Executive Summary

Two main issues, which arose in the past year, encouraged us to supplement our standard methodology used to estimate illicit flows based on the World Bank Residual method adjusted for trade misinvoicing.

First, we investigated the net measurement of inward from outward capital flight traditionally used by economists in academic journals. We reaffirm our commitment to a gross outflow approach, rather than a net approach, because only a return of licit capital that is recorded can offset loss of capital. The return of unrecorded and illicit capital cannot be used for productive purposes. In other words, the gross/net issue is linked to the nature of the capital.

Second, we explored the effect of the global financial crisis on both illicit and licit flows, determining that the residual method of estimating illicit flows adjusted for trade misinvoicing may include some licit capital as well as illicit. Moreover, if the CED+GER method includes licit capital, the support for a gross outflows approach is strengthened, as one cannot be sure whether the inward capital flight is licit or illicit in nature. Therefore, we present estimates of illicit flows using both the CED+GER method and the conservatively focused Hot Money Narrow method adjusted for trade misinvoicing (HMN+GER).

A firm judgment as to which method provides a more accurate method for estimating illicit flows is somewhat premature at this stage. *While the HMN+GER method provides more conservative estimates of illicit outflows, it may exclude certain illicit transactions such as round-tripped FDI which could be erroneously recorded as private sector flows.* We invite readers to comment on the appropriateness of the two methodologies for estimating illicit flows including reasons why one should be preferred over the other.

Using robust (non-normalized) estimates for both measures, we found that in 2010 developing countries lost between US$858.8 billion to US$1,138 billion, implying that as much as US$279 billion of the higher figure could be licit capital flows of the private sector—outflows that took place as a result of “normal” portfolio maximizing considerations. While the two estimates were quite close in the early 2000s, capital market liberalization in many large emerging markets may have encouraged more licit or “normal” capital flight over the years. The gap between the HMN+GER and CED+GER estimates widened, reaching a peak in 2008 at the onset of the global economic crisis. In the following year, outflows of legal capital flight dropped more sharply than illicit outflows. The latter showed a steady upward trend for all developing countries more or less immune to macroeconomic shocks and adjustments.

We then further analyzed the gap between the two non-normalized (or robust) estimates in order to shed light on possible legal capital flight from the various regions of the developing world during the 10-year period studied. We observed that in the case of developing Europe, the MENA region, and Western Hemisphere, the gap tends to widen over time, reaching a peak in 2008 although it has closed in the following two years. The widening gap is perhaps the result of more normal capital flight due to a relaxation of capital controls. In all three regions, licit outflows plunged in 2009 due to the effects of the crisis on domestic and foreign capital markets noted above. In the case of Asia, the gap, which was almost nonexistent in the early 2000s, began to widen in 2005 and reached a peak in 2008 at the onset of the crisis. But the gap closed almost completely in 2009 as both licit and illicit outflows from Asia fell in tandem.

A finding that is worrisome is that the HMN+GER measure of illicit flows increased at a faster pace than the CED+GER measure (13.3 percent vs. 12.6 percent). The adverse implication is that increasing illicit flows are likely to result from a worsening of governance-related drivers given the scant evidence of a systematic increase in measurement errors.

In order to avoid overlap and to focus more sharply on flows that are likely to be purely illicit, we analyze trends, shares, and country rankings based on the HMN+GER method. According to this measure, illicit flows from developing countries in the robust calculation increased by over US$500 billion since 2001 implying a real growth rate of 8.6 percent per annum on average, which exceeded their average rate of economic growth (6.3 percent per annum). We established that about 80 percent of illicit outflows were channeled through the deliberate misinvoicing of trade, although the shares of outflows from trade misinvoicing and the balance of payments have fluctuated.

We found that Asia, accounting for 61.2 percent of cumulative outflows, was still the main driver of such flows from developing countries. Indeed, five of the ten countries with the largest illicit outflows (China, Malaysia, the Philippines, India, and Indonesia) are in Asia. The Western Hemisphere, led by Mexico, follows at 15.6 percent, with the Middle East and North Africa (MENA) at 9.9 percent. Developing Europe follows MENA in share size, making up 7.0 percent of illicit flows, with the balance flowing out of Africa (6.3 percent).

MENA had the highest growth rate of illicit capital in real terms (26.3 percent per annum on average), followed by Africa (23.8 percent), Asia (7.8 percent), Europe (3.6 percent), and Western Hemisphere (2.7 percent). The rapid growth of outflows from the MENA region was due mainly to the increase in crude oil prices, which drove the region's current account surplus. It seems that rising oil prices provide more incentive for unrecorded flows. The finding is consistent with Almounsor (2005) who also found a significant positive link between illicit outflows and crude oil prices.

Trade misinvoicing continued to be the preferred method of transferring illicit capital from all regions except the MENA region where it only accounted for 37 percent of total outflows over the

decade ending 2010. At one extreme, Asia preferred trade misinvoicing over balance of payments leakages by 94 percent to 6 percent. Trade misinvoicing was also the dominant channel of illicit outflows from the Western Hemisphere (84 percent), Africa (65 percent), and developing Europe (53 percent).

According to the HMN+GER method, the ten countries with the largest outflows of illicit capital (in declining order of magnitude) were China, Mexico, Malaysia, Saudi Arabia, the Russian Federation, the Philippines, Nigeria, India, Indonesia, and the United Arab Emirates. Total outflows from China over the decade ending 2010 (US$2,742 billion) exceeded total cumulative outflows from all other nine countries on the list (US$1,728 billion). The new rankings imply that illicit flows impact more people more adversely than what the previous IFF reports indicated. This is because the CED+GER rankings included Kuwait, Venezuela, Qatar, and Poland among the top ten countries with the largest outflows. However, these countries have relatively much higher income and fewer people living on less than US$2 a day, compared to the Philippines, Nigeria, India, and Indonesia which are ranked among the top ten countries under the HMN+GER methodology. *Hence, the revised rankings do a much better job of reflecting the adverse impact of illicit flows on poverty compared to the CED+GER method.*

Finally, we explored the significant statistical issues related to the recording of sovereign wealth funds (SWFs) in the balance of payments and how incomplete or incorrect recording of SWF-related transactions can lead to errors in estimating illicit flows (due to errors in recording balance of payments variables). If, for instance, there is a drawdown of reserve assets to invest in SWFs and the drawdown is fully recorded, while an SWF-related drawdown to pay off external debt is not recorded then the increased use of funds is not offset by a decline in external debt which would be reflected in an increase in unrecorded capital outflow. Had the subsequent debt repayment been correctly recorded, there would have been no change in unrecorded outflows. Errors could also be introduced in the appropriate recording of reserves due to SWF-related deposits. We conclude that the criteria as to whether specific SWF funds are to be considered part of reserve assets should not be based on mechanical rules but should be based on judgments regarding encumbrance, control, and ease of availability.

We looked at the net errors and omissions (NEO) in the balance of payments for a group of ten countries with the largest SWFs. While NEOs are driven by many factors, the purpose was to see whether there is a simple casual link between SWFs and NEOs given the statistical capacity of the SWF country. Normally we would expect countries with strong statistical systems to do a better job of capturing SWF transactions. In general, we found that there is little correlation between the balance of payments of certain countries with large SWFs and the relative strength or weakness of their statistical systems. This led us to believe that SWF transactions do not seem to adversely impact the NEO, although there are a few notable exceptions. The finding that the NEO in the balance of payments data reported by United Arab Emirates, Saudi Arabia, and Qatar to the IMF

are relatively high imply that estimates of illicit flows from these countries must be interpreted with caution due to the risk of significant measurement errors.