



STUDY

# The allure and pitfalls of market based finance for sustainable development

Financial sector policy and the Addis Ababa Action Agenda

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# Foreword

In September 2015 in New York, at the United Nations, all the world's governments agreed to commence on a fifteen year project to eradicate extreme poverty and deliver environmentally, socially and economically sustainable development: the Agenda 2030, with its 17 sustainable development goals (SDGs). They also agreed, at the International Conference on Financing for Development in Addis Ababa in July 2015, on a broad outline of ways to promote the financing of the investments needed to deliver the sustainable development agenda and related policy goals (as on international trade, technology development and diffusion), and to strengthen economic governance in countries and internationally. The main donor countries have not yet put any effort into increasing public financing to the degree needed, but are instead seeking ways to boost domestic and international private financing of this investment. It is uncertain, however, whether the current mix of policy incentives and disincentives will encourage the necessary financing.

In fact, much reform of the international financial system has taken place since the global financial crisis of 2008/09. It has aimed to reduce the vulnerability of economies to renewed financial crisis, as well as to solve the economic and financial difficulties that the crisis caused. While these efforts to prevent another crisis are needed, there is a debate today on whether the steps taken are adequate or whether they discourage private financing of the long-term investment needed for sustainable development in developing countries.

Politicians and people concerned about development should therefore inquire into the orientation and adequacy of financial regulation reform and related financial policy matters. To assist in this end, this paper takes stock of those parts of the Addis agreement that address an expanded role of international private finance in development and the requirements for reform of financial regulation and the international and monetary financial system to implement that role.

The views and opinions expressed herein are those of the authors and do not necessarily reflect the views of Brot für die Welt (Bread for the World).

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# Introduction

The Addis Ababa Action Agenda addresses broad concerns on public and private finance for development, along with related trade and technology matters.

One part of the Addis Ababa Action Agenda hereafter Addis Agenda or AAAA) addresses financial regulation reform and the interface of the public and private sectors, regarding ways to mobilize the massive financial resources required to undertake the global infrastructure investments that are needed to achieve the Sustainable Development Goals (SDGs). It is estimated that around \$1 trillion to \$1.5 trillion of additional annual investment in developing countries is needed. While looking to an expanded role for domestic public and private resource mobilization in developing countries, the Addis conference also embraced the need for greater international capital flows to help realize these investments. Capital flows to developing countries are structured in the following ways: as traditional, official development assistance and multilateral bank loans to governments, mixed public-private partnerships, direct foreign investment in factories and farms, international bank loans, and private investor purchases of government or corporate securities. While still looking to official international flows to carry out activities not easily established on a for-profit basis, the Addis Agenda sees a growing role for private flows.

As there seem to be limited political prospects for expanding official flows to developing countries, there is a certain allure to envisaging a larger role for private financing. The AAAA is thus accepting an apparent general trend as inevitable. One consequence is that international policy on finance has shifted from seeing it as a major source of one problem – a possible global crisis – to seeing it as the solution to another problem: the finance gap for sustainable development (Hiss 2014, Chiapello 2015). However, as has been observed by critical analysts of financialization, and of the financialization of sustainable development in particular, there is a danger in embracing the financial industry (Hiss 2014). Simply welcoming private finance without attending to the risks that accompany it, especially its short-term character, the volatility and crises it induces, and the risks to development which emerge from it, is dangerous.

The AAAA acknowledges some of these problems, such as the short-term nature of certain capital flows or the risks related to large and volatile capital flows. However, what is missing from the Agenda is specificity

regarding the required changes the required changes to the regulatory framework that would allow private sector financial flows to support the SDGs in a safe way, and move investor incentives towards the purchase of more long-term financing instruments, rather than through those types of mutual funds that are identified as dangerous. While surplus capital in the West seeking profitable outlets in emerging markets can help finance projects for SDGs, the current configuration of the international monetary and financial system (IMFS) does not effectively channel funds to such uses, and leaves the international economy subject to volatility and crisis. Asset managers and investment banks arrange non-bank private capital flows that have been classified as worrisome “shadow banking” by the international regulatory community. Indeed, the regulators’ analyses show that shadow banking activities pose severe risks of financial instability both to advanced economies as well as developing countries (BIS 2016a, FSB 2014, IMF 2015).

The proposals of the AAAA hence need to be analyzed in the context of the current IMFS, which is itself in need of reform if it is to channel private financial flows in a way that actually serves development objectives. In fact, while the emphasis in the Agenda is on the additional mobilization of private capital, it does not blindly follow free market ideology; it acknowledges in several paragraphs the downsides of private finance for development and capital account liberalization. As such, the AAAA states clearly that a robust risk-based regulatory framework for all kinds of financial intermediation needs to be in place (paragraph 38), that there need to be tools available to handle excessive capital flow movements (paragraph 105), and that the IMFS needs to be reformed so that policymakers of major economies take account of international spillovers from their domestic policies (paragraph 105).

Nevertheless, in the subsequent international policy debates, these important points have taken a backseat to issues such as the appropriate design of Public-Private Partnerships (Oxfam 2015, Jomo et al. 2016), or key policies against climate change (Chhibber 2016), as well as concerns about the role of domestic public finance (TWN 2015), the quality of aid or the ownership of aid programmes (CSO 2015). Therefore the spotlight now needs

to be shifted towards designing the institutional arrangements of the IMFS necessary to safeguard sustainable development while mobilizing the finance needed for that development. A rigorous implementation of appropriate reform proposals could ensure that capital flows will benefit sustainable development goals in emerging market economies (EMEs) and developing countries (DCs), and not destabilize them.

For example, while there are calls to transform shadow banking activities outside of the regulated banking framework into “resilient market-based financing” (FSB 2014), the reforms necessary to attain such a status are facing severe political headwinds and can under no circumstances be taken for granted. Given the current regulatory fatigue, it is likely that only minor reforms will be undertaken. Public pressure for stronger reform is thus necessary.

Indeed, it is the view of the authors that civil society can play an important role in advocating for concrete reforms on shadow banking and other measures essential to implement the broad policy intentions embedded in the Addis Agenda. This paper thus seeks to specify a set of changes in regulation that would help achieve the sustainable development goals with these private means. The focus will be placed on two interrelated aspects that are mentioned in the AAAA, and that are crucial to achieving sustainable private flows of funds for development. First: under which conditions can asset managers and other private agents be attracted to invest in long-term sustainable development projects? Second, how does the IMFS need to be shaped in order to allow capital flows, including short-term capital flows, to enter into emerging markets without posing risks to financial stability?

To answer these questions, this paper will proceed as follows: first we will document the stance the AAAA takes on private capital flows. Second, we will demonstrate the current situation with respect to private capital flows into emerging and developing countries, seeking to clarify the changing nature of these flows after the financial crisis of 2008/09. Private capital flows are largely denominated in foreign currency and are subject to stampede out of the host country. They often take the form of purchases of debt securities issued by companies and governments in emerging markets. In order to explain the changing nature of private capital flows, we will focus on the growing role of asset managers, their clients and the investment banks that create the traded securities (together, the shadow banking system) and the dangers these

actors’ business models are posing. In this context, we look at the potential of insurers and commercial banks to become long-term investors in the sustainable financing that the AAAA calls for. We will then ask what factors explain why they do not provide more long term financing for sustainable development. In the fourth section we will discuss some of the regulatory measures needed to reform the IMFS in order to attract private sources to finance the SDGs in a sustainable way.

## Chapter 1

# Addis Ababa Action Agenda and Financing for Development: formulated goals and omitted specifics

The AAAA has a positive perspective on private investment, which is seen as a major potential driver of inclusive economic growth, job creation and productivity. The AAAA invites businesses to “apply their creativity and innovation to solving sustainable development challenges” and “to engage as partners in the development process, to invest in areas critical to sustainable development” (paragraph 35). In this context public policy is assigned the role of creating a supportive institutional framework and of incentivizing private financing to contribute to sustainable growth. While there are many interesting suggestions with respect to finance at the national level,<sup>1</sup> what exactly should be done on the international level and with respect to international capital flows remains unspecified.

Private capital inflows to EMEs and DCs are seen in the AAAA as “vital complements to national development efforts”, especially foreign direct investment (FDI) and flows through a more stable international financial system (paragraph 35). The private sector should be incentivized to foster long-term investments (paragraph 36), which the development of long-term bond markets would promote (paragraph 44), attracting long-term institutional investors, such as pension funds and insurance companies (paragraph 47). The AAAA thus offers broad guidance on how to promote long-term finance for sustainable development; however, it lacks commitment to a detailed work programme to bring this about.

In particular, the AAAA calls on institutional investors to invest more in infrastructure projects. It calls on global as well as national standard-setters to identify adjustments that would encourage long-term investments within a prudent risk-taking framework and robust risk control (paragraph 47). On the one hand, it emphasizes the need to adjust domestic and global institutional frameworks that would enable projects to be eligible for institutional investors – for example, satisfying the International Financial Reporting Standards. On the other hand, it is clear that domestic frameworks need to be in place that will allow for the absorption of capital inflows without destabilizing domestic financial markets.

In addition, the institutional framework of the international monetary and financial system is merely touched upon in the Agenda. This reflects the limited consensus on the reform of the IMFS. Nevertheless, reform consensus is fundamental for private finance for development, as we know from how the turbulent states of international financial markets have affected DCs and EMEs for decades, most recently during the Great Financial Crisis (Ocampo et al. 2008; Griffith-Jones 1998; Griffith-Jones and Ocampo 2009). Furthermore, monetary policy decisions taken by advanced economies do not sufficiently take into account spillovers to EMEs, as the ‘taper tantrum’ of 2013 illustrated (to be noted below).

The AAAA reform agenda emphasizes in paragraph 104 the need for sound regulation of financial markets, and welcomes the steps taken to build resilience on the one hand and to reduce vulnerability and spillover effects on DCs on the other. Paragraph 105 acknowledges that regulatory gaps and misaligned incentives continue to pose risks to financial stability, and points to the need for further reforms of the international financial and monetary system, namely the strengthening of “international coordination and policy coherence to enhance global financial and macroeconomic stability.” This paragraph also acknowledges “risks from large and volatile capital flows” and recommends macroeconomic policy adjustments as well as macroprudential<sup>2</sup> and, “as appropriate”, capital flow management measures (CFMs).

In general, the AAAA thus takes up critical aspects with regard to the framework of the international financial and monetary system, but it falls short of making any direct recommendations for action. In paragraph 44, for example, it is acknowledged that foreign investors “now play a significant role” in capital markets of some developing countries. But it is also acknowledged that the volatility caused by them needs to be managed. Unfortunately, no indication is made on what that management should look like. Other issues which are insufficiently addressed in the AAAA are the trade-off of private finance for development and financial stability, the

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1 — Many proposed measures for international assistance to national governments sound desirable, e.g. the promotion of quality infrastructure projects through enhanced technical support (Paragraph 14).

2 — Standard prudential regulations require banks to have enough capital to withstand most negative developments. Macroprudential regulations typically reduce such capital requirements during economic recessions to encourage lending when banks are doing less and increase them during economic booms when banks may be lending excessively.



possibility of coordination between source and recipient countries to curtail excessive capital movements, or macroprudential regulations and capital flow management measures (CFMs) that recipient countries might adopt. Further subjects include how to promote the more desirable long-term and local-currency denominated flows, and possible inconsistencies between the wish to adopt CFMs and prohibitions on their use in bilateral investment treaties (BITs) and free trade agreements (FTAs). These issues will be addressed below, but first we will show how international capital flows to EMEs increased due to unconventional and highly accommodative post-crisis monetary policies in advanced economies (BIS 2016a). The consequences of those monetary policies are as yet unclear.

## Chapter 2

# Financial flows into Emerging Market and Developing Countries

In this section we will demonstrate that the monetary policies jointly adopted by the major economies caused expanded, mainly short-term, capital flows to EMEs and DCs, which is not the type of financing most appropriate for the long-term sustainable development projects that are envisioned in the AAAA.

The UN (2016b) adopts the same perspective when it states that sudden shifts in short-term capital flows can “seriously undermine sustainable development” and “cannot be regarded as part of sustainable finance.”

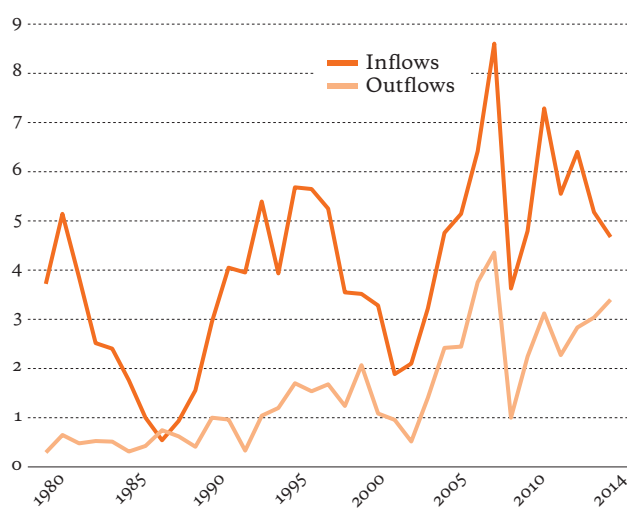
What private capital flows mean for the objectives of the AAAA depends on the type of inflow. Increasing debt flows to EMEs and DCs could support sustainable development goals, if they were long-term oriented and increased the capacity to repay the debt through rising incomes over time. Given the current environment in the IMFS, it is questionable whether this is the case, since capital flows reflect the search for short-term yield and are generally not caused by a stronger commitment of private investors to the financing of long-term development projects. The patterns of debt flows to EMEs illustrate that the different types of debt inflow respond to different profit incentives. They also show that the level of dollar-denominated debt is increasing rapidly since the Great Financial Crisis of 2007/08. The AAAA touches

on the question of different types of capital flows, but does not sufficiently differentiate between them. An inflow of long-term debt flows due to stronger commitment by private investors means something very different to an inflow of short-term debt flows from private investors looking for profitable short-term investments.

The following graph shows that the volatile influx of capital into a sample of developing countries is by no means a phenomenon that started after the recent financial crisis. Whereas it was changes in the inflows of funds which was the driving factor that reduced net inflows until the 1990s, net outflows became more volatile and explain more of the change in net inflows after 2000. Recently, capital outflows increased significantly and exemplify the high volatility of capital moving in and out of EMEs.

The table below, taken from a World Bank study (IDS 2016), summarizes aggregate net capital flows to EMEs and DCs between 2000 and 2014. As can be seen, net inflows grew almost ten-fold during this time and reached their apex at just below \$1.2 trillion in 2013. Official creditors only amounted to about 4 percent of total net inflows in 2014. However, the continuous increase in private debt inflows more than made up for the slowing growth of official lending. In 2014, net inflows from private creditors were 85 times as big as in 2000, with long-term borrowing amounting to 5 times as much as short-term borrowing in the later year. Bonds, bank loans and other private loans share the long-term debt slice equally. Bond flows have increased continuously since the crisis, which contrasts with the more erratic, volatile net flows of banks and other private sources. As expected, short-term capital flows are volatile as well. On the equity side, while FDI inflows remained stable over the years, portfolio equity investments were smaller and more volatile.

Gross capital inflows played a dominant role in net capital inflow slowdown episodes in the 1980s and 1990s. However, the role of gross capital outflows increased in the 2010–15 slowdown.



**Figure 1:** Gross Capital Inflows and Outflows of Emerging Market Economies, 1980–2014 (Percent of GDP)  
Source: IMF 2016a: 73.

## 2.1 Monetary policy in major economies and debt flows to Emerging Market Economies (EMEs)

To deepen the understanding of current private capital flows, it is necessary to have a close look at the Global Financial Crisis of 2008, which brought significant changes to financial intermediation. Commercial banks needed to “deleverage” (reduce how much of their lending was financed by bank borrowing) and were constrained

<b>Net financial flows</b>	<b>2000</b>	<b>2005</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>
Net inflows	144.8	400.7	674.6	1,105.2	1,020.6	1,054.8	1,190.4	1,132.3
Net debt inflows	2.2	97.7	213.9	508.7	447.5	447.9	563.5	463.9
Official creditors	-2.7	-37.3	79.4	76.4	32.6	27.7	27.6	43.8
of which: World Bank	7.4	4.1	18.1	22.9	6.8	12.5	14.0	17.3
of which: IMF	-7.9	-33.0	26.4	13.4	0.5	-8.4	-17.7	-1.3
Private creditors	4.9	135.0	134.5	432.3	414.9	420.1	535.8	420.1
Long-term	15.2	71.9	76.8	178.3	239.8	283.7	348.0	348.5
Bonds	23.0	35.3	56.4	116.4	119.5	179.4	182.4	175.8
Banks and other private	-7.8	36.5	20.4	61.9	120.2	104.3	165.6	172.7
Short-term	-10.3	63.1	57.8	254.0	175.1	136.4	187.8	71.6
Net equity inflows	142.6	303.0	460.7	596.4	573.1	607.0	626.9	668.4
Foreign direct investment	124.7	237.9	348.6	472.5	569.4	514.5	554.6	575.7
Portfolio equity	17.9	65.1	112.0	124.0	3.7	92.5	72.3	92.7

**Table 1:** All low- and middle-income countries (US\$ billion unless otherwise indicated)

Source: IDS 2016: 19.

by new regulation (Basel III), while parts of the shadow banking sector expanded their lending activities, especially asset management companies (Doyle et al. 2016). The deleveraging of commercial banks was thus combined with expanded lending through financial markets, managed by asset management companies and investment banks which created the securities traded by the asset managers. At the same time, central banks in advanced economies flooded their domestic banks with cash through large-scale purchases of bonds and pushed interest rates to about zero, prompting investors to look elsewhere and purchase higher interest albeit riskier assets from EMEs.

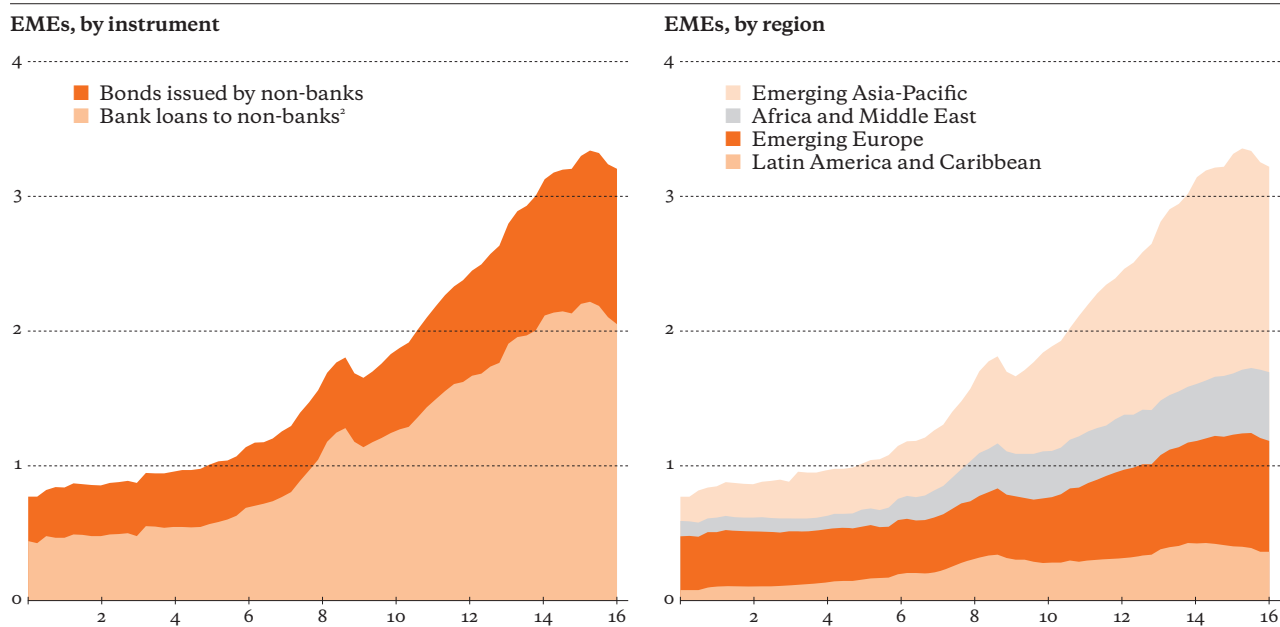
The outcome was the rise of potentially destabilizing levels of foreign debt in developing countries, denominated in US dollars (USD/\$). It was the most perilous threat to sustainable debt flows to EMEs and DCs in the current conjuncture (BIS 2016a, 2015). From 2009 until 2015, the stock of dollar-denominated bond issuance grew more rapidly than bank debt, although both grew rapidly. This stemmed on the one hand from yield searching global investors in a low interest rate environment and, on the other hand, from the post-crisis bank balance sheet repair (deleveraging) and new banking regulations.

As the figure 3 below shows, there was a rapid build-up of foreign-currency denominated debt after the Great Financial Crisis, reaching its peak in 2015 with \$3.3 trillion outstanding, declining to \$3.2 trillion in 2016. Importantly, two thirds of the outstanding amount are bank loans to non-banks in EMEs, mostly issued by

domestic banks (McCauley et al. 2015); only one third are bonds issued by non-banks in EMEs. Banks thus poured into EMEs when the monetary authorities in the major economy countries pushed interest rates to zero and flooded their home markets with liquidity. However, as the monetary authorities in key markets signalled an end of their unusual policies, outstanding bank loans have begun to contract.

This experience gives further evidence of the risks to the capital-importing economies that built up in the current IMFS. It also shows that monetary policy decisions in advanced economies have potentially destabilizing effects on financial stability in EMEs, and that bank loans are still an important factor when analyzing risks from foreign-denominated debt. The IMFS amplifies the build-up of financial imbalances through international interaction of financial regimes, via external financing and monetary regimes, and via the international use of currencies (Borio et al. 2014).

This increased issuance of dollar-denominated debt in the developing economies raises risks that the cost of making dollar interest payments and rolling over maturing debt with new borrowings will rise. That is, at some point the cheap funding opportunities in foreign currency will end: e.g. if rates in advanced economies are increasing, as happened in 2013 (Nechio 2013). Recent history provides plenty of examples of problems when the build-up of foreign-denominated debt is followed by international interest rate increases, e.g. the Mexican crises of 1982 and 1994 (Kaminsky and Reinhart 1999, CGFS 2009).



**Figure 2:** US dollar-denominated credit to non-banks outside the United States<sup>1</sup> (Amounts outstanding, in trillions of US dollars) Further information on the BIS global liquidity indicators is available at [www.bis.org/statistics/gli.htm](http://www.bis.org/statistics/gli.htm).  
Source: BIS 2016b: 21.

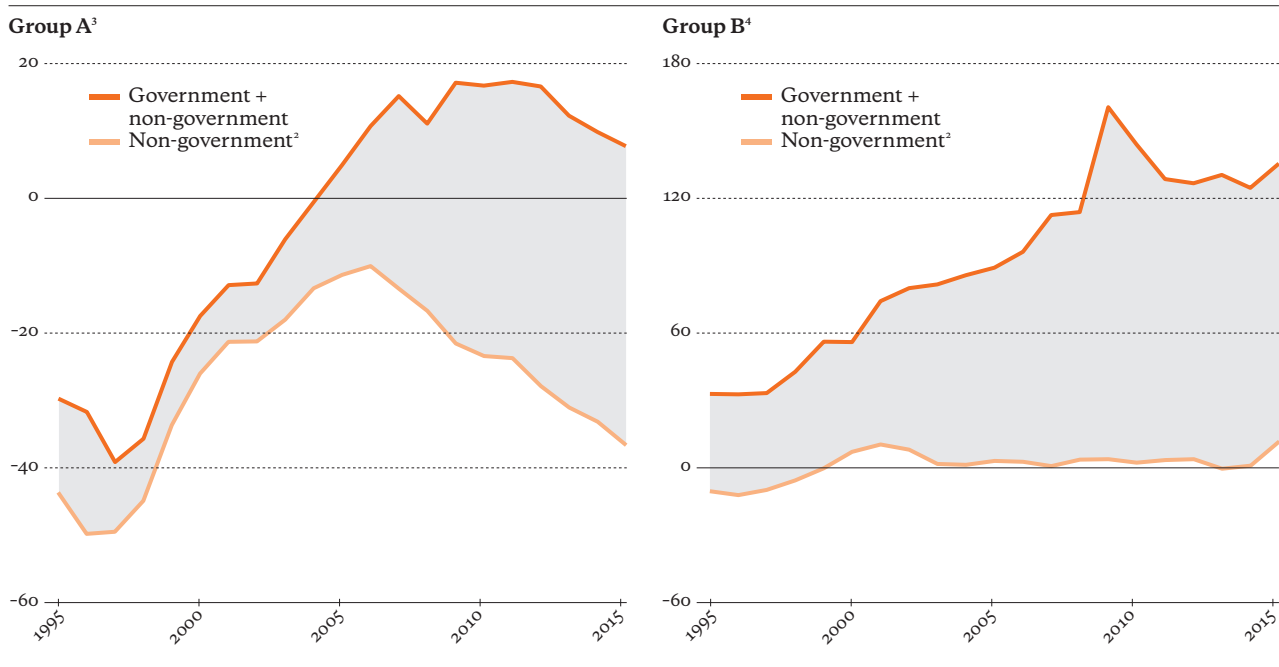
- 1 — Non-banks comprise non-bank financial entities, non-financial corporations, governments, households and international organisations.  
2 — Loans by LBS-reporting banks to non-bank borrowers, including non-bank financial entities, comprise cross-border plus local loans. For countries that are not LBS-reporting countries, local loans in USD are estimated as follows: for China, local loans in foreign currencies are from national data and are assumed to be composed of 80 percent USD; for other non-reporting countries, local loans to non-banks are set equal to LBS-reporting banks' cross-border loans to banks in the country (denominated in USD), on the assumption that these funds are onlent to non-banks.

Such a reversal of interest rates could again become a real problem, but this time because of the debt of the private sector rather than of governments, as was the case in previous crises (e.g. in the Latin American debt crisis of the 1980s). This is shown by the graph below, which depicts the net foreign currency assets (assets minus liabilities valued in foreign denominations) of the total economy and the non-government sector in two groups of EMEs, as a percentage of exports. Note that while the non-governmental sectors of group-B countries have not departed far from a zero net asset position, the net asset position of the group-A countries has been a net debt position throughout the period shown and has steadily worsened since 2006, amounting to almost 40 percent of exports in 2015. And while the very strong net asset position of the governments of the group-B countries sends

their overall ratio to over 120 percent of exports, the net assets of the governments of group-A countries almost makes the group an overall net debtor despite substantial government reserve holdings.

The amount of net foreign currency assets determines how problematic foreign-denominated debt can become for the domestic corporate sector, with a growing negative position indicating increasing vulnerabilities.<sup>3</sup> These vulnerabilities are aggravated by the channels through which the debt is accumulated. Rather than being long-term loans by banks, the non-government sector in EMEs increasingly finances itself on international capital markets. As the table below shows, while more than 60 percent of gross cross-border loans issued by banks to EMEs between 2010 and 2013 flowed to banks in developing countries (which mostly passed on those

3 — If there is a large net liability position in foreign currency, a rate hike by the central bank issuing the foreign currency would stimulate net capital outflows and a depreciation of the country's exchange rate, thus increasing the economy's real debt burden significantly.



**Figure 3:** Net foreign currency assets of EMEs.<sup>1</sup> (As a percentage of exports)

Source: Turner 2016: 58.

- 1 — For net foreign currency assets, outstanding positions of year-end. Calculated with aggregates of the economies listed in footnotes 3-4.  
 2 — Excluding the central bank and general government assets/liabilities where these can be identified separately.  
 3 — Brazil, Chile, Colombia, the Czech Republic, Hungary, Indonesia, Malaysia, Mexico, Peru, the Philippines, Poland, South Africa, Thailand and Turkey.  
 4 — China, Chinese Taipei, India, Korea and Russia.

funds to the local non-bank sector), more than 70 percent of international bonds were issued by non-banks, meaning that non-bank lenders to emerging markets have become an increasingly attractive option for non-bank borrowers.

It is important to understand the origin and motivation of the rather steady increase of bond inflows since 2009. Given low yields in advanced economies, higher-yielding assets in emerging market economies have become more attractive to global investors, particularly for asset management companies that need to profitably invest their clients' money. The rationale behind these purchases of bonds from EMEs, however, is not to commit to long-term projects, but to make short-term profits and return to safer asset classes as soon as interest rates in advanced economies normalize. Two complications can arise when the capital flows reverse: firstly, excessive capital flows will destabilize EME and DC financial markets, most of which are small in terms of daily trading, thus posing risks to their financial stability. Secondly, in that moment, the rollover of debt will become more

expensive for corporates in EMEs that have leveraged up. More problematic than the rollover risk may be the currency risk if the bonds are denominated in foreign currency (especially US dollar), since a relative depreciation

	International bank borrowing	International bonds
Total	862.5	991.3
Banks	545.1	286.9
Non-banks	317.3	704.5

Table 2 summarises the emerging markets aggregate. During the past 3,5 years (that is, from 2010 to the first half of 2013 inclusive), EM borrowers have raised about \$990 billion on international bond markets. Non-banks accounted for more than \$700 billion. One simple summary of the greater importance of financing of non-banks by international bonds is that it is twice as large as cross-border lending by international banks. But international banks are still heavily engaged in interbank business (\$545 billion).

**Table 2:** External financing of EMEs: banks versus non-banks (\$ billion over the period 2010-2013 H1)

Source: Turner 2014: 6.

of the local currency will raise the value of the real debt to be serviced. With regard to financing for development goals, this would mean that long-term projects financed with short-term debt may have to be halted due to lack of financing, as financial booms become financial busts.

That the negative foreign currency positions accumulated by the private sector in EMEs and DCs can quickly turn into problems is thus linked to the growing role that asset management companies play, being the ultimate buyers of these corporate bonds. In the next section, we will describe the particular dangers to the steadiness of financial flows, crucial for sustainable development, which stem from their business model. These actors and their short-term orientation will then be contrasted with institutional investors, given their potential to act as long-term investors.<sup>4</sup> The final section introduces the role of commercial banks and state-owned development banks as potential mediators for such long term investments, a role that regulation currently prevents them from playing.

## 2.2 The impact of asset managers

The non-bank financial industry matches firms needing funds (equity or debt) with investors seeking placements for their funds. The instruments for transferring the funds from the “buy side” to the “sell side” are securities of one form or another that are exchanged for the cash transferred. Investment banks on the sell side structure the securities, and asset managers help their investor clients choose which securities to buy, hold and sell. Some of the asset managers also design certain classes of securities that are underwritten by other securities, such as mutual funds composed of shares of individual company stocks. These derivative securities are sold to customers who wish to spread the risk of loss by holding a part of a large and diversified portfolio of securities instead of individual ones. Mutual funds may include equity, debt or virtually any other type of security. Special types of

mutual funds include exchange-traded funds (ETFs) that hold securities that mimic a published index of a class of securities, and money market mutual funds (MMFs), which invest in short-term securities, such as commercial paper issued by large corporations or banks, or short-term government securities (IMF 2015).<sup>5</sup> The problem that this universe of asset managers makes for developing countries is that they invest globally and thus are “very big fish” in a small pond when they buy or sell the securities of developing countries, whose movements may well lead to large volatilities.

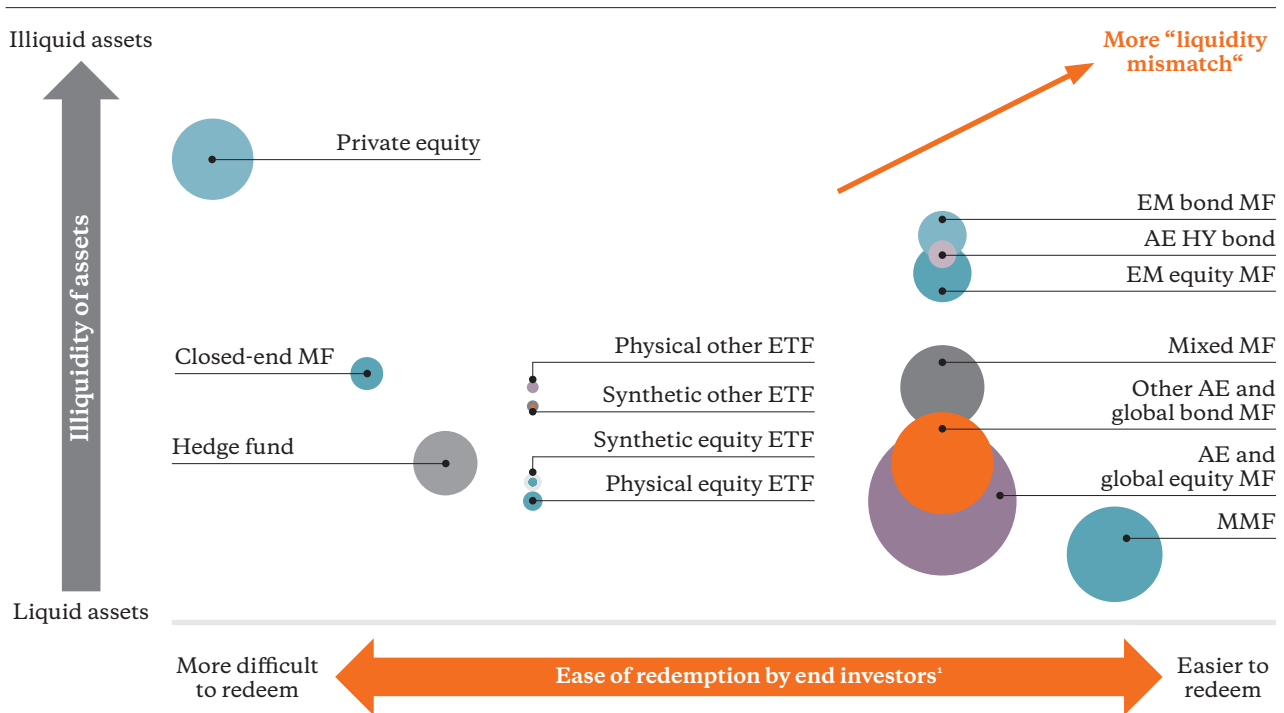
The sheer amount of assets under management of asset management companies (which was US \$79 trillion at the end of 2013 (IMF 2015)) offers opportunities in EME and DC securities, but it also raises concerns about financial stability. The BIS (2014a: 77) notes that asset management companies have “significant and systemic implications for EME financial markets” when making asset allocation decisions, given the sheer volume of their assets under management. For example, a reallocation of 5 percent of assets under the management of asset management companies would amount to a portfolio flow of \$3.5 trillion, which is an equivalent to 13 percent of the total stock of EME bonds and equities. The International Monetary Fund (IMF, 2016a: 99) underlines their potential to trigger global spillovers to banks in Asia and to other emerging markets. The implications of asset management companies as a source of risk to financial stability were also analyzed in detail in a 2013 report from the Office for Financial Research of the US Treasury (OFR 2013).

In their April 2015 Global Financial Stability Report, the IMF analyzes in detail the implications of asset management companies for financial stability. The main concerns are about the liquidity mismatches of funds. In this respect, the largest risks stem from the open-ended mutual funds, which make up about 42 percent of the 79 trillion assets under management (IMF 2015: 95). Investors in these funds enjoy the profits and bear the losses incurred by the funds’ asset managers, although their structure

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4 — Evidently, in the current moment, pension funds and other long term investors are the clients of these asset managers. However, there is no automaticity regarding this decision, as pension funds and insurers could well take autonomous long-term investment decisions in these countries.

5 — A private equity fund is a special type of asset manager that buys enough shares of a company to take a management position with the intent of raising the profitability of the bought firm and selling it at a profit. A hedge fund is another special type of asset manager that supplements the funds of its investors with usually large borrowings to leverage the positions it takes in the securities in its portfolio and thus is high risk, despite the name ‘hedge’ which suggests it lowers risk.



**Figure 4:** Liquidity Mismatches (Size of bubbles represents relative global assets under management as of end-2013)  
 The mismatch between the redemption risk to funds and market liquidity of funds' assets is most notable among bond mutual funds—especially corporate and emerging market debt funds, though these are relatively smaller segments.  
 Source: IMF 2015: 22.

makes them potentially volatile. Open-end mutual funds allow new investors to buy shares in the mutual fund, and existing investors to sell their shares on demand at any time, albeit at the weighted average market price of the securities in the fund's portfolio. These features of open-end mutual funds generate "rational risk" of mass exit by end-investors (Sissoko 2016). The risk stems from "first mover" advantages: those who sell when the underlying security prices have just begun to fall will receive the most; but if the run continues and the mutual fund needs to sell shares itself in order to make good on its commitment to its investors, it further drives down the prices, exacerbating the run. Of the 30 trillion dollars in open-end mutual funds, the category most exposed to these run risks are bond funds, which make up about a third of the total (IMF 2015: 124). These bond funds expanded rapidly, given the yield search in advanced

economies as well as corporates in EMEs that could not get funding via bond markets before.<sup>6</sup>

This risk of runs is aggravated if the funds are invested in less liquid assets, such as emerging market bonds, meaning that the bond prices during a "sell off" have to fall more to find a willing buyer. The concern is centered on the possibility of a self-amplifying feedback loop, where redemption requests by end-investors force funds to sell bonds into illiquid markets, which in turn leads to more requests for redemptions by end-investors which leads to further losses. The figure below from the IMF report of 2015 shows that the emerging market bond funds and emerging market equity funds are the ones with the highest mismatch between the illiquidity of assets and the ease of redemption.

The growth of international purchases of securities from these smaller and less liquid markets can amplify

<sup>6</sup> — Ramos-Francia and Garcia-Verdu (2016) show how monetary policy stances in advanced economies affected bond flows to and from EMEs and how run-like dynamics are attached to these flows.

their price movements, significantly raising their prices when the buyers enter and lowering them when they leave.<sup>7</sup> The increasing market share of international asset management companies, especially in smaller and less liquid markets in EMEs, also leads to a higher ownership concentration of assets, which has been shown to lead to more volatility of asset prices in times of crisis.

The incentive structure under which portfolio managers operate in these firms also worsens volatility, as it encourages herding behavior; i.e., managers are judged in comparison to the profits made by peers and by the use of common benchmarks, which increases correlated behaviours (Miyajima and Shim 2014). Also, in trying to outperform competitors, excessive risk-taking behaviour by asset managers can complement and amplify the risks of herding behavior.<sup>8</sup> The risks are further amplified by asset managers and individual investors who borrow funds to purchase securities. The post-crisis monetary policies in advanced economies offered very cheap financing for investors who wished to increase their holdings by borrowing against the value of the securities they owned. In this context and in the search for yield, they invested an increasing portion in EMEs and DCs, where they found corporations happy to issue and sell them foreign or local-denominated bonds.

While the volatility from herd behavior of international investors in securities is a concern, there are also reasons for concern about it being too easy for local firms to issue bonds to international markets. Serena and Moreno (2016) further show that the proceeds of the bonds may not be used for sustainable investments, but instead for purchasing short-term assets. Also concerning is their finding that firms which borrowed offshore tend to be less profitable than those that are able to borrow on-shore, or than firms that do not issue any bonds. If unprofitable firms in EMEs can issue international bonds that are purchased by asset management companies for investors with short-term horizons, the goal to use market based financing to achieve sustainable development goals will not be achieved. In other words, under current regulation, asset management practices could seriously impair the objectives laid out in the AAAA.

Improved data on risk taking, as well as macroprudential regulation, is necessary to reduce the risks posed by asset management companies, and liquidity risk management tools are available to counter the above mentioned risks (BIS 2016a, FSB 2014, IMF 2015). A first concern is liquidity mismatches – that is, maintaining high liquidity in the mutual fund’s own shares while the securities it holds are less liquid. Calls for regulation (IMF 2015) focus on the reduction of liquidity mismatches by requiring larger fund cash reserves or limiting the ability of investors to sell their shares on demand. But a drawback would be reducing the attractiveness of mutual funds that would finance long-term projects for sustainable development. The focus on regulatory efforts for market protection thus creates a trade-off between financial stability and the use of this model for long-term financing in EMEs and DCs.

## 2.3 Long-term institutional investors

Institutional investors, such as pension funds, insurers, endowments and sovereign wealth funds, can play an important role in financing sustainable development, but the AAAA does not show how to make long-term institutional investors attracted to long-term financing – an aspect already criticized in the run-up to the Addis Ababa Conference by Schmidt-Traub and Sachs (2015). Institutional investors operate with longer-term liabilities that should make them a promising candidate for financing long-term sustainable development projects in EMEs and DCs. Nevertheless, institutional investors have largely chased short-term (quarterly) profits attainable from asset management companies rather than invest funds directly into long-term projects that are less liquid.

The following table shows current and potential allocation of institutional investors to infrastructure projects in EMEs and DCs, and illustrates how the investment of a small portion of their assets under management (AUM) could have a significant impact on the financing of long-term infrastructure projects.

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<sup>7</sup> – Shrek et al. (2015) show that concerted selling by asset managers can lead to large-scale market fluctuations in EME bond values.

<sup>8</sup> – Correlated behavior of asset management companies that lead to large-scale market fluctuations in EM bond markets are empirically observed, for example, by Shrek et al. (2015).



<b>Institutional Investors</b>	<b>AUM USD \$</b>	<b>Current Investment in EMDE Infrastructure</b>	<b>Potential Investment in EMDE Infrastructure</b>	<b>Comments</b>
<b>OECD Institutional Investors</b>	79 trillion +	<1% = total leading investors c10% most in domestic markets	1% assets = \$750 billion	WEF (2011) breakdown of institutional investors AUM to truly long-term capital = \$6.5 trillion Around 1% of this implies c\$50 billion target
<b>Emerging Market Institutional Investors</b>	4.5 trillion  NB growth potential - e.g. EM pension funds currently \$2.5 trillion AUM estimated to rise to \$17.4 trillion by 2050	Even more limited than leading OECD investors  Chilean pension funds 1.5%	1% assets = c\$50 billion	This target could be much higher as many EM institutions can only invest in domestic markets
<b>Sovereign Wealth Funds</b>	4 trillion	0-5%	c5% assets = c\$250 billion	Many of new EM SWF being set up to specifically invest in domestic infrastructure
<b>EM pension reserve and social security funds</b>	1 trillion	Limited - ad hoc examples (up to 10%)	10% assets = c\$100 billion	High target as these funds are often the largest single source of capital in a developing country

**Table 3:** Current and Potential Allocation of EM Institutional Investors to EM Infrastructure  
Source: Inderst and Stewart 2014: 4.

Looking at institutional investors from the member countries of the Organization for Economic Cooperation and Development (OECD), already just a small amount of their assets under management would be enough to cover the amount of annual investment in infrastructure projects around the globe (between \$5 and \$7 trillion) needed to achieve the SDGs. Given, at the same time, that current investments account for less than 1 percent of total assets under management of OECD institutional investors, it is evident that therein lies the biggest potential for financing sustainable development projects. In comparison, the capacity of institutional investors from EMEs to achieve these objectives is rather small. The same holds for Sovereign Wealth Funds, even if many of these funds are newly created to finance domestic infrastructure projects.

In addition, the introduction of the new regulatory framework for insurers in Europe (Solvency II) disincentivizes insurers (which are an important type of institutional investor) from making investments in long-term infrastructure projects, and is therefore at odds with the outcomes of the AAAA (Schmidt-Traub and Sachs 2015). Insurers are induced to sell assets they already own because of an increase in the quantity and quality of regulatory capital (SCR charge), and are incentivized to invest in short-term highly-rated debt instead of in

long-term equity investment in EMEs and DCs (Spencer and Stevenson 2013). Solvency II, just like Basel III for banks and the European Capital Requirements Directive IV (CRD IV) for banks, building societies and investment firms, creates a trade-off between financial stability and private long-term finance for development, and incentivizes insurers to purchase assets that are not in line with long-term project financing in EMEs and DCs. Such standards undermine efforts to mobilize long-term financing from institutional investors. Instead of aligning financial stability with financing for sustainable development goals, recent reforms by global and European standard-setting bodies focus on the former at the expense of the latter. The most attractive way today for insurers to acquire exposure to bonds in EMEs and DCs is to use the services of asset management companies, resulting in the aforementioned negative impacts on financial stability in those countries (OFR 2013: 4). What is missing for the realization of the sustainable development goals is an agent with the capacity to monitor firms and their projects on the ground and develop a project pipeline in which long term investors could invest. Commercial banks have played this role historically and, as we will argue, should be considered more in an agenda that seeks to generate financing for development.

## 2.4 Commercial banks

Commercial banks from advanced economies have had a large presence in EMEs and DCs for decades, growing significantly during the pre-crisis period of globalization and financialization (Claessens 2008). While most of the lending was denominated in foreign currency, implying currency risks (World Bank 2008) and the possibility for transmitting shocks from the home to the host banking system (de Haas 2012)<sup>9</sup>, there were several benefits attached to their increased presence: credit availability and efficiency increased (World Bank 2008; de Haas 2012). Shocks to the domestic banking system could be balanced out by the domestic branch drawing on the resources of its foreign parent. Foreign commercial banks contributed to sustainable development goals by investing, syndicating and structuring long-term financing arrangements for infrastructure projects, facilitated by their in-house expertise (Schmidt-Traub and Sachs 2015: 101-102).

In the aftermath of the Great Financial Crisis, commercial banks from advanced economies have reduced their presence in EMEs and DCs significantly compared to the pre-crisis period (Classens 2016).<sup>10</sup> The tightening of bank regulation post-crisis has decreased their contribution to long-term development projects, and decreased the number of investable infrastructure projects for institutional investors (ibid).<sup>11</sup> Commercial banks have brought their expertise to bear on syndicating and structuring the financing of long-term projects, which may be less available elsewhere. In addition, the steady increase of more volatile cross-border lending by the banks from developed countries mostly to banks within EMEs and DCs is worrisome. The increased use of funding by local banks in foreign currency, foremost in US dollars, in these countries creates risks to the local banking system due to the volatile nature of these funds (see above).

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<sup>9</sup> — e.g. Claessens and van Horen (2014) show how lending of foreign banks was reduced more than lending of local banks during the Great Financial Crisis.

<sup>10</sup> — This trend was partially offset by the increase of the presence of foreign banks from other EMEs and DCs (Claessens 2016).

<sup>11</sup> — Post-crisis bank regulation reforms made capital flows to the EME non-financial corporate sector relatively more expensive for banks, as Basel III and CRD IV place a premium on highly-rated, standardized securities with on-balance sheet risk retention (Spencer and Stevenson 2013). Furthermore, the newly introduced Liquidity Coverage Ratio (LCR) for banks in Basel III makes illiquid assets like long-term investments for sustainable development in EMEs unattractive. The second new liquidity requirement, the Net Stable Funding Ratio (NSFR), also makes long-term assets uninteresting since banks become more sensitive to liquidity mismatches (ibid.).

## Chapter 3

# Summary and outlook

The AAAA implicitly calls for the application of robust risk-based regulatory frameworks for shadow banks (paragraph 38). Given the risks to financial stability posed by the incentive structure of asset managers and the demands of their institutional and other investors, this is a pressing issue. On the other hand, these investors manage a great amount of money that could be invested in longer-term assets in EMEs and DCs, which would help to achieve SDG objectives. The search for yield among investors in advanced economies leads to easy funding conditions through bond issuance. However, the increase of debt held in foreign-denominated currencies could destabilize the financial and economic systems in EMEs and DCs once the funding conditions become more difficult. Moreover, it could become more challenging to roll-over loans which could disrupt longer-term projects that are in line with SDGs.

The AAAA acknowledges the need to reform the IMFS, but without elaborating on a plan. The reduction of the build-up of financial imbalances due to different interest rates in advanced economies and EMEs is important and can be achieved by longer-term capital flows to these countries and the issuance of debt in local currencies. Currency risks and rollover risks point to the risks of short-term capital movements. However, purchases of assets with shorter maturity are advised by standard-setters to reduce liquidity mismatches (Basel III, Solvency II). This makes sense in terms of financial stability but at the cost of long-term capital flows to EMEs and DCs. Infrastructure projects' need for long-term financing is unlikely to be met with current regulatory intentions. Currently, from the point of view of regulators and policymakers, there is a trade-off between financial stability and funding conditions in EMEs and DCs, generating tendencies to raise the costs of holding assets with long-term maturities, and conflicts with the need for long-term project financing. The AAAA remains vague on reconciling both objectives.

Given the transformation from bank-based to market-based financing in financial flows in EMEs and DCs, illustrated by the growing relevance of international debt securities as compared to cross-border bank loans, it is imperative to find answers to these questions. Under the current institutional framework, increased interest rates in advanced economies might lead to systemic distortions of international financial markets. The current international financial environment is inherently fragile and indicates the need for an institutional framework

that promotes financing for development as well as ensuring financial stability. The current IMFS tends to increase the risk of financial crises for two reasons: first, due to the close interconnectedness of financial markets, which can promote unsustainable credit booms, and second due to the monetary regimes, which spread monetary conditions from advanced economies to other countries, given that currencies are used beyond national borders (Borio et al. 2014). In the next chapter we will seek to sketch out the regulatory measures needed to alleviate the worst of these effects.

### 3.1 The need for a sound framework for private capital flows to make a contribution

This section illustrates the implications of the preceding information on three interrelated policy fields. First, regulatory reforms of commercial banks (Basel III/CRD IV) and insurance companies (Solvency II), which should not disincentivize them to commit to long-term projects that promote sustainable development. Second, capital flow management measures (CFMs) which should be regularly used to channel capital flows in ways that benefit domestic development goals and reduce risks posed to financial stability, thereby serving two different but interrelated goals. Third, since speed and size of capital flows may overstrain the global financial safety net (GFSN) and CFMs, better coordination of monetary policies between central banks of major economies is warranted to reduce the risk that the latter will be overstrained.

These three layers are interlinked with each other and should be coordinated in order to increase the efficacy of introduced measures. Prudential regulation, CFMs and central bank coordination are interrelated fields, which are at the centre of the question of whether private capital flows can promote sustainable development goals. The institutionalization of prudential regulation, the potential for countries that face excessive capital flows to employ CFMs as they see fit and the coordination of central banks regarding their monetary policies would be the foundations to channel capital flows to work for SDGs. In the following we will focus on these three layers, and on the necessary next steps to achieve improvement in them.

## 3.2 Prudential Regulation

Commercial banks and investment banks have played an important role in project structuring, loan syndication<sup>12</sup> and bond issuance for long-term projects. However, due to the financial crisis and the subsequent tightening of bank regulation post-crisis, bank intermediation of long-term loans was expected to decrease (Schmidt-Traub 2015: 102). Even if market actors can substitute for the reduced long-term investments by commercial banks, the lack of expertise regarding project structuring and syndication expertise could impair long-term investment objectives as laid out in the AAAA (ibid.). While the World Bank, regional development banks and the new development bank led by China and the BRICS members can play a project-coordinating and financing role, private banking institutions may retain at least a part of their former role.

Historically, commercial banks have played an important role in the economic development of European economies (Gerschenkron 1962). Instead of weakening the capacity of commercial banks to structure and fund long-term projects, regulatory efforts should aim at promoting their role. That means we are not calling for a weakening of current regulations, but for shaping regulation in a way that incentivizes long-term investments for sustainable development projects without endangering financial stability. The maturity of bank loans is relatively short in EMEs and DCs; for example 41 percent of bank loans in high income countries have maturities longer than 5 years, while this is the case for only 12 percent of bank loans in low income and lower middle income countries (Sachs and Schmidt-Traub 2015: 97). Based on their function as credit intermediators with local capacities, and their expertise in structuring and syndicating loans for long-term projects in EMEs and DCs, commercial banks can be helpful to promote funding of sustainable development projects. Therefore, regulatory action should seek to re-facilitate this role, by making investment in long-term syndicated bonds less onerous.

Also, while regulation of asset managers is urgent in order to tackle the systemic risk they pose (as noted earlier), their effects on financing in EMEs and DCs should not be ignored. This is especially true when asset

management companies are involved in small and illiquid EME asset markets. One approach to reducing the liquidity risks involved in emerging market bond and equity funds is to structure them as closed rather than open-ended funds, thereby removing the opportunity for rational runs by investors. However, this also makes investing through them less attractive to investors. A consultative FSB document from June 2016 (FSB 2016) recommends instead that liquidity risk management tools, such as being able to impose advance notice requirements for withdrawals, should be used by asset management companies in order to reduce run risks. It is, however, unclear whether and how these measures will be imposed and how it will impact the behavior of those companies in EMEs. A third approach would be to adopt measures discouraging speculative capital flows (CFMs, discussed below, are a case in point).

Lastly, institutional investors with long-term liabilities are a prime candidate to finance long-term projects in EMEs and DCs. Prudential regulations which focus on reducing liquidity mismatches should aim to make long-term assets more attractive. The objectives of the European Long-Term Investment Funds (ELTIFs) proposed by the EU Commission indicate that the financing of long-term investments with long-term liabilities is feasible (EU Commission 2015). Investments, as for long-term infrastructure, are to be promoted by the design of ELTIFs, which target specifically pension funds or insurance companies, but also retail investors. Liquidity mismatches would be reduced not by shortening the maturity of assets, but by locking up shareholder funds, meaning that end-investors would not be able to get their money back for a specific time. A second step would be to incentivize asset management companies to set up and manage this type of fund. As asset management companies will need to monitor the markets to determine which projects are worth pursuing, public policy should seek to lower these transaction costs through cooperation with local and regional development banks which screen possible projects.

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<sup>12</sup> — In projects requiring large-scale financing, one or more banks may create a syndicated loan in which shares in the loan are offered to other banks or institutional investors. The lead bank or banks manage the loan for the syndicate. Shares in the syndicate can be sold or traded.

### 3.3 The need for capital flow management measures

While the AAAA does approve of the use of capital flow management measures “[w]hen dealing with risks from large and volatile capital flows” (paragraph 105), there is no discussion of institutional impediments to the use of such measures. EMEs and DCs should be free to use CFMs as they see fit to prevent excessive capital flows from destabilizing financial markets and sustainable development. However, such liberty of use might be constrained by investment and trade agreements, which therefore should be reviewed.

While CFMs should be supported, as they can prevent a breakdown of financial systems, it would also be desirable to widen the policy space for EMEs and DCs to employ them to channel capital flows toward longer-term investments. Regular use of capital flow measures should be advocated in order to help overcome “inaction bias” (waiting too long to react to a policy challenge) at the domestic level. The AAAA mentions CFMs only as tools to prevent destabilizing capital in- and outflows in emergency situations, but they also can be a tool to move the composition of capital flows toward long-term oriented ones. For example, the imposition of unremunerated reserve requirements (e.g., interest-free deposits at the central bank for a year) on financial inflows led to positive effects in certain Latin American countries in their efforts to fight volatile short-term capital flows in the 1990s (French-Davis 2010). By targeting capital inflows according to their specific characteristics like maturity or currency denomination, these measures can make short-term capital flows more expensive. While it is questionable whether CFMs alone can prevent the build-up of financial imbalances when macroeconomic policies are misaligned, free capital accounts are a potential risk to financial stability in EMEs and DCs (Borio et al. 2014).<sup>13</sup>

However, the widening of policy space to employ CFMs could conflict with existing bilateral investment treaties (BITs) and free trade agreements (FTAs). For example, the United States model BIT, meant as the starting point in an actual bilateral negotiation, is restrictive towards the use of CFMs. The only option to use CFMs is when “the integrity and stability of the financial

system” is at stake (Article 20 of the US model BIT), which means it is inadmissible to use them in order to reduce the build-up of financial imbalances. FTAs and BITs may also contain articles that limit the ability of the host country to set minimum local content requirements or offer subsidies for new foreign-financed investments in remote areas, which may hamper the development of local industry. Since BITs and FTAs are used as a tool to liberalize capital flows (Gallagher 2015), it is necessary to closely monitor ongoing negotiations to draft them.

The Group of 20 have already adopted parts of a perspective which is aimed at reducing obstacles to a world with liberalized capital accounts (Alexander and Caliarì 2016). This development thus needs to be closely monitored.

### 3.4 Central Bank Coordination

Paragraph 105 of the AAAA states that regulatory gaps and misaligned incentives continue to pose risks to financial stability and point to the need for further reforms of the international financial and monetary system (IMFS), including the strengthening of “international coordination and policy coherence to enhance global financial and macroeconomic stability.” It is also acknowledged that “national policy decisions can have systemic and far-ranging effects well beyond national borders.” For the case of monetary policy decisions, which countries make on the basis of their domestic macroeconomic variables, coordination is needed among monetary policies of countries in order to prevent global instabilities from occurring.

The current architecture of the IMFS amplifies financial surges and collapses and needs to be reviewed (Borio et al. 2014) to prevent policy incoherences. Which initiatives should be pursued to achieve this is not part of the agenda of the AAAA. That such action is urgent was demonstrated by the destabilizing effect, the so-called “taper tantrum” of 2013, when the Federal Reserve announced that it would increase policy rates in the future, which triggered a rapid sell-off in EM bonds and destabilized global financial markets. The ‘taper tantrum’ illustrates that monetary policies of major central

<sup>13</sup> — For a reduction of the potential destabilizing capital flows, the coordination of monetary policies among countries in the Global North and the Global South is a necessary measure.

banks in advanced economies can cause spillover effects in EMEs and DCs. The international use of the US dollar and interconnected financial markets makes policy decisions of central banks in the former also relevant for financial stability and financing conditions in the latter.

Central banks created a wide transnational network for consultation consisting of a range of different platforms (Marcussen 2006). Therefore, the problem is not one of a lack of coordination efforts among central bankers, but that many EMEs and DCs are excluded from these meetings. Within these meetings, central bankers do not coordinate their policies with regard to negative spillovers to non-participating countries. This is not surprising since the mandate of central banks is domestic and there is no model available in order to get guidance for policymaking.

The AAAA is explicit in the objective to strengthen international coordination to enhance global financial stability. One way forward in this respect, as the Bank for International Settlements has proposed (BIS 2016a), is to further develop central bank coordination which could entail coordination of changes in interest rates. This could help to safeguard global financial stability since it would moderate the build-up of global financial imbalances, such as the growth of foreign-currency denominated debt in EMEs due to global interest rate differentials after the Great Financial Crisis. If monetary policies are coordinated in a way that smooths global capital flows, the need for EMEs and DCs to rely on CFMs is reduced.

These larger measures would also reduce the dependence on the regulation of asset management companies and the shadow banking system more broadly. Proposals by academia (CIEPR 2011) and examples like the coordination of central banks during the last global financial crisis point to the tendency to focus on coordination efforts among major central banks in advanced economies. However, it would be desirable for central banks of EMEs and DCs to take an active part in the policy coordination. The call for improving the Global Financial Safety Net (GFSN) is an important policy proposal in this respect. Consisting of inter-central bank swap lines (liquidity lines), foreign exchange reserves, regional financial agreements and IMF loans, the GFSN is useful in times of distress in financial markets. In the vein of the global financial crisis, the US Federal Reserve authorized dollar liquidity swap lines with the Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan and the Swiss National

Bank. However, the network of swap lines which emerged post-crisis is highly exclusive and does not include central banks from EMEs and DCs. The main reason given for the restrictive use of swap lines are “moral hazard” concerns for countries with lower institutional qualities; that is, concerns that they would abuse the support and delay corrective policy actions (see Aizenman et al. 2011; Scheubel and Stracca 2016).

However, it is questionable whether the current GFSN is sufficient to handle a future unravelling of short-term capital flows (Rajan 2014). In particular, access to the euro and the dollar, the main currencies in which companies in developing countries issue foreign debt, needs to be secured for the central banks of these countries – an aspect of a sustainable financial system that the Federal Reserve currently rejects on grounds of lacking safety. Hence, the creation of a global swap line between central banks of advanced economies and EMEs is desirable (Truman 2013, Helleiner 2014). The extension of a global safety net is a reachable objective. While central bank coordination meets strong opposition from central banks and influential neoclassical economists (e.g. Blanchard 2016), the case for global safety nets is accepted by policymakers and economists alike. Measures like standing liquidity swap lines from major central banks in advanced economies to DCs and EMEs do not receive a lot of opposition and should therefore be adopted. The strongest counter argument is that these liquidity lines cause moral hazard problems (i.e., less cautious policy making). This is a weak argument since it is based on the assumption that central banks in developing countries have, ipso facto, less qualified staff compared to their counterparts in developed countries.

However, the GFSN is only a second-best option, as it is preferable to reduce the spillovers by coordinating monetary policies beforehand. As stated before, coordination among central banks, not only among major central banks in advanced economies, can prevent excessive capital flows from overrunning lines of defence in recipient countries. Macroprudential regulation and CFMs alone cannot endure capital flow movements generated by changes in monetary policies. Therefore, major central banks need to be pushed to internalize any negative spillovers they cause in other countries. The US Federal Reserve, for example, only takes into account negative spillovers when they spill back to the US economy. Domestic mandates of central banks are a convenient counterargument to such a request but are

not satisfactory in a world with interconnected financial markets in which monetary policy decisions are easily transmitted to other countries.<sup>14</sup>

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**14** — In this context, looking at the Inaugural Report of the Inter-Agency Task Force on Financing for Development (IATF 2016), which reports annually on the progress of the implementation of the AAAAA, is cause for concern, as measures that focus on the architecture of the international monetary and financial system to limit the procyclicality of capital flows remain too vague.

## Chapter 4

# Conclusion and Recommendations

Unconventional and highly accommodative monetary policies post-crisis caused a temporary and unsustainable surge in financial flows into emerging markets. What needs to be in place, however, are global and domestic institutional frameworks that direct a sustainable flow of private capital into desirable long-term investments. If these frameworks are not in place domestically, capital inflows will finance investments that are not in line with the kind of investments prioritized by the AAAA. If they are not in place internationally, excessive short-term capital movements will endanger the completion of development projects in DCs and EMEs as well as the financial stability of those countries.

In fact, banking regulation and regulation of institutional investors on the one hand, and lack of investable development projects on the other limit desirable long-term capital flows of institutional investors into DCs and EMEs. At the same time, asset management companies

are still largely unregulated even though they pose a large risk to financial stability. Regulatory recommendations by the IMF (2015) are similar to efforts by Solvency II, Basel III and CRD IV in that an unintended side effect is to make long-term assets less attractive to hold for these entities.

A trade-off between financial stability and private finance for development does not need to be the case if regulations are designed in a way that disincentivize short-term cross-border flows and incentivize long-term financing for projects in DCs and EMEs. Reforms of domestic and institutional frameworks could aim at turning these trends in directions that are aligned with the outcomes of the AAAA. Concerning the international monetary framework, capital flow measures may be useful to further discriminate between desirable and less desirable capital flows. They are a very useful tool in a world with uncoordinated monetary policies which

AAAA	Implementation	What happened so far?	Critical comments
<b>Regulatory framework</b> Paragraph 38, 104, 109 <ul style="list-style-type: none"> <li>• Robust-risk-based regulation for all financial intermediation,</li> <li>• strengthening of macroprudential regulation,</li> <li>• reduction of systemic risks posed by shadow banking system.</li> </ul>	“We will hasten completion of the reform agenda on financial market regulation, including assessing and if necessary reducing the systemic risks associated with shadow banking [...]”. (AAAA, Paragraph 109)	“The world’s principal financial centres worked together to reduce systemic risks and financial volatility through stronger national financial regulation, including Basel III and the broader financial reform agenda”. (AAAA, Paragraph 104)	The shadow banking system, particularly asset management companies, needs to be regulated – the disincentivization of short-term and incentivization of long-term investments by institutional investors would benefit sustainable development goals.
<b>Capital flow management measures (CFMs)</b> Paragraph 105 <ul style="list-style-type: none"> <li>• Regulatory gaps and misaligned incentives pose risks to financial stability.</li> <li>• Spillover effects of financial crises to developing countries.</li> <li>• Further reforms of the international financial and monetary system need to be pursued.</li> </ul>	“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” (AAAA, Paragraph 105)	CFMs became a feasible policy option again, driven by a rethinking in the IMF and new developments in neoclassical economics (IMF 2012)	<ul style="list-style-type: none"> <li>• EMEs and DCs need to be able to use CFMs to prevent destabilizing capital flows and to channel capital flows according to development objectives.</li> <li>• Screening of negotiations of FTAs and BITs since they may entail clauses that forbid the employment of CFMs.</li> </ul>
<b>Policy coordination</b> Paragraph 105 <p>“Regulatory gaps and misaligned incentives continue to pose risks to financial stability, including risks of spillover effects of financial crises to developing countries, which suggests a need to pursue further reforms of the international financial and monetary system.”</p>	“We will continue to strengthen international coordination and policy coherence to enhance global financial and macroeconomic stability” (AAAA, Paragraph 105).	Central banks in advanced economies continue unconventional monetary policies with purely domestic scope (Brainard 2015).	<ul style="list-style-type: none"> <li>• Major central banks in advanced economies need to be pushed to take into account spillovers they produce to EMEs and DCs.</li> <li>• Wider coordination of monetary policies could prevent the build-up of unsustainable financial imbalances that have harmful effects for development.</li> </ul>



nurture short-term capital flows with possible negative implications for financial stability. More coordination between monetary authorities in DCs, EMEs and advanced economies would result in less excessive capital flows that induce employment of CFMs as well as disincentivize short-term speculative arbitrage movements.

An international financial and monetary framework in line with the AAAA would be based on

- more coordination between monetary authorities that will discourage excessive and speculative capital flows,
- financial regulation that promotes long-term investments in DCs and EMEs without increasing systemic risk and
- domestic frameworks in DCs and EMEs that are attractive to finance and a more active role of reformed development banks.<sup>15</sup>

The AAAA only focuses on the domestic frameworks. Therefore, a stronger commitment to the first two aspects is needed if private finance for development objectives are to be reached. The table below seeks to summarize the different entry points for policy action and how they relate to the AAAA.

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15 — On the latter, see Griffith-Jones, 2016.

# Abbreviations

AAAA	Addis Ababa Action Agenda
BIS	Bank for International Settlements
BIT	Bilateral Investment Treaty
CFMs	Capital flow management measures
CGFS	Committee on the Global Financial System
CSOs	Civil society organisations
DC	Developing countries
ELTIF	European long-term investment fund
EME	Emerging market economies
ETFs	Exchange-traded funds
EU	European Union
FDI	Foreign direct investment
FSB	Financial Stability Board
FTA	Free trade agreement
GFSN	Global financial safety net
IATF	Inter-Agency Task Force on Financing For Development of the UN
IMFS	International monetary and financial system
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
MMFs	Money Market Mutual Funds
NAV	Net asset value
NBNI G-SIFI	Non-bank non-insurer global systemically important financial institutions
NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Co-operation and Development
OFR	Office of Financial Research
PPP	Public-Private Partnership
QE	Quantitative Easing
SDG	Sustainable Development Goal
SME	Small and medium-sized enterprise
UNEP	United Nations Environment Programme
URR	Unremunerated reserve requirements
USD	US dollar

# Glossary

Basel III	New banking regulation imposed by the BIS Basel Committee on Banking Supervision to strengthen regulation, supervision and risk management of the banking sector.
Project pipeline	The process of planning and construction projects.
CRD IV	New banking regulation implemented on 18 July 2013 by the EU Commission in order to strengthen the banking system.
Equity	Is the difference between the value of assets and the value of liabilities on the asset.
Rational run	A run that is triggered by individual rational behaviour.
Rollover	The process of refinancing debt.
Solvency II	Regulation of European insurers that became applicable on 1 January 2016.
Taper tantrum	The announcement of the Federal Reserve to normalize (taper off) its monetary policy (by increasing policy rates) caused global market volatilities.
Trade-off	A trade-off between two objectives arises if the achievement of one of these comes at the expense of the other.

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