

Executive Summary

According to the latest estimates presented in this report, developing countries lost between US\$775 billion and US\$903 billion in 2009, down from US\$1.26 to US\$1.44 trillion in 2008 that was reported in the 2010 GFI report *Illicit Financial Flows from Developing Countries: 2000-2009*. The main reason for the sharp falloff in nominal non-normalized illicit flows in 2009 is due to a decline in source of funds (new external loans, foreign direct investments) relative to use of funds and also a shrinking of trade volumes as a result of the global economic crisis. According to the latest IMF's World Economic Outlook (on-line database), over 2008-2009, the current account surplus of developing countries declined from US\$679.8 billion to US\$287.8 billion, new external loans fell from US\$282.7 billion to US\$263.1 billion, while investor caution led to a squeeze on inflows of foreign direct investment from US\$467 billion to US\$310.6 billion. While unrecorded transfers of capital through the balance of payments fell sharply due to the significant decline in source of funds relative to use of funds, trade mispricing fell significantly due to the largest falloff in export and import volumes since the September 2001 attacks.

Conservatively estimated, illicit flows increased in current dollar terms by 14.9 percent per annum from US\$353 billion at the start of the decade to US\$775 billion in 2009. Adjusting for inflation, illicit flows increased at least by 10.2 percent over the decade with outflows from Africa growing the fastest (22.3 percent), followed by MENA (19.6 percent), developing Europe (17.4 percent), Asia (6.2 percent), and Western Hemisphere (4.4 percent).

Asia accounted for 44.9 percent of total illicit flows from the developing world followed by MENA (18.6 percent), developing Europe (16.7 percent), the Western Hemisphere (15.3 percent), and Africa (4.5 percent). Many of the top ten countries with the largest transfers of illicit capital are located in the MENA region, while Asia's dominant share is mainly driven by China and Malaysia.

The largest ten countries' cumulative (normalized or conservative) illicit outflows during 2000-2009 in declining order of magnitude are China (\$2.5 trillion), Mexico (\$453 billion), Russia (\$427 billion), Saudi Arabia (\$366 billion), Malaysia (\$338 billion), Kuwait (\$269 billion), United Arab Emirates (\$262 billion), Qatar (\$170 billion over nine years as data for 2000 are not available), Venezuela (\$171 billion), and Poland (\$160 billion). On average, these ten countries account for 70 percent of the illicit outflows from all developing countries over the period 2000-2009.

There are significant variations in how individual country shares of illicit financial flows move over time. For instance, China continues to be the largest exporter of illicit capital by far. However, China's role diminished considerably with its share of all-developing-world outflows falling from 48 percent in 2000 to 26 percent in 2008 before rising to 38 percent in 2009 as outflows from other countries declined even more due to the global economic crisis. If current trends continue, Russia, Saudi Arabia, the United Arab Emirates, and Kuwait, all oil exporters, will become more important as sources of illicit capital. (See Table C).

The methodology for estimating illicit financial flows used in this study is based on i) the World Bank Residual model (using the change in external debt or CED), and ii) trade mispricing (using the Gross Excluding Reversals method or GER). Unrecorded capital leakages through the balance of payments (CED component) capture illicit transfers of the proceeds of bribery, theft, kickbacks, and tax evasion. The GER method captures the outflow of unrecorded transfers due to trade mispricing. (See Note on Methodology in the Appendix).

Apart from differences in the extent to which major exporters of illicit capital drive such flows from developing countries, the methods for the transfer of these funds also vary. For instance, while trade mispricing is the major channel for the transfer of illicit capital from China, the balance of payments (captured by the CED) is the primary conduit for the unrecorded transfer of capital from oil exporters such as Kuwait, Nigeria, Qatar, Russia, Saudi Arabia, the United Arab Emirates, and Venezuela. Mexico is the only oil exporter where trade mispricing is the preferred method of transferring illicit capital abroad while Malaysia is the only country in this group where both channels, CED and GER, are used in roughly comparable portions to transfer such capital.

Trade mispricing accounts for an average of 53.9 percent of cumulative illicit flows from developing countries over the period 2000-2009 (Table A). The GER share has generally been falling since 2004 when it was 59.0 percent. Over the decade ending 2009, unrecorded leakages through the balance of payments (CED component) have been increasing relative to trade mispricing—on average they accounted for 46.1 percent of cumulative transfers of illicit capital.

There are four variables required for the estimation of illicit flows using the Residual model: change in external debt, net foreign direct investment, current account balance, and change in reserves. In addition, four variables (exports and imports of various countries and the world) are required to estimate export under-invoicing and import over-invoicing. As these variables can be correlated, principal components analysis (PCA), a statistical technique, was applied to shed light on the dominant components that can “explain” the underlying structure of data among multiple variables. The advantage of applying PCA to the problem of explaining the variation in illicit flows from various regions is that the exercise yields just one or two components that account for the majority of the observed variation in the “target” variable (in this case, illicit flows). We found that the cumulative variance explained by the first two principal components varies between regions—it ranges from a high of 85.5 percent in the case of Asia to a low of 54.9 percent in the case of the MENA region. This means that accounting for variations in IFFs from Asia may be less complicated than explaining such variations in outflows from the MENA region. Judgments on principal components that explain the majority of the variations in IFFs are based on a combination of the size of weights assigned to the variables in question *within the most promising principal component* and the size of the fixed regression coefficient. This interpretation seems to do a reasonable job of explaining the falloff of IFFs from developing countries and regions in 2009 as a result of the global economic crisis.