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The Arab Financing for Development Scorecard**Domestic and international private business and finance****Summary**

The new global financing for development framework recognizes domestic and international private business activity and investments as major drivers of productivity, inclusive growth and job creation, with strong potential for contributing to the achievement of the 2030 Sustainable Development Agenda. Yet, current levels of domestic and international private finance remain weak in the Arab region.

Over the past decade, the Arab region has witnessed significant negative net capital flows, with private development finance flowing out rather than remaining in the region to serve its sustainable development. Moreover, as foreign direct investments became scarce and risk averse, both in reaction to the 2008 global crisis and conflict in some Arab countries, regional efforts to ensure a sustained flow of private finance gave way to competitive attitudes and beggar-thy-neighbour tendencies. Intraregional remittances continue to provide a relatively stable source of financing that offsets, to varying degrees, the negative flows associated with other forms of cross-border capital movements. Given these negative capital flows, it is vital to improve investment climates and enhance financial inclusion, including harnessing the potential of small and medium enterprises.

Representatives of member States are invited to consider global and regional trends in domestic and international private business and finance presented in this document, and comment thereon.

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Introduction

1. The Third International Conference on Financing for Development resulted in a new global framework to finance the ambitious 2030 Agenda for Sustainable Development. The Addis Ababa Action Agenda was designed to mobilize all sources of finance (public, private, domestic, international, bilateral, multilateral, traditional and innovate)¹ to create the fiscal space for Governments to work towards sustainable development, and to serve as a means of implementation of the 2030 Agenda and its 17 Sustainable Development Goals (SDGs).
2. The present document is intended to serve as input to, and should be read in conjunction with, the Arab Financing for Development Scorecard. The first section maps the landscape of international public and private finance in 2015 (the baseline-year established by the Action Agenda to monitor the implementation and progress of financing for development). The second section provides an analytical assessment (qualitative and quantitative) of the state of private finance in the Arab region, including cross-border flows, and the main determinants affecting the mobilization of such finance, taking into account regional contexts and realities as emphasized by the Action Agenda.

I. GLOBAL TRENDS IN DOMESTIC AND INTERNATIONAL PRIVATE BUSINESS AND FINANCE

3. The Action Agenda recognizes that private international capital flows, particularly foreign direct investment, and a stable international financial system are vital to national development efforts. The new global financing for development framework highlights the link between stable long-term private finance, both domestic and international, and the achievement of sustainable development. The new global financing for development framework also recognizes the need to develop competitive investment climates, remove perceived cross-border constraints, reduce policy and risk uncertainties, and promote capital markets.

A. INVESTMENT CLIMATE

4. The United Nations Inter-Agency Task Force on Financing for Development has identified several global benchmark initiatives to monitor the nexus between investment climates and competitiveness. It has found a positive correlation between removing regulatory impediments, red tape and other challenges facing businesses, on the one hand, and improvements in quantitative measures of competitiveness (institutional or policy related), on the other. Economies that rank high in competitiveness indicators tend to have simpler governance structures for doing business, thereby creating enabling domestic conditions for sustainable private sector investment.

B. CROSS-BORDER CAPITAL FLOWS AND FINANCIAL STABILITY

5. By the end of 2015, global foreign direct investment (FDI) flows rose by 38 percentage points to reach \$1.7 trillion. The rise was largely attributed to a surge in merger and acquisition operations (equity investments) that amounted to \$721 billion. Discounting these corporate reconfigurations, a moderate increase in FDI flows of 15 per cent was registered. In 2015, developed countries FDI inflows almost doubled to \$984 billion, whereas inflows to developing countries reached \$752 billion.²
6. The pace of financing for development inflows to developing countries appears to be slowing, and has not translated into an equal expansion of productive capacity across countries, including the Arab region.

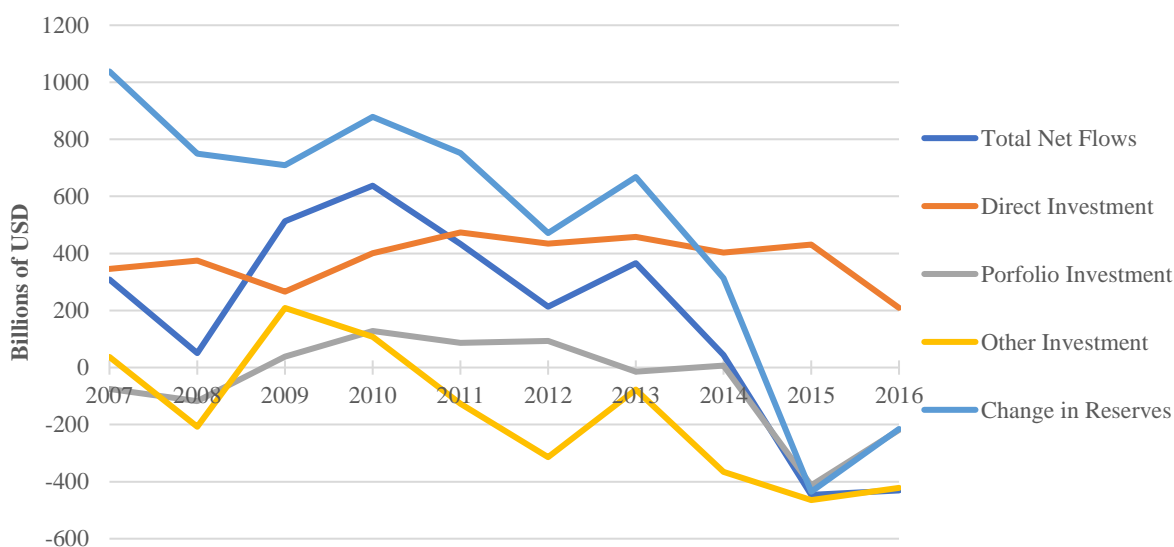
¹ The new global financing for development framework includes the following seven priority action areas: domestic public resources; domestic and international private business and finance; international development cooperation; international trade as an engine for development; debt and debt sustainability; addressing systemic issues; and science, technology, innovation and capacity-building.

² <http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=1782> .

A key reason for this is the risks associated with the continued decline in commodity prices, especially crude oil, metals and minerals. Foreign direct investment patterns to developing countries are yet to be aligned with aspirations of realizing structural transformation, social inclusion, environmental sustainability, and achieving the SDGs.

7. Total net capital transfers turned negative as developing countries recorded net financial outflows of \$543 billion in 2015 and \$456 billion in 2016³ (figure 1 shows changes in capital flows associated with direct and indirect investment, capital servicing, income and current transfers, and the net change in official international reserves). These reversals in capital flows have not been witnessed since 1990. Moreover, such figures do not factor flows of unrecorded (mostly illicit) capital, classified as leakages of domestic resources under the Action Agenda.

Figure 1. Net financial flows to developing countries including the Arab region, 2007-2016



Source: www.un.org/development/desa/dpad/wp-content/uploads/sites/45/publication/2017wesp_full_en.pdf.

Note: Direct investment as defined by the International Monetary Fund is the category of international investment that reflects the objective of a resident entity in one economy of obtaining a lasting interest in an enterprise resident in another country.

8. International cross-border bank lending represents the largest form of cross-border capital flows. On a net basis, capital outflows from developing countries reached \$465 billion in 2015. The World Economic Situation and Prospects 2017 report indicates that “long-term lending to developing countries stagnated since the 2008 financial crisis and that the declining share of long-term claims shows that the growth of bank credit has been fuelled by short-term loans”.⁴ The decline and volatility of total flows to developing countries, predominantly driven by shifts to short-term lending and the stagnation of long-term credit, hold severe implications for the 2030 Agenda at the global and regional levels.

C. FINANCIAL INCLUSION

9. On average, 95 per cent of private enterprises across the world are small and medium enterprises, accounting for over 60 per cent of employment and contributing between 16 per cent of GDP in low-income countries to 51 per cent of GDP in high-income countries.⁵ Access to credit and financial services remains a

³ www.un.org/development/desa/dpad/wp-content/uploads/sites/45/publication/2017wesp_full_en.pdf.

⁴ Ibid.

⁵ http://www.edinburgh-group.org/media/2776/edinburgh_group_research_-_growing_the_global_economy_through_smes.pdf.

constraint for small and medium enterprises and micro-enterprises. By 2010, the total unmet need for credit by all formal small and medium enterprises in developing countries was estimated at \$700- \$850 billion, and at \$2.1-\$2.5 trillion for micro-enterprises.⁶ In 2016, the Inter-Agency Task Force on financing for development stated that by 2016, the unmet need for credit for small and medium enterprises amounted to \$2.6 trillion in developing countries, and to \$110-\$140 billion in the Arab region.⁷

10. Access to credit and financing is a major constraint to private sector development, and is linked to weak financial inclusion. The international community has renewed its commitment to strengthening financial inclusion under the Action Agenda, an objective that resonates with SDG targets 1.4; 2.3 and 5.a that mandate equal access to financial services for all, particularly women. Moreover, SDG target 8.10 calls for enhancing the capacity of domestic financial institutions to improve access to banking, insurance and financial services for all.

D. REMITTANCES AND PRIVATE INVESTMENT SUSTAINABILITY REQUIREMENTS

11. The Action Agenda underscored the importance of facilitating the flow of international remittances. The amount of money migrants transfer each year has been steadily rising over the last decade. International remittances totalled \$553.5 billion in 2015. Traditionally, remittances were considered as a more stable means of financing than cross-border private capital flows; however, they too have been affected by the weakened global economy. The global average cost of remittances amounted to 7.3 per cent by the end of 2015,⁸ remaining far above the target set in SDG 10.c (By 2030, reduce to less than 3 per cent the transaction costs of migrant remittances and eliminate remittance corridors with costs higher than 5 per cent). Cutting remittance costs by 5 percentage points worldwide, as prescribed by the Action Agenda, can provide \$16 billion a year in additional development finance, equivalent to 12 per cent of official development assistance in 2015.⁹

II. REGIONAL TRENDS IN DOMESTIC AND INTERNATIONAL PRIVATE BUSINESS AND FINANCE

A. INVESTMENT CLIMATE IN THE ARAB REGION

12. The Global Competitiveness Index sets out the policies, institutions and other factors needed to set sustainable paths to socioeconomic development. Although country rankings do not necessarily account for regional/country specific idiosyncrasies, the Index remains useful for tracking progress in creating a conducive and supportive environment for sustainable development. The 2016 Global Competitiveness Index showed that the Arab region continued to exhibit several shortcomings, particularly in four domains: labour market efficiency, business sophistication, innovation and higher education, and vocational training.

13. Gulf Cooperation Council countries scored higher than North African countries in almost all areas, except for market size. However, the performance of Mashreq countries was hampered by a weak macroeconomic environment, investment climate, and infrastructure. As shown in figure 2, improvements associated with doing business in the Arab region are correlated to raising competitiveness.

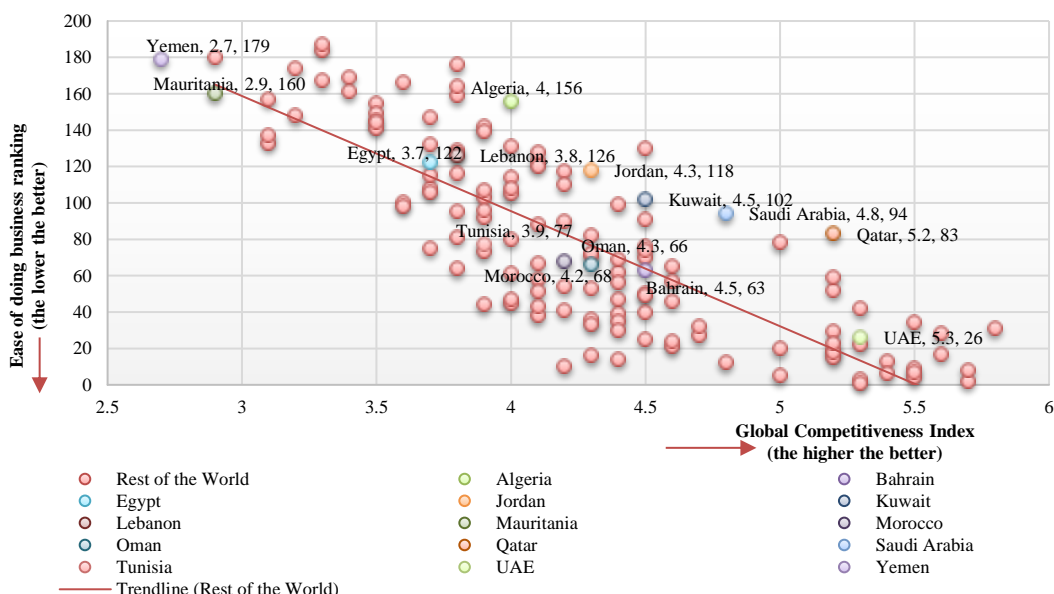
⁶ http://mckinseysociety.com/downloads/reports/Economic-Development/Two_trillion_and_counting.pdf.

⁷ <http://mckinseysociety.com/two-trillion-and-counting/>.

⁸ The average global cost of remittances averaged 7.4 per cent by the end of 2016, and 7.32 per cent by the end of the second quarter of 2017.

⁹ <http://remittanceprices.worldbank.org/en>.

Figure 2. Arab competitiveness index vs.ease of doing business



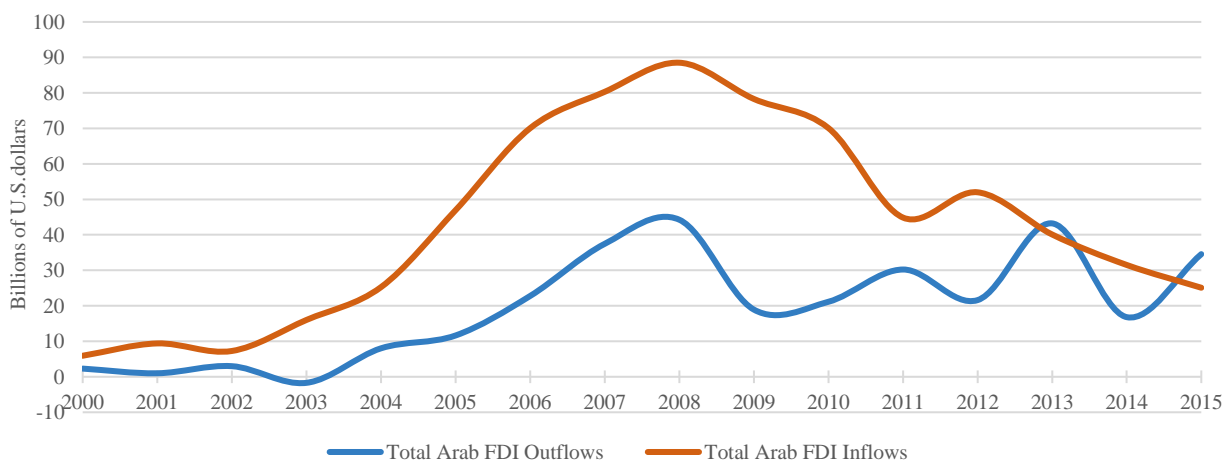
Source: Compiled by ESCWA, based on data from the World Bank and the World Economic Forum.

B. CROSS-BORDER CAPITAL FLOWS IN THE ARAB REGION

14. The Action Agenda recognizes foreign direct investment (FDI) as a driver of productivity, inclusive economic growth and job creation. In this context, the new global financing for development framework underscores the importance of managing volatilities associated with the movement of FDI across borders, and the need to foster long-term quality investment flows. Nonetheless, inward FDI flows in the Arab region remain considerably volatile, and do not reveal an expansion in productive capacities.

15. Foreign direct investment patterns are yet to be aligned to realize SDG aspirations. By 2015, the region received \$25.08 billion in FDI inflows, down from an all-time high of \$88 billion in 2008. The 2015 drop in FDI inflows occurred while Arab countries were maintaining around 750 bilateral and international investment agreements. Between 2005 and 2015, oil rich Arab economies were responsible for nearly 65 per cent of total FDI flows into the Arab region. However, the region witnessed \$34.5 billion in outflows by the end of 2015, with a net FDI outflow effect of \$9.4 billion - the seventh annual decline since 2008 (figure 3).¹⁰

Figure 3. Foreign direct investment in the Arab region

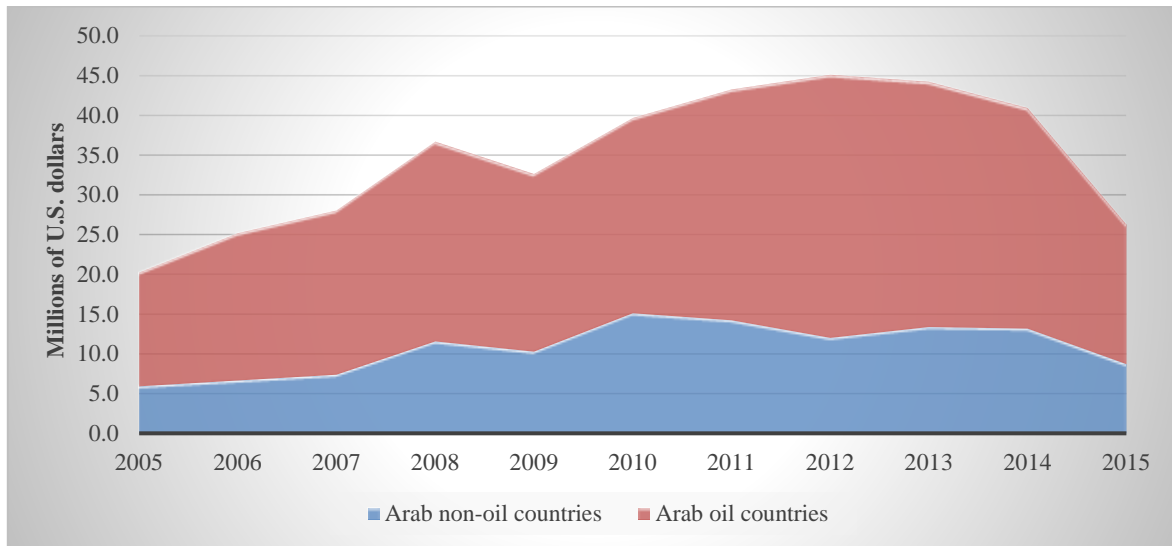


Source: ESCWA calculations, based on UNCTAD data.

¹⁰ <http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=1555>.

16. When these figures take into account the magnitude of repatriated profits on FDI (derived by foreign investors using primary income on direct investments), the situation challenges the contemporary view that FDI in the case of the Arab region constitutes a sustainable financing channel. According to statistics from the International Monetary Fund, profits repatriated on FDI or reinvested in places other than in the Arab region averaged \$39.9 billion between 2011 and 2015 (figure 4).¹¹ Oil-rich Arab economies accounted for 69 per cent of the total profits repatriated by foreign nationals outside the region between 2005 and 2015. In 2015, repatriated profits on FDI amounted to \$26 billion or 104 per cent of the value of FDI inflows, representing returns on investment, interest and income on equity, and fund shares.

Figure 4. FDI profit outflows from the Arab region



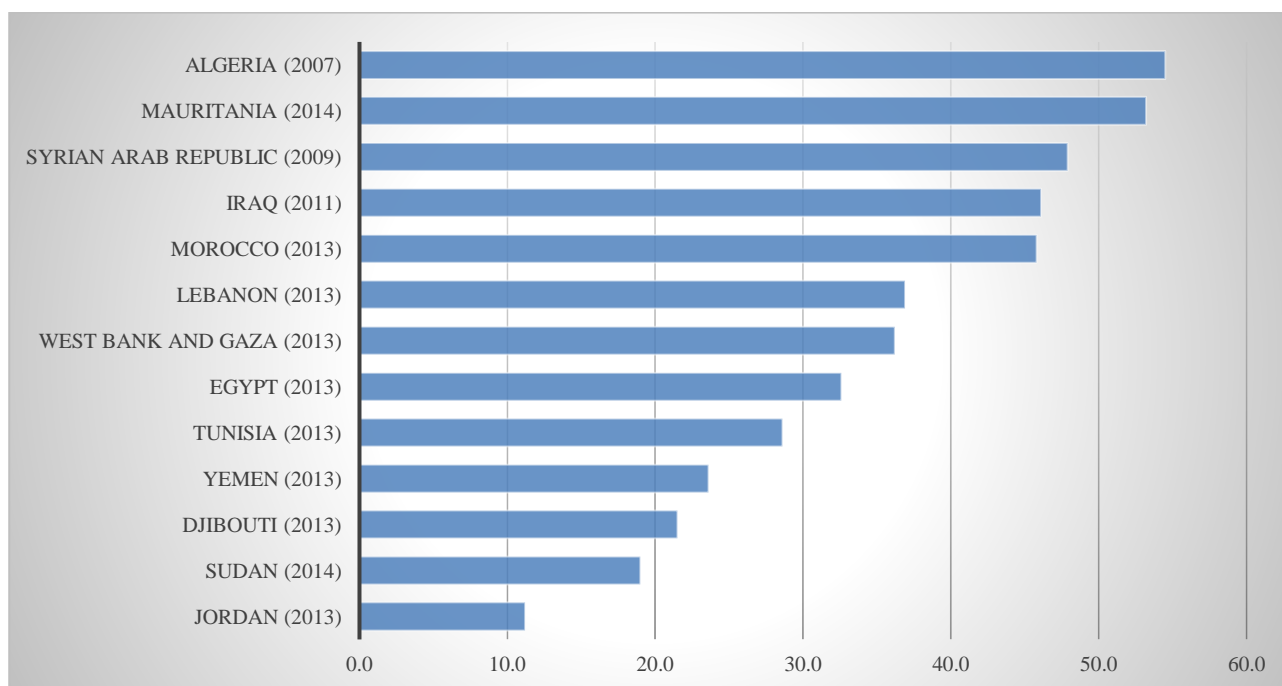
Source: Compiled by ESCWA, based on International Monetary Fund data.

17. Between 2011 and 2015, total net cross-border capital flows from the Arab region turned negative. During this period, the region witnessed inflows of foreign direct investment, portfolio investments, and other official flows amounting to \$213.2 billion. However, the region also witnessed outflows on foreign direct investment and repatriated profits amounting to \$346 billion. Arab intraregional investments remain meagre when compared with total investments of Arab sovereign funds outside the region estimated at \$2,450 billion (representing 40 per cent of total global wealth held in sovereign wealth funds).

C. FINANCIAL INCLUSION IN THE ARAB REGION

18. Small and medium enterprises (SMEs) and micro-enterprises in the Arab region represent a comparable share of private sector contributions to GDP to those witnessed at the global level, and may even be higher due to the size of informal enterprises. The employment potentials offered by such enterprises are therefore likely to be undercounted in official records due to informality. According to the World Bank, most small and medium enterprises (between 86-97 per cent) in the Arab region are micro-enterprises, whose promotion is positively correlated with development. However, the magnitude of the correlation remains subdued by the significant share of micro-enterprise activity discounted due to informality (figure 5).

¹¹ Data from <http://data.imf.org/regular.aspx?key=60979251>. Data is missing for the following countries: Qatar, Mauritania, Somalia and the United Arab Emirates. The following countries have missing data for some years: Algeria (2004), Bahrain (2015), the Comoros (2013-15), Kuwait (2004-2008), Libya (2014-2015), Syria (2011-2015), Palestine (2007), and Yemen (2004).

Figure 5. Arab firms competing against informal enterprises, (%)

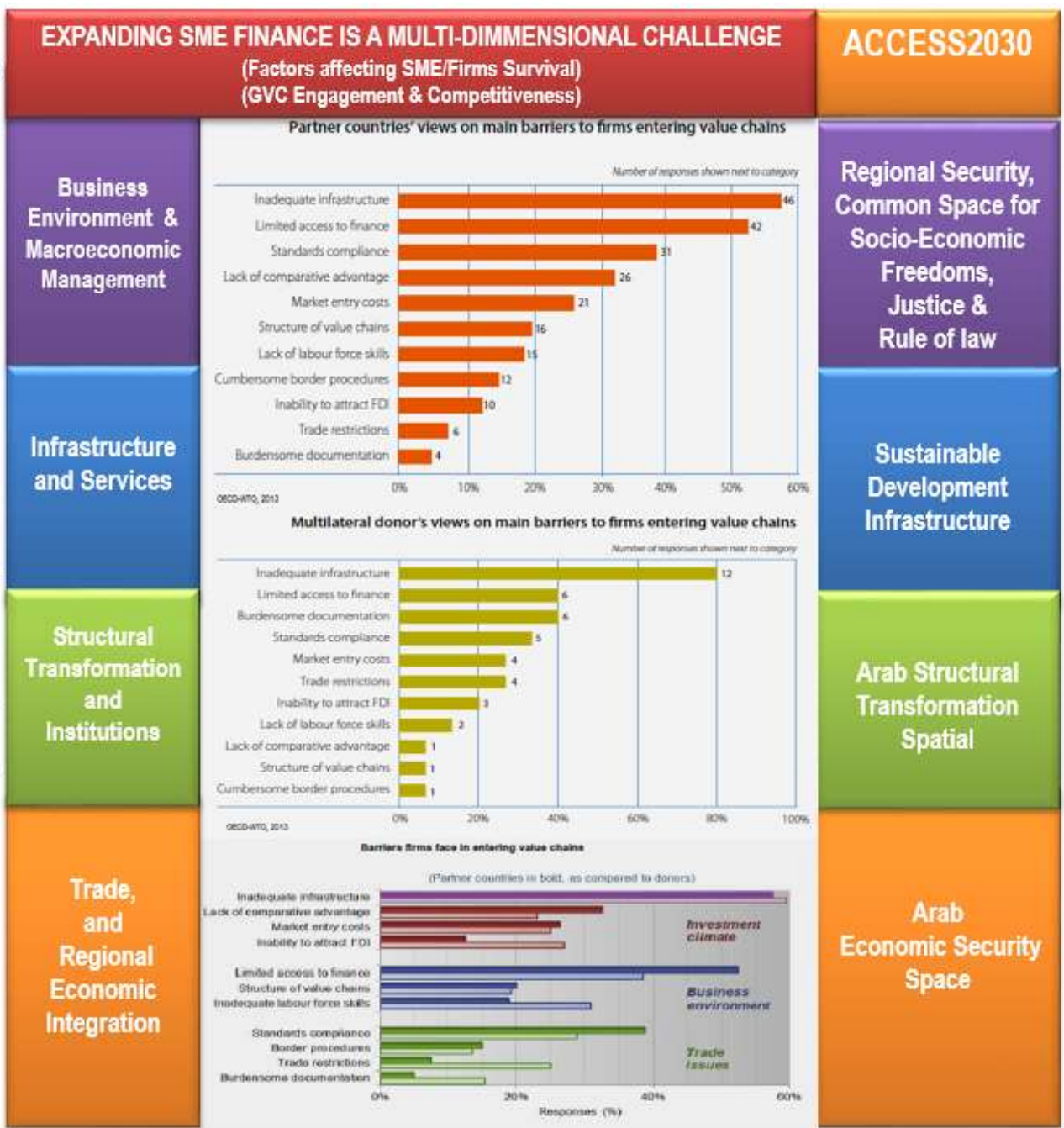
Source: Enterprise Surveys, World Bank.

19. Many policy interventions have been proposed over the years to migrate SME activities to the formal economy, including streamlining procedures, simplifying tax codes and regulations, and providing tax incentive. Another dimension worth recognizing is that, small and medium enterprises engaging in foreign trade activities are more productive than non-trading firms. However, border barriers and other non-tariff barriers constrain their engagement in international trade, and their ability to connect to global value chains to draw on the technological prowess of international firms.

20. The poor coverage and scope of credit information available to banks and insufficient collateral are often cited as reasons why banks remain reluctant to lend to small and medium enterprises. As a result, access to credit remains an obstacle to the expansion of the private sector. However, access to finance is not the only underlying issue constraining SME activities; rather it is a blend of three constraints (investment climate, business environment, and trade barriers) that can be addressed through concerted national and regional action, as elaborated in the Arab Common Citizens Economic Security Space (ACCESS) framework,¹² including the four types of interventions proposed to foster Arab SME operations (figure 6).

¹² www.unescwa.org/sites/www.unescwa.org/files/publications/files/arab-development-outlook-vision-2030-english.pdf.

Figure 6. Arab Vision 2030 and multidimensional challenges of small and medium enterprises



Source: Compiled by ESCWA, based on data from the World Trade Organization and the Organization for Economic Cooperation and Development.

21. The capital structure of small and medium enterprises in the Arab region is less geared towards debt financing, although greater use of debt to finance SME activities has been found to significantly increase employment. Many countries across the region have increased their support to small and medium enterprises, including the recent directives issued by the Egyptian Central Bank mandating domestic banks to allocate 20 per cent of their loan portfolio baskets to support small and medium enterprises. On the regional front, the 2009 Arab Economic and Social Summit announced the establishment of a \$2 billion special fund to finance SME activities across the Arab region.

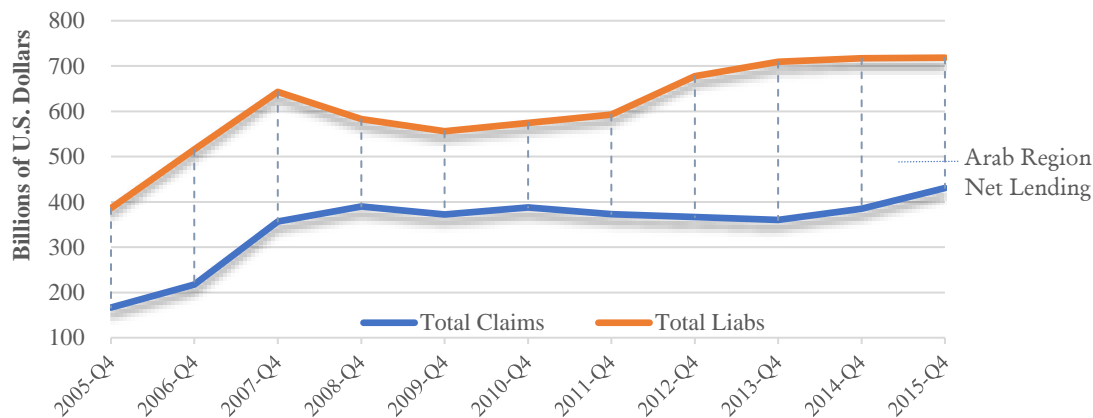
22. ESCWA estimates suggest that a 1 per cent addition in credit can increase the number of jobs by 1.01 per cent. Accordingly, to create 60-75 million new jobs by 2030 (to achieve full employment) or to ensure social and political stability, the region would require \$290-\$362.5 billion (in 2011 constant prices) in additional credit to finance SME activities. These figures match the International Finance Corporation's estimates, which suggest that outstanding SME credit is in the range of \$300-\$360 billion.¹³

23. Inclusive finance strives to enhance access to financial services for both individuals and micro, small and medium enterprises. In developing countries, access to financial services is crucial to strengthening financial sectors and domestic resource mobilization, and can therefore make a significant contribution to social and economic development. In the Arab region, nearly 70 per cent of adults on average do not have a bank account. This figure goes up to more than 85 per cent in the developing countries of the region, constituting the largest area of exclusion from formal financial services in the world. Similarly, access to formal credit is less than half the global average.¹⁴

24. According to a joint survey prepared by the International Monetary Fund, in partnership with the Arab Monetary Fund, roughly 39 per cent of the 216 surveyed Arab banks experienced a significant decline in the scale and breadth of their correspondent-banking relationships (CBRs) between 2012 and 2015. In addition, the number of account closures is increasing, with 63 per cent of Arab banks reporting the closure of CBR accounts in 2015, compared with 33 per cent in 2012. The termination of banking relations with correspondent banks in the region is attributed to risk aversion, changes to legal and regulatory requirements (money laundering), and lack of profitability of some services provided by corresponding banks in the Arab region.

25. The Arab region in total, owing to the strong external financial wealth of the Gulf Cooperation Council, has remained a net lender to international banks and non-financial institutions, although its margin narrowed in 2015 (figure 7).¹⁵

Figure 7. Arab claims and liabilities



Source: <http://www.bis.org/statistics/bankstats.htm>.

¹³ International Finance Corporation (2013). <http://data.worldbank.org/data-catalog/b4d6-42j9>. Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises <https://www.ifc.org/wps/wcm/connect/4d6e6400416896c09494b79e78015671/Closing+the+Credit+Gap+Report-FinalLatest.pdf?MOD=AJPERES>.

¹⁴ <http://pubdocs.worldbank.org/en/948081461702869195/N6-ME.pdf>.

¹⁵ Total liabilities to residents in the Arab region are the liabilities reported by the banks in the reporting countries for locational banking statistics (LBS). Total claims of residents in the Arab region are the claims reported by banks in the LBS reporting countries. These liabilities and claims mostly represent deposits and loans from residents in Arab countries. Hence, bank claims are money borrowed by the Arab region, and liabilities are the money lent. The data represent the total liabilities and claims for the fourth quarter of every year for data reported only by banks for all instruments. See http://stats.bis.org/bis-stats-tool/org_bis_stats.ui.StatsApplication/StatsApplication.html.

26. The total liabilities owed by international financial and non-financial institutions to Arab clients remains greater than the total claims of those institutions to Arab nationals. The differences between claims and liabilities reached their peak in 2013, registering nearly \$350 billion. Over the period 2000-2015, total liabilities of reporting banks to Arab clients exceeded their claims. By the end of 2015, the net liabilities of foreign banks and non-financial institutions amounted to \$287.8 billion, representing an opportunity cost of investing these assets in the region.

D. REMITTANCES AND ALIGNING PRIVATE INVESTMENTS WITH SUSTAINABILITY REQUIREMENTS

27. The Action Agenda recognizes the positive contributions of migrant remittances to financing inclusive growth and sustainable development. Commitment to mobilizing remittances as an international private source of financing development is also captured in SDG 17. With a total migrant population estimated at more than 24 million,¹⁶ remittance inflows into the Arab region has gained increasing importance over the past decade. Arab migrant remittances have increased 4.3 times, from \$11.47 billion in 2000 to \$49.11 billion in 2015, representing 9 per cent of total remittances sent to developing countries.

28. The share of intraregional Arab remittances has steadily increased since the onset of political change in the region in 2011, reaching \$29 billion by 2015; whereas remittance inflows into the region have stagnated, hovering at an average of \$22.2 billion per year between 2011 and 2015. In absolute terms, since 2013, remittance inflows to the region have been greater than the net inflows of foreign direct investment and official development assistance from outside the region.

29. Over the last two years, ESCWA has conducted several internal studies to provide a conceptual foundation for understanding how remittances impact financing for development. The studies examined the relationship between remittances and development, and the role of different stakeholders in enhancing the inflows of remittances towards national development. The following three major findings were made with respect to the utilization of remittances for economic development: with the exception of a few countries, there is predominant absence of national strategies and policies to channel remittances to development; overall, there is relatively weak financial and institutional infrastructure to support remittances, which is aggravated by weak penetration of the banking system to remote areas; and there is a lack of sufficient and consistent data/information on remittances to provide tailored policy recommendations to harness remittances for development, especially regarding remitters' characteristics, channels used to transfer money, and the use of the transferred money by recipients (consumption versus investment).

¹⁶ According to the International Labour Organization, there are 232 million migrants globally, 150 million of which are migrant workers (including 11.5 million migrant domestic workers). The Arab region accounts for 11.7 per cent of all migrant workers, and hosts 50.8 per cent of all male migrant domestic workers in the world. See http://www.ilo.org/global/topics/labour-migration/publications/WCMS_436343/lang-en/index.htm.