

# Executive Summary

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This annual update on illicit financial flows from developing countries incorporates a number of methodological enhancements and analyzes possible drivers of trade misinvoicing, by far the largest component of illicit flows. While there are no changes to the basic model used (e.g., coverage of countries, focus on gross outflows only) since the first update was published in January 2011, the current version adjusts previous estimates of trade misinvoicing by explicitly recognizing the role of Hong Kong as a trade entrepôt. Furthermore, we now estimate trade misinvoicing for major developing countries that report bilateral trade data based on their trade with each advanced country (i.e., on a country-by-country basis). The previous method involved estimating misinvoicing by comparing each developing country's trade with the world in the aggregate. While the "Hong Kong effect" reduces our estimate of overall trade misinvoicing, the country-by-country approach increases the total amount of outflows identified; on net, these effects combine to produce a much more accurate and representative depiction of the global problem that illicit flows pose to the developing world.

**Nominal illicit outflows from developing countries amounted to US\$946.7 billion in 2011, up 13.7 percent from US\$832.4 in 2010.** Controlled for inflation, illicit outflows from developing countries increased in real terms by about 10.2 percent per annum.

We find that the pattern of illicit outflows, trend rate of growth, and impact in terms of GDP all vary significantly among the five regions. **Asia accounts for 39.6 percent of total illicit outflows from developing countries compared to 61.2 percent of such outflows in the 2012 IFF Update.** Asia's much larger share of total illicit outflows in the 2012 IFF Update resulted from an overestimation of China's trade misinvoicing due to the "Hong Kong effect." Correcting for the Hong Kong effect sharply reduces the share of outflows from Asia. Nevertheless, Asia still has the largest share of illicit flows among the regions, and six of the top 15 exporters of illicit capital are Asian countries (China, Malaysia, India, Indonesia, Thailand, and the Philippines).

**Developing Europe (21.5 percent) and the Western Hemisphere (19.6 percent) contribute almost equally to total illicit outflows.** While outflows from Europe are mainly driven by Russia, those from the Western Hemisphere are driven by Mexico and Brazil.

**The Middle East and North Africa (MENA) region accounts for 11.2 percent of total outflows on average.** MENA's share increased significantly from just 3 percent of total outflows in 2002, reaching a peak of 18.5 percent in 2009, before falling to 12 percent in 2011. **In comparison, Africa's share increased from just 3.9 percent in 2002, reaching a peak of 11.1 percent just before the Great Recession set in (2007), before declining to 7 percent in 2011, roughly on par with its average of 7.7 percent over the decade.**

The volume of total outflows as a share of developing countries' GDP increased from 4.0 percent in 2002 to 4.6 percent in 2005. Since then, barring a few upticks, illicit outflows have generally been on a declining trend relative to GDP, and were 3.7 percent in 2011.

The ranking of various regions based on their respective IFFs to GDP ratios looks quite different from the ranking based on the volume of outflows. **For instance, while Africa has the smallest nominal share of regional illicit outflows (7.7 percent) over the period studied, it has the highest average illicit outflows to GDP ratio (5.7 percent), suggesting that the loss of capital has an outsized impact on the continent.** Illicit outflows at an average of 4.5 percent of regional GDP also significantly impact developing Europe. Outflows per annum from Asia amount to an average of 4.1 percent of regional GDP, and leakages of illicit capital from MENA and the Western Hemisphere equal about 3.5 percent of regional GDP. However, in the case of MENA, outflows as percent of GDP increased significantly from 1 percent in 2002 to 6.8 percent in 2009, before declining to 3.9 percent in 2011. In contrast, barring a few upticks, outflows from the Western Hemisphere as a share of regional GDP have declined steadily from 4.1 percent in 2002 to 2.6 percent in 2011.

**The MENA region registered the fastest trend rate of growth in illicit outflows over the period studied (31.5 percent per annum) followed by Africa (20.2 percent), developing Europe (13.6 percent), Asia (7.5 percent), and Latin America (3.1 percent).** The sharply faster rate of growth in illicit outflows from the MENA region is probably related to the rise in oil prices.

The 2012 IFF Update showed that certain MENA countries like Saudi Arabia, UAE, and Qatar can have large errors and omissions due to the incorrect or incomplete accounting of sovereign wealth fund transactions in the balance of payments. Therefore, including these countries along with other countries that do not have this issue may distort the ranking of exporters of illicit capital. If we exclude these countries, then cumulative outflows from the top fifteen exporters of illicit capital amount to US\$4.2 trillion over the decade ending 2011 comprising slightly over 70 percent of total outflows. The top three exporters of illicit capital were China (US\$1,076 billion), Russia (US\$881 billion), and Mexico (US\$462 billion). **Six of the top 15 exporters of illicit capital are in Asia (China, Malaysia, India, Indonesia, Thailand, and the Philippines), two are in Africa (Nigeria and South Africa), four are in Europe (Russia, Belarus, Poland, and Serbia), two are in the Western Hemisphere (Mexico and Brazil), and one is in the MENA region (Iraq).**

Trade misinvoicing comprises the major portion of illicit flows (roughly 80 percent on average). Balance of payments leakages (Hot Money Narrow measure) fluctuate considerably and have generally trended upwards from just 14.2 percent of total outflows in 2002 to 19.4 percent in 2011. However, there is little reason to believe that purely statistical errors in compiling balance of payments data have trended upwards for developing countries as a whole.

The study finally focuses on possible drivers of illicit flows using a cross section of 55 developing countries for which data are available for the ten year period 2002-2011. Regression analyses using the panel data find scant evidence that macroeconomic drivers impact trade misinvoicing. Rather, we find trade misinvoicing to be driven largely by a set of four factors—three of a regulatory nature and one governance-related. The regulatory drivers are the export proceeds surrender requirement (EPSR) and the extent of capital account openness, while the governance related driver is the state of overall governance in the country, which we represent with the World Bank Control of Corruption indicator.

Although there are some serious limitations in formulating the EPSR as a dummy variable, we find that exporters seem to view it as a confiscatory measure. Hence, they seek to circumvent it by retaining funds abroad through export under-invoicing.

The panel data regressions also show that an increase in corruption increases trade misinvoicing while capital account openness leads to greater export misinvoicing in both directions if openness is not accompanied by stronger governance. In fact, as the experience of developed countries show, greater openness and liberalization in an environment of weak regulatory oversight can actually generate more illicit flows.