the credit quality and stability of the financial system⁷⁶ (see chapter III.F).

Financial sector strategies could also promote lending to sustainable activities by establishing national stan-

dards and encouraging private initiatives. Sustainable lending started with the assessment of environmental and social risks in the due diligence process of banks. The Equator Principles is a voluntary global framework that many banks have adopted to that end (box 5). This has helped some countries establish national standards.

Box 5

The Equator Principles: Fifteen years later

In 2018, the Equator Principles, which have become the most tested and applied global benchmark for sustainable project finance, marked their fifteenth anniversary. The Principles are based on the International Finance Corporation's Environmental and Social Performance Standards and require participating banks to apply a minimum of standards to reduce environmental and social risks in their project finance operations. Today, 94 banks in 37 countries adhere to the Equator Principles, covering over 80 per cent of project finance transactions in emerging markets. The Equator Principles are a unique example of financial market self-regulation. In countries that had no standards or had poor enforcement of existing ones, the banks who followed the Principles effectively set the local and national standards.

Source: International Finance Corporation.

While the equator principles set standards for environmental and social safeguards, there are also calls to better define sustainable lending in terms of lending with a positive impact on sustainable development. In 2018, the International Capital Market Association published a set of Green Loan Principles to bring further clarity on green loan products. China's Green Credit Guidelines is an example of a standard set by a financial regulator in this area. Banks should also be urged to integrate sustainability into their strategies and business models. Countries could, for instance, encourage local banks to better disclose their climate-rated financial risks—as promoted by the Task Force on Climate-related Financial Disclosures (see chapter III.F)—or to adopt the Principles for Responsible Banking that UNEP FI is developing to help banks align their strategy with global goals.

6.2.6 Capacities

Clearly, the human dimension cannot be overlooked in any development strategy. A financial sector strategy should therefore include a capacity-building component. Sufficient capacity is necessary at three levels, at least: regulatory bodies, financial institutions and financial consumers. Financial supervision and regulation depend greatly on the staff quality in the responsible bodies, while local financial institutions

may need specific training to serve more frontier market segments and manage risks adequately. Basic financial literacy is also essential in order for financial services to benefit the poor and to help avoid abuse while also contributing to reduced loan defaults; this does not, however, obviate the need for consumer protection, as even financially literate people can end up being subject to fraud.

Box 6

Women's representation in finance

Women account for less than 2 per cent of financial institutions' chief executive officers and less than 20 per cent of executive board members. Contrary to common perceptions, many low- and middle-income countries have a higher share of women on bank boards and banking-supervision agency boards compared with advanced economies. Econometric analysis suggests that, controlling for relevant bank- and country-specific factors, the presence of women as well as a higher share of women on bank boards appears associated with greater financial resilience. A higher share of women on boards of banking-supervision agencies is also associated with greater bank stability. This evidence strengthens the case for closing the gender gap in leadership positions in finance.

Source: Ratna Sahay and Martin Cihak, "Women in Finance: A Case for Closing Gaps", IMF Staff Discussion Notes, No. 18/05 (September 2018).

6.2.7 Government tools

Governments can support the financial sector in enhancing access to finance, particularly for MSMEs, through a variety of tools, such as

- **Guarantees:** the most commonly used government instrument is partial credit guarantees. These help address the lack of collateral that companies may have by providing banks with partial coverage in case of debtor default. However, their contribution depends on their design (e.g., extent of coverage, fee and eligibility criteria). Poorly designed schemes may not succeed in reaching firms that are credit constrained, and entail risks for public balance sheets that are difficult to assess;
- **Subsidies:** the use of subsidies can incentivize lending to certain segments and be channeled through financial institutions. For example, the microfinance business model relies on subsidies to make up the difference between the cost of providing services to the poor and the revenues generated. A review of more than a thousand institutions found that the subsidy represents, on average, 13 cents per dollar lent, and also tends to be enduring rather than being phased out over time;⁷⁷

■ **Public investment:** equity financing is challenging for small companies that cannot access capital markets. Countries have set up mechanisms, such as public investment companies, to overcome this challenge, either through direct investments into SMEs, co-investment funds, or fund of funds, often alongside private investors. In Europe, for example, government agencies have contributed to 29 per cent of Venture Capital funds raised in 2017 (compared to 14 per cent in 2007).⁷⁸

These types of interventions can be most effective when done through a specialized institution, such as a national development bank. The above-mentioned instruments are not fiscally neutral and need to be properly designed to achieve their goals, prevent inappropriate incentives (e.g., undermining the necessary discipline and prudence in the loan origination process) and limit market distortions (e.g., crowding out non-guaranteed lending). Risks to the public balance sheet also need to be managed. This is an important issue for national development banks (see chapter III.F).

7. Consider the impact on growth and inequality

It is often assumed that financial sector development automatically leads to economic growth and supports the SDGs. However, history shows that the impact of the financial sector on growth and inequality depends on a range of factors.

7.1 Finance, growth and inequality

A financial sector strategy should consider how the financial sector impacts growth and inequality. The linkages between financial sector development and GDP growth have been established in the literature since the 1990s.⁷⁹ Since then, the size of the financial sector has grown significantly in both developed and developing countries, often much more rapidly than the overall economy.⁸⁰

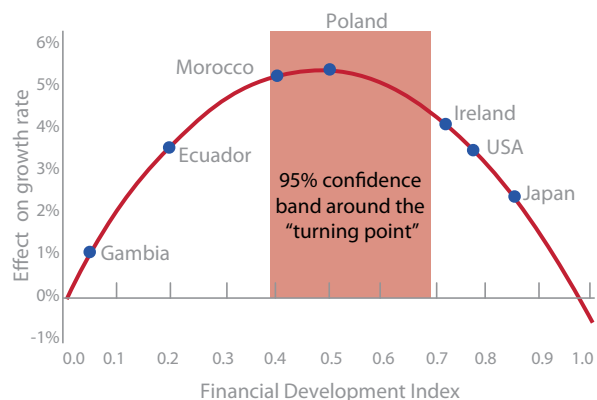
Recently, there have been questions about the negative effects that can result from an overly developed financial sector. In this context, there is a need to distinguish financial depth from financial breadth. While an improvement in access to financial services should benefit the poor, there are concerns over whether the benefits of greater financial deepening eventually level off. There are also growing concerns over whether high levels of financialization—defined as the increase in size and influence of financial markets and institutions in the overall economy—could exacerbate inequality.

Figure 12 illustrates this non-linear relationship between further financial sector development and economic growth,⁸¹ while holding other growth determinants constant. Based on data from 128 countries in the period 1980–2013,⁸² there is a bell-shaped relationship between financial development and economic

growth. The results show that for countries at a low stage of financial sector development, further financial deepening is positively correlated with growth.

However, at higher stages of financial sector development, the gains in growth from further financial development reach a plateau, and eventually start to decline. Although there is not a single inflection point that applies to all countries, one study found that when private credit reaches about 100 per cent of GDP, the impact of further financial sector development on growth can turn negative,⁸³ alongside an increase in volatility.⁸⁴ Greater financial deepening, rather than financial access, has been identified as the driver of this weakening effect on growth. This can be in turn due to several factors: funds allocated to speculative bubbles instead of productive assets; financial crises preceded by credit booms;⁸⁵ or diversion of talent towards financial services and away from other economic sectors.⁸⁶ Financial development that occurs at a pace that is too rapid may also generate higher instability.

Figure 12
Relationship between financial development and economic growth
(Percentage)



Source: Ratna Sahay and others (2015).

The impact of financial sector development on growth depends on several factors, and particularly on the quality of a country's regulatory framework; high-quality regulation can help broaden access to credit without jeopardizing financial stability. Likewise, the composition of finance is important. Credit to businesses has been found to be more growth-friendly than credit to households,⁸⁷ particularly when household financing is used for consumption, such as of imported goods. Regarding businesses, the impact on growth and development is linked to the extent to which finance is raised for productive investment. For example, is money raised through initial public offerings (IPO) used to payback initial shareholders (which would simply be an ownership transfer) or to realize new investments?

The development impact might also be reduced if incentives in capital markets introduce a short-term bias where immediate financial performance by corporate executives is valued over raising long-run company value through investments (e.g., using earnings for share

buybacks to boost stock prices instead of reinvesting them in business development). According to Goldman Sachs, aggregate share repurchases (or buybacks) by S&P 500 companies rose by nearly 50 per cent to \$384 billion in the first half of 2018, which is more than these companies spent on capital expenditures over the period.⁸⁸

Financial sector development also affects income distribution, alongside many other factors, such as market concentration (see below), globalization (see chapter III.D) and technological change.⁸⁹ Empirical studies have, however, produced mixed results surrounding the nature of this relationship. On one hand, there is evidence that financial development, measured as the ratio of private credit to GDP, benefits the poor and reduces income inequality. This is because a more developed financial system can better address market imperfections, such as information asymmetry between lenders and borrowers. For the poor, this helps to alleviate credit constraints given their lack of collateral and credit history.⁹⁰ Better access to financial services also helps some people escape poverty by encouraging savings while lessening the effects of financial shocks, such as job losses and crop failures. Realizing these benefits, countries have tried to promote greater financial inclusion.

On the other hand, some recent studies have contested this positive relationship.⁹¹ Financialization may contribute to income inequality by capturing a disproportionate share of profits and level of earnings. For example, the financial sector represents 7 per cent of the economy in the United States of America, and creates 4 per cent of all jobs, but takes 30 per cent of all private sector profits.⁹² In Europe, financial sector workers make up 19 per cent among the top 1 per cent of earners, with the overall employment share of the financial sector at 4 per cent.⁹³

Excess financialization can also generate higher instability and crises, which may widen inequality. For example, the global financial crisis caused wealth declines across all socioeconomic groups. However, the decline in percentage terms was greater for less-advantaged groups.⁹⁴ While top income earners experience a sharp fall in asset values, the impact of a crisis on the poor tends to be more painful as unemployment rises. In the aftermath of a crisis, lower tax revenues and policy interventions, such as measures to rescue too-big-to-fail banks, contribute to a decline in fiscal space and may prompt Governments to roll back on redistributive policies that aim to address income inequality.

Greater financialization can also coincide with some degree of regulatory capture.⁹⁵ A larger financial sector may be capable of influencing policymaking in its favour by, for example, weakening policies that impact financial sector profits and foster more equal income distribution (e.g., undermining regulations that protect financial consumers, promoting tax cuts and fiscal austerity, and limiting minimum wages).

The impact of financial development on inequality may also not be linear and depends on how finance is provided. A recent study found that more finance reduc-

es income inequality, but only up to a point. Beyond that point, inequality rises if finance is expanded via market-based financing, but does not rise when finance grows via bank lending.⁹⁶

Well-functioning financial systems are vital in supporting capital accumulation and productivity growth. Nevertheless, countries need to be cognizant of the risks of over-financialization as they progressively develop domestic financial markets. Since developing countries have relatively smaller financial systems compared to developed economies, the risks emanating from an oversized financial sector are likely to be more limited. These countries can reap significant growth and stability benefits from further financial sector development. More developed countries, by contrast, may benefit from a smaller financial sector.

Financial supervision and regulation must keep up with efforts to deepen or liberalize financial systems. Effective and appropriate regulation and supervision is critical for all countries, notably to identify and contain systemic risks. Investment incentives also need to change to avoid rewarding short-termism and speculation. Implementation, however, can be challenging, both for countries with limited capacities and for those with well-developed financial systems with well-established incentive structures.

In addition, policymakers need to have a deeper understanding of the linkages between inequality, financial stability and crisis to take appropriate measures. For instance, high income inequality may generate excess savings in the economy, as the wealthy tend to save proportionally more than low-income households. In the past, these savings have sometimes led to excessive risk taking. In periods of high liquidity coupled with stagnant wages, workers may also be willing and able to take on more credit to maintain or improve their standards of living.⁹⁷ This may result in an unsustainable build-up of debt, as well as a deterioration in the overall quality of financial assets, increasing the risk of a financial crisis. Addressing inequality could thus have positive spillovers on financial stability.

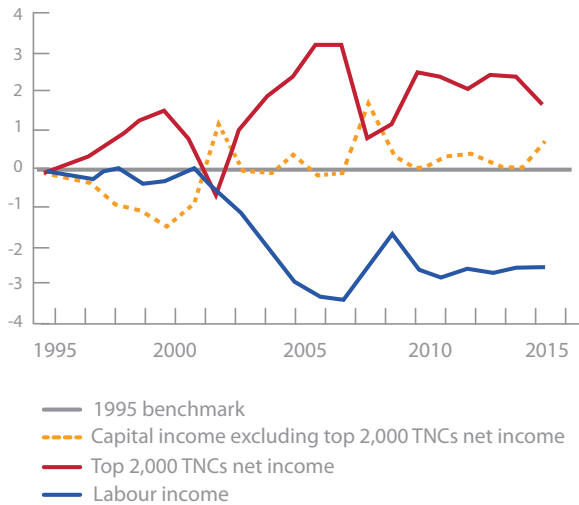
7.2 Market concentration and income distribution

Rising inequalities are also reflected in the falling share of wages in total income, which has been on a declining path for more than three decades. The average wage share has fallen from about 57 per cent of world gross product in 1990 to about 52 per cent in 2017, with market concentration identified as a cause of this fall.⁹⁸ As shown in figure 13, the deterioration of labour income has been more or less mirrored by the accumulation of profits of the top transnational corporations. The share of surplus profits by the top 100 firms (profits above a benchmark representing the median rate of profit) rose from 16 per cent in the period 1995–2000 to 40 per cent in the post-crisis period (2009–2015).⁹⁹

Such market power is associated with income inequality, highlighting the broad importance of the

issue.¹⁰⁰ There are, for example, concerns that large firms with market power benefit from monopsony power in labour markets, contributing to the stagnation of wages.

Figure 13
Labour income and profits of transnational corporations
 (Changes from 1995 measured as per cent of world gross product)



Source: *Trade and Development Report 2018*, p. 57.

A wide range of indicators suggests that, on average, market power has been increasing¹⁰¹ in some countries, with global implications. This appears to be the case across a range of industries, including finance, and may have particular consequences for the evolution of the digital economy.¹⁰²

The growth in market power is likely due to a range of factors, including changes in the structure of the economy due to growth of digital technologies. Digital super-firms are fast becoming the dominant firms not only in their countries of origin, but also globally, with impacts beyond the technology sector, such as in retail. For example, Amazon’s profits-to-sales ratio increased from 10 per cent in 2005 to 23 per cent in 2015, and that of Alibaba went from 10 per cent in 2011 to 32 per cent in 2015. These developments have reinforced the distributional effects of technological change and globalization favouring capital and higher-level skills.¹⁰³ Digital technologies also bring new forms of anticompetitive conduct, requiring competition regulators to adapt to rapidly evolving markets.

To address the negative effects of market power and concentration, countries need to reconsider their policy tools in the areas of competition, education, finance and tax. They should also cooperate to address the challenge of rent seeking at the international level as these issues cannot be solved only with national policies. For example, international organizations could gather information on regulatory frameworks and monitor global market concentration trends and patterns, as a first step towards coordinated international best practices guidelines and policies.

Endnotes

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