POLICY BRIEF

Financial Capital in Ethiopia, Indonesia, and Trinidad and Tobago

Trends and policy implications

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Key Messages

- Except for Indonesia, financial capital contributes positively to total wealth in all countries. However, Trinidad and Tobago and Ethiopia began accumulating more liabilities than assets toward the end of the study period.
- The accumulation of financial liabilities does not pose a threat to long-term well-being so long as they are well managed to optimize future returns.
- In line with the UN Secretary-General's views, the international community needs to scale up efforts to reduce public debt burdens. This will require addressing the high cost of debt, increasing affordable long-term financing, and expanding contingency financing in emergency situations.
- For greater financial resilience, the sources of debt financing should be diversified, particularly in Trinidad and Tobago.
- Assessing financial capital should also consider the situations of domestic agents, particularly households. Interventions should include initiatives to bring households debt at a sustainable level.

For more than half a century, GDP has been accepted as the most relevant measure of a country's economic success. GDP is defined as the aggregate measure of income in an economy during a given time period. However, it is often used, inappropriately, as a proxy measurement for well-being more broadly. A recent policy brief published by the UN Secretary-General invites member states to move beyond GDP by measuring what truly matters for sustainability and prosperity (United Nations, 2023). It demonstrates just how damaging it can be to rely on GDP as a broad measure of progress. This note outlines the shortcomings of GDP as an indicator of progress. It suggests more meaningful measures that meet the UN Secretary-General's criteria for robust metrics that can move the world beyond GDP: concise, widely accepted, comparable, iterative and dynamic, country-owned, scientifically robust, statistically sound, and applicable to decision making (United Nations, 2023).

Box 1. Comprehensive/inclusive wealth measures five types of assets:

- **Produced capital** consists of roads, railways, ports, houses, machinery, and other manufactured assets.
- **Natural capital** includes market-oriented natural resources such as timber, minerals, oil, and gas. It also includes the non-market economic value of ecosystems, such as wetlands, and forests.
- **Human capital** comprises the collective knowledge, skills, and capabilities of the labour force—the result of lifelong learning in both formal and informal settings.
- **Financial capital** includes bank deposits, stocks, bonds, and other forms of financial assets.
- **Social capital** represents the norms and behaviours that structure and support productive interactions between members of society, including safety, inclusivity, and trust in institutions.

Sources: International Institute for Sustainable Development (IISD), 2018; World Bank, 2021.

While gains in GDP are, under certain conditions, linked to improved human well-being, there are well-documented negative impacts on well-being associated with GDP growth. These negative impacts can include the depletion of natural resources, increasing greenhouse gas emissions, and a growing divide between the rich and poor. In addition, GDP figures do not capture the value of important long-term investments in human well-being, such as education and health care, or the value of many measures to address climate change. There is a growing body of applied research to identify indicators intended to address the shortcomings of GDP as a measure of well-being. Such indicators are intended to better reflect our understanding of prosperity. Among the various indicators, comprehensive or inclusive wealth (C/IW) is seen as a methodologically sound measurement that complements GDP and meets the criteria of the new measures laid out by the UN Secretary-General (United Nations, 2023). C/IW is a valuable instrument for policy-makers to use to move beyond GDP and better reflect the foundations of prosperity and well-being in their decisions.

Partial findings of the project on Measuring Comprehensive Wealth to Promote Sustainable Development[1] carried out by IISD are summarized below. This project developed C/IW estimates for Ethiopia, Indonesia, and Trinidad and Tobago and identified their relevance to policy making. The findings reported here focus only on financial capital (see Box 1 for a description of all five elements of the C/IW portfolio). Additional notes in this series focus on the results relating to other elements of the C/IW portfolio.

[1] See more on the project here: https://www.iisd.org/projects/measuring-wealth-promote-sustainable-development

What Is Financial Capital?

In the context of comprehensive wealth accounting, financial capital measures a country's net foreign financial assets, i.e., the difference between the foreign financial assets owned by residents and the domestic financial assets owned by foreigners. This measure is also known as the country's international investment position (IIP), though the World Bank uses the term "net foreign assets." Foreign financial assets comprise all financial claims, shares, or other equity in corporations, plus gold bullion held by monetary authorities as a reserve asset. Foreign financial liabilities are the counterparts of assets and include all financial obligations of citizens that oblige them to provide a payment or series of payments to the rest of the world.[2]

Like other assets of the comprehensive wealth portfolio (natural capital, produced capital, human capital), financial capital can be used to support a country's long-term prosperity. When foreign financial assets exceed liabilities (that is, when the IIP is positive), financial capital increases the stock of wealth. Like a savings account, these financial resources can be used for economic, social, and environmental projects to support the well-being of current and future generations. If, on the other hand, the IIP is negative, the country has an overall liability vis-à-vis the rest of the world, and its wealth is lowered.

Trends for Financial Capital

Financial capital in this project was measured in real (inflation-adjusted) per capita terms in both local currencies and USD[3] to allow for comparison among the countries. The results show that in Trinidad and Tobago, real per capita financial capital was negative up to 2007, making the country a debtor nation during those years (Figure 1). However, from 2008, financial capital increased considerably to 26,817 Trinidad and Tobago dollars (TTD) (USD 6,442), resulting in a change in the country's position from debtor to lender. This important change is largely explained by increased holdings of foreign financial assets due to the creation of the Heritage and Stabilisation Fund in March 2007 (Ministry of Finance, n.d.). Since 2008, financial capital remained positive in all years to 2020 except in 2011, where the value dropped below zero. Financial capital peaked in 2014 at TTD 34,600 (USD 8,300) per capita.

In Ethiopia, financial capital remained positive for the entire period, except in 2019/20 (Figure 2). In 1994/95, the value of the index was ETB 412 (USD 48) and peaked at ETB 1,131 (USD 133) in 2010/11 before declining gradually to ETB -122 (USD -14) in 2019/20. The accumulation of liabilities at a rate higher than that of assets since 2010/11—to the point where the country became a net debtor in 2019/20—is largely explained by the accumulation

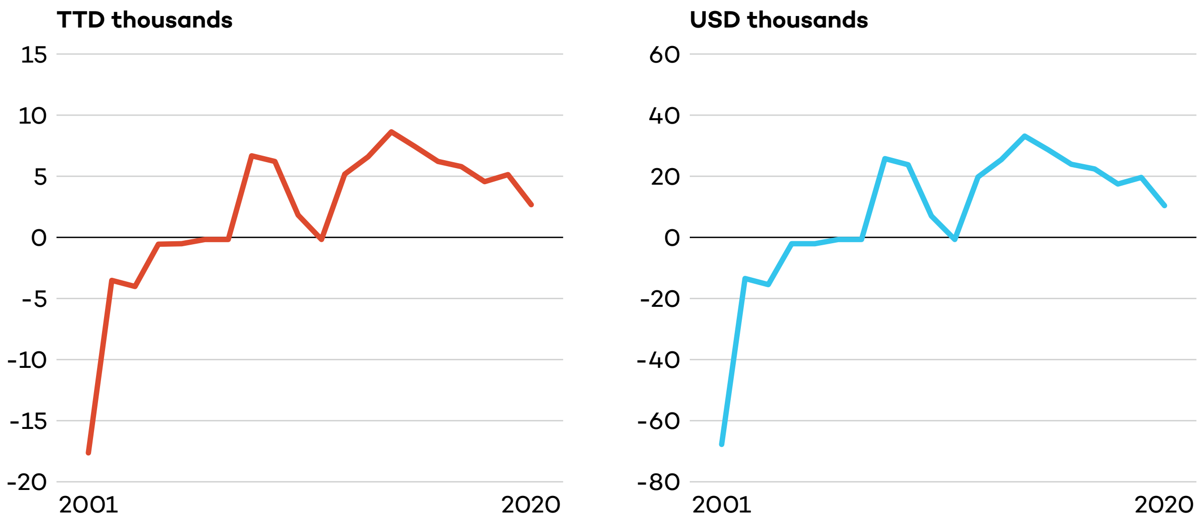
[2] At the national level, domestic financial assets and liabilities cancel one another out; that is, domestic financial assets held by citizens are exactly equal to the corresponding domestic financial liabilities held by other citizens. As a result, domestic financial assets and liabilities held within the country have no impact on the comprehensive wealth portfolio.

[3] All values in constant local currency use 2017 as the base year (and 2016/17 as the base for Ethiopia). All values in constant USD also use 2017 as the base year and the 2017 purchasing power parity (PPP) conversion rate from local currency to USD, as reported by the World Bank (2024d). The application of the 2017 PPP conversion rate to the entire time series results in identical growth trends over time, regardless of whether the results are presented in constant local currency or constant USD.

of foreign debt and foreign direct investment (FDI) flows. The World Bank data shows that in 2020 the total amount of foreign debt accumulated by Ethiopia was estimated at USD 30.36 billion (World Bank, 2024b). This amount accounted for around 28.4% of the country's gross national income (World Bank, 2024a). The expansion of FDI inflow to the country also coincides with the year 2010/11, when financial capital began to decline. According to the World Bank (2024c), the share of FDI to GDP more than doubled between 2010 and 2020, increasing from 1% to 2.2%, mainly driven by China, Saudi Arabia, and Turkey (United States Department of State, 2021).

Indonesia is the only country where financial capital remained negative for the entire period for which data were available (2001–2020). Financial capital per capita remained below IDR -9.7 million (USD -2000) up to 2008 (Figure 3). From 2008, the value rapidly declined to IDR -21 million (USD - 4,500) in 2015 before gradually increasing up to IDR -14 million IDR (USD -3,000) in 2020. Indonesia's Law No. 25 of 2007 on capital investment may have contributed to the sharp decline of financial capital since 2008 (President of the Republic of Indonesia, 2007). The law was an important milestone in the Indonesian business environment as it created important incentives for foreign investors (United States Department of State, 2021). Regulations under this law included several measures, such as equal legal status between foreign and domestic investors; protection of foreign investors against expropriation; consideration of all areas for investment except those with harmful impacts on safety, security, health, environment, and moral of the nation; strengthening of foreign investors' property rights; flexibility of entrance and exit for foreign investors, and the provision of tax incentives for industries providing contributions to the economy.

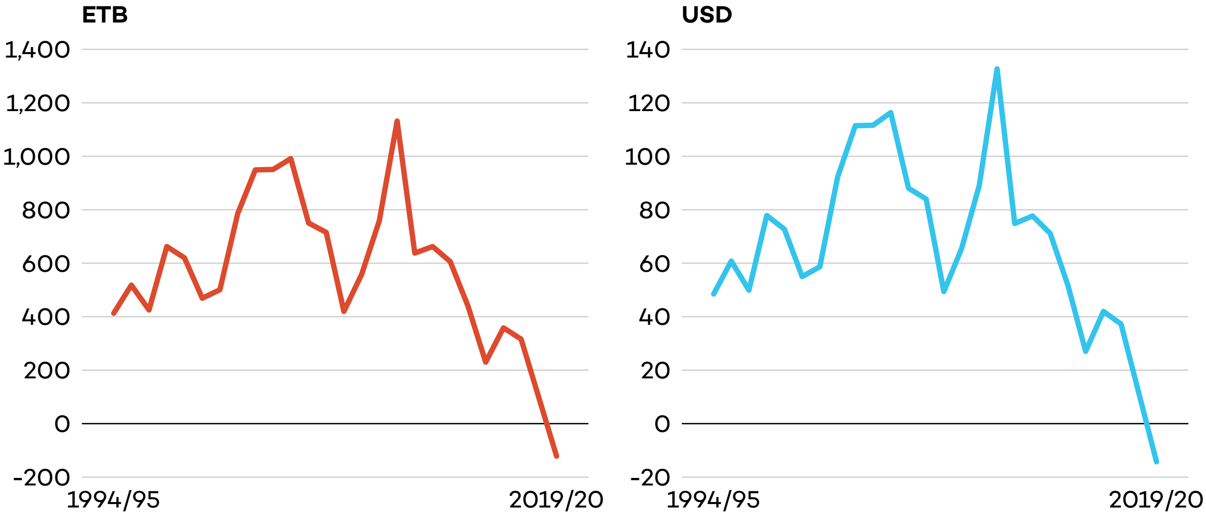
Figure 1. Trinidad and Tobago



Source: Central Bank of Trinidad and Tobago (n.d.).

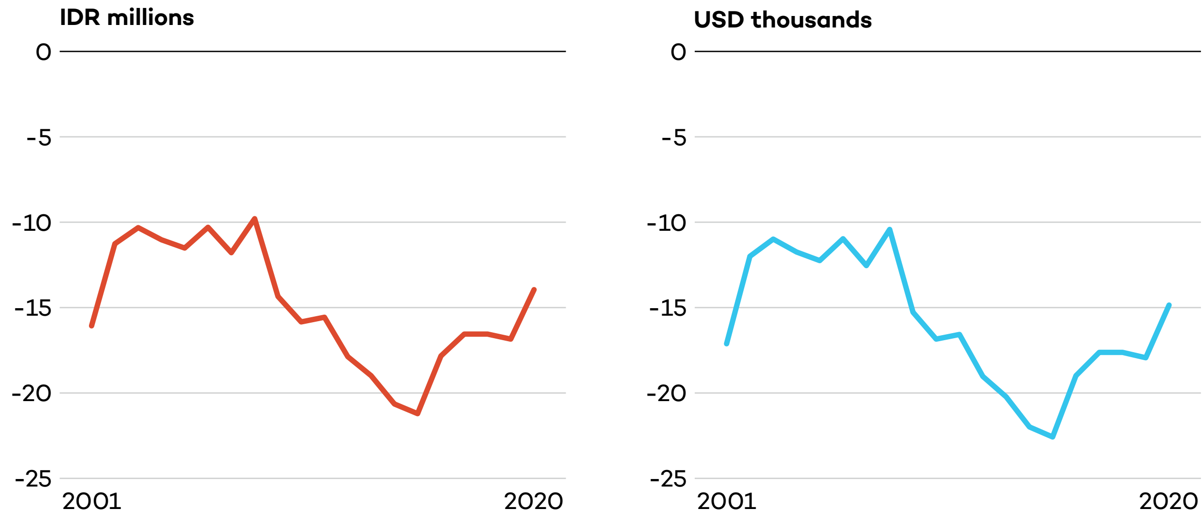
Indonesia launched a sovereign wealth fund in early 2021. In the short term, this new fund will likely increase the country's foreign financial liabilities. Unlike other sovereign wealth funds that focus on investing national savings in international financial markets, Indonesia's fund will be used to attract more FDI in the form of co-investors to support the country's development (Daga & Ngui, 2022). If this increase in foreign capital inflow is well managed, it should result in positive outcomes for the country.

Figure 2. Ethiopia



Source: National Bank of Ethiopia (n.d.).

Figure 3. Indonesia



Source: Central Bank of Indonesia (n.d).

Policy Implications

Financial capital plays a vital role in prosperity. Positive financial capital drives total wealth (and thus well-being) upward, while a negative value reduces wealth. Financial capital in Indonesia remained negative for the entire study period, while in Ethiopia and Trinidad and Tobago, it generally contributed positively to wealth. However, in later years, these two countries began accumulating more liabilities than assets. In Trinidad and Tobago, financial capital began to decline in 2014. In Ethiopia, the beginning of the decline corresponded to the year 2010/2011. The following policy implications can be drawn from these results:

Financial Capital and its Link to Other Capitals

Though financial capital may contribute less to wealth than other assets, it is essential for policy-makers to pay close attention to the extent to which other components are linked to it. Two examples illustrate this link: human capital and produced capital. Well-managed financial liabilities (such as FDI) can generate jobs in sectors important to the economy. Likewise, income earned from a sovereign wealth fund[4] can be used for investment in sectors like education: this will result in positive impacts on human capital. Similarly, foreign investment used to build roads, buildings, airports, and other infrastructure projects will boost produced capital.

Governance and Accountability

According to the World Bank (2021), the second largest debtor nation in the world on a per capita basis is the United States,[5] with an IIP estimated at -30,271 USD per capita in 2018, much lower than any of the three countries in this study. One of the reasons the U.S. and other developed economies remain dynamic despite their significant foreign financial liabilities is their capacity to attract and manage capital inflows, thanks to robust regulatory frameworks and business environments relative to developing economies.[6] This demonstrates the benefits to all countries of effective management of financial assets and liabilities to ensure returns are optimized. Policies to achieve this include combatting fiscal fraud (Organisation for Economic Co-operation and Development, 2014), tax evasion, money laundering, and corruption. They also include banning discrimination against foreign investors (World Trade Organization, 2022), and ensuring political stability (Ngoc et al., 2023).

Public Debt Management

Public debt is an essential component of the development process. It is used to finance expenditures in sectors that are, ideally, beneficial for both people and the planet. However, when public debt is too high and not well managed, it can be an impediment to progress. This is the case in many developing nations; for example, the 2023 International Monetary Fund (2023) World Economic Outlook shows that in 2023, public debt represented 38% of GDP in Ethiopia, 39% of GDP in Indonesia and 53% of GDP in Trinidad and Tobago. According to the United Nations Conference on Trade and Development, public debt in developing countries can reach such levels due to two factors (UN Global Crisis Response Group, 2023):

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[4] A sovereign wealth fund is a portfolio of foreign financial assets managed by a government and used to generate income for the nation. Both Indonesia and Trinidad and Tobago have such funds.

[5] Ireland was the largest debtor on a per capita basis in 2018, at -125890 USD.

[6] The 2020 World Bank (2020) *Doing Business* report—which assesses the regulatory effectiveness and institutional quality of business processes worldwide—shows that developed countries are the ones topping the global ranking. Moreover, a study by Kim and Zhang (2020) found that when GDP growth is high, developed countries generally experience net capital inflows, while developing countries experience net capital outflows, suggesting that net capital inflows are pro-cyclical in developed countries and countercyclical in developing economies.

1. increasing financing needs to address growing challenges such as health, cost of living, and climate change
2. an unequal international financial architecture that makes developing countries' access to financing inadequate and expensive.

To address this growing concern, actions from both the international communities and governments will be required. At the international level, the measures recommended in the UN Our Common Agenda Policy Brief on Reforms to the International Financial Architecture (United Nations, 2023a) and the SDG Stimulus (United Nations, 2023b) focus on the following three actions:

1. addressing the high cost of debt and growing risks of debt distress
2. rapid scale up of affordable long-term financing for countries' development
3. expansion of contingency financing to countries in need.

The debt-for-nature swap[7] implemented in 2009 between Indonesia and the United States for ecosystems in Sumatra of nearly USD 30 million (Huff, 2009) is an example of an international effort that can support both developing countries and the environment.

Diversification of Financing Sources

When financial flows rely on only a few dynamic sectors, a decline in those sectors can have negative and long-lasting consequences for the country. Examples include foreign income that depends on the export of a few major commodities or a sovereign wealth fund that is built with revenues from just a handful of sectors; for example, in Trinidad and Tobago, the Heritage and Stabilisation Fund depends on revenues from the petroleum sector (International Forum of Sovereign Wealth Funds, 2024). With the decline of the oil sector, financing sources should be diversified to meet the goal of the fund to guarantee the prosperity of future generations.

Domestic Financial Capital

Although financial assets and liabilities have no impact on national wealth when their owners are both national residents, they certainly have an impact on the wealth of individual sectors within the country, notably households. It is crucial to understand and address issues related to the financial assets of households. In Trinidad and Tobago, for instance, household debt represents around 30% of the country's GDP (Central Bank of Trinidad and Tobago, 2022).

[7] A debt-for-nature swap is defined as the forgiveness of debt in exchange for a commitment by the debtor to mobilize domestic resources for the environment.

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