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Asia-Pacific Trade and Investment Report 2017:

Review of recent trends and developments

Channelling trade and investment into sustainable development

Summary of the Asia-Pacific Trade and Investment Report 2017

Note by the secretariat

Summary

The present document is based on the forthcoming *Asia-Pacific Trade and Investment Report 2017*, which is the main substantive document prepared for the fifth session of the Committee on Trade and Investment. The *Report* comprises two parts. In the first part, the focus is on trends and developments pertaining to trade in merchandise and commercial services and foreign direct investment (FDI) flows. Forecasts of the trade performance in the region for 2018, which take into account trade protection-driven economic uncertainties are given. The second part of the *Report* contains an analysis on how trade and investment are interlinked and can be channelled into sustainable development. In the *Report,* it is strongly noted that "business as usual" trade and investment policies are not sufficient to address the three dimensions of sustainable development effectively. The importance of trade and FDI as key engines of economic growth and development at the aggregate level is stressed. However, it is noted they can adversely affect some groups of people or sectors of an economy and put pressure on the environment if left unchecked. In that context, trade and investment linkages are explored, and the impacts of various policy scenarios on the three dimensions of sustainable development are reviewed. Keeping in mind the need for comprehensive regulation of sustainable development issues along with dedicated social and environmental policies applicable to all the countries in the region, one of the recommendations in the *Report* is to consider implementing targeted trade and investment and adjustment policies. Some examples are to promote trade and investment in greener technologies and to help least developed countries increase exports, as envisaged by the Sustainable Development Goals. The present document also includes actions that may be taken at the regional level. Among them are to promote harmonization and the use of international standards in setting sanitary and phytosanitary measures and product standards; build capacity for negotiation of preferential trade agreements with sustainable development provisions; and support the collection of more accurate trade- and investment-related socioeconomic and environmental data, such as firm-level gender-disaggregated data on ownership, production, trade, and emissions. The Committee on Trade and Investment may wish to consider these actions and provide guidance on future direction.

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I. Introduction

1. The present document is based on the forthcoming *Asia-Pacific Trade and Investment Report 2017*. The *Report* comprises two parts. The first part covers recent trends and developments in the areas of trade, investment and integration among economies in the region, starting with trade in merchandise and commercial services and followed by changes in foreign direct investment (FDI). The second part includes an overview of a framework for channelling trade and investment into sustainable development, which is the theme of the 2017 *Report,* followed by a review of linkages between trade, investment and growth and results from modelling the impact of different trade policy scenarios on growth, inequality and greenhouse gas emissions. The *Report* concludes with some key recommendations and issues for consideration by the Committee.

II. Recent trends and developments

A. Merchandise trade: bouncing back but under growing trade-policy uncertainties

2. After suffering from a lacklustre performance in recent years, global trade appears to have trended higher in the first six months of 2017. The contraction of trade in imports and exports had already begun to ease in 2016, when global trade declined by 4.3 per cent compared to a double-digit rate in 2015. Forward-looking indicators, such as the expansion of export orders, container shipping and air freight, indicate that global demand will continue to strengthen in the third quarter of 2017.

3. Regional trade trends have also improved from the weakest post-crisis recorded trade performance. Regional exports and imports fell by less than 5 per cent in 2016, after declining by almost 10 per cent and 15 per cent respectively in the previous year. However, the export performance in 2016 varied within the region: exports recovered in developed economies, especially from Japan, and declined slightly in developing Asian and Pacific economies. Notably, the export performance of China, for the first time in a decade, was worse than the rest of the region, contracting by 7.7 per cent. Driven mainly by the sizable trade slowdown with China, exports from developing economies in the region declined by 5.3 per cent in 2016. On the other hand, exports from developed economies grew by 2.7 per cent, mainly on the back of the increase in exports from Japan.

4. China is a leading driver of trade and investment in Asia and the Pacific. In 2016, one third of the global exports from the region were from China, and 28 per cent of the imports were shipped to the country. A large proportion of Chinese trade with the world represents indirect trade from the rest of the region because of the strong production and trade linkages between China and the other economies of Asia and the Pacific. Consequently, the recorded growth of Chinese imports and exports, by 20.7 per cent and 8.1 per cent respectively during the first four months of 2017, as compared with the same period in the previous year, is an encouraging sign for the rest of the region. The recovery of trade with China is also benefiting commodity-exporting economies, which were severely affected by the commodity price collapse during the period 2014-2016.

5. Intraregional trade remains high, accounting for more than half of the total Asia-Pacific trade worldwide. However, it is highly concentrated and dependent on several economies in two subregions: East and North-East Asia

and South-East Asia. More than a half of intraregional exports continue to be designated for the East and North-East Asian subregion. China plays the dominant role in intraregional trade, contributing one third of interregional exports. Hong Kong, China and Japan are ranked second and third in this regard, with shares of 11 per cent and 10 per cent, respectively.

6. China is the source of nearly a quarter of the imports for all other countries in the region, and is the number one export destination for 21 economies in the region. The second largest intraregional export destination is Australia (largest destination for five economies), while Hong Kong, China and Japan share third place (top destination for four economies each). On the other hand, 42 economies in the region absorb less than 5 per cent of the intraregional exports. This structure of intraregional trade, with the hub in East and North-East Asia (or rather China), is a reflection of the existing regional value chains and production networks. There is great potential for intraregional trade, which could be tapped by opening trade connections between and among other Asia-Pacific subregions. Broadening the intraregional trade network requires improvements in trade infrastructure as well as the development of institutions to support such trade.

7. In addition to persistent volatility of commodity prices and exchange rates, the most notable challenges to boosting trade in the region are linked to heightened uncertainty about policy directions in major trading partner economies. Since 2016, a sense of angst about rising trade protectionism has deepened on the back of the election of populist parties and candidates in major developed countries. The populist stance on trade issues has included not only calls for more protection for local producers, but also the renegotiation of free trade commitments at international or bilateral levels, challenging the supremacy of the multilateral rules. This willingness to abandon the multilateral rules and unravel trade agreements may have serious repercussions on global trade and the world economy.

8. The increase in trade policy uncertainties can have adverse impacts on long-term trade prospects. While the rise of protectionism will surely impede trade almost immediately, the anticipation of unfriendly policies towards foreigners may prompt firms to delay export activities or overseas investment. In addition, indirect effects of policy uncertainties are triggering increased market volatility and a higher risk premium in the credit market which, in turn, is raising the cost of doing business. Thus, anticipated and actual protectionist actions could have ripple effects on investment and consumption overall.

9. Analysis in the *Report* indicated that uncertainties relating to trade-related topics soared rapidly in 2016. Greater uncertainty tied to economic policies is clearly associated with the slower growth of trade in the Asia-Pacific region. The analysis also indicates that policy changes in the Asia-Pacific economies respond to policy changes made by large economies outside the region. This suggests that the fear of a trade war might not be exaggerated because countries that impose protectionist actions may be retaliated against. The recent dynamic of trade policy uncertainties in the United States of America may spur changes in, for example, fiscal, health-care, and migration policies. This further suggests that detecting trade barriers may become harder as barriers increasingly take the form of non-tariff and behind-the-border measures.

10. Rhetoric of protectionism is still only partially reinforced by actions. Between mid-October 2015 and mid-May 2017, 256 trade restrictive measures and 296 trade liberalizing measures were introduced at the global level.[1] In the Asia-Pacific region, 69 new trade restrictive measures were imposed, as compared with 75 liberalizing measures in the same period. Asian and Pacific economies accounted for 27 per cent of the trade restrictive measures introduced globally and 25 per cent of those that promote trade liberalization. India and Indonesia were responsible for the largest number of new trade restrictive measures, with 21 and 16 measures respectively. In terms of liberalization, India and China led the region by adding 17 and 12 new liberalizing measures respectively. Encouragingly, from a global perspective, the number of restrictive measures set globally in 2017 actually declined, yet their cumulative effects are found to be affecting trade significantly.

11. Trade remedy measures give governments some flexibility in the application of their commitments to WTO by allowing them to respond to particular situations, typically by imposing temporarily higher tariffs on imports from particular sources. Between mid-October 2015 and mid-May 2017, 514 new trade remedies were initiated worldwide, of which 271, or 53 per cent, were initiated by Asia-Pacific economies. The number of initiations of trade remedy measures has increased substantially globally and regionally when compared to the number of initiations set in the previous reporting period (mid-October 2014 to mid-May 2016). The initiations substantially outstripped terminations (232 and 113 terminated measures worldwide and within the region, respectively), culminating in a large increase in the number of trade remedy measures. Measures directed towards metal products, particularly steel products, and chemicals, plastics and rubber accounted for a large share of this increase. By far, the most common form of trade remedies pertained to anti-dumping. India led the region with the introduction of 30 trade remedies in the reporting period, followed by China, which introduced seven measures.

12. Non-tariff measures are the most commonly used policy instruments among all trade restrictive measures. Hikes in tariffs accounted for only 44 per cent of trade restrictive measures during the reporting period. A closer look into non-tariff measures shows that in the Asia-Pacific region, 370 sanitary and 355 phytosanitary measures and technical barriers to trade were initiated in 2016. The most affected sectors were agriculture and food. Developing countries typically have comparative advantages in these two sectors, hence, they are disproportionally affected by them.

13. Taking into consideration the above-mentioned challenges, the secretariat anticipates that the growth prospects of merchandise exports from Asia-Pacific economies will continue to pick up at a moderate level of 4 per cent per year in terms of volume, while import volume is projected to increase by 5.5 to 5.7 per cent. The nominal values of exports and imports will increase on the back of the expected rise in export prices. In the light of the growing uncertainties, however, there is a significant risk that trade expansion recorded recently would not continue in 2018. A major risk is the possible increase in restrictive trade policies. The protectionist actions could affect global demand and investment flows, and cut economic growth potential over the medium to long term. As a result, trade growth in 2018 would decline from the previous year in Asia and the Pacific, with export volume seen expanding by 3.2 per cent and import volume increasing less than 2 per cent.

[1] As reported by World Trade Organization (WTO), document WT/TPR/OV/W/11. Available from www.wto.org/english/news_e/news17_e/trdev_24jul17_e.htm.

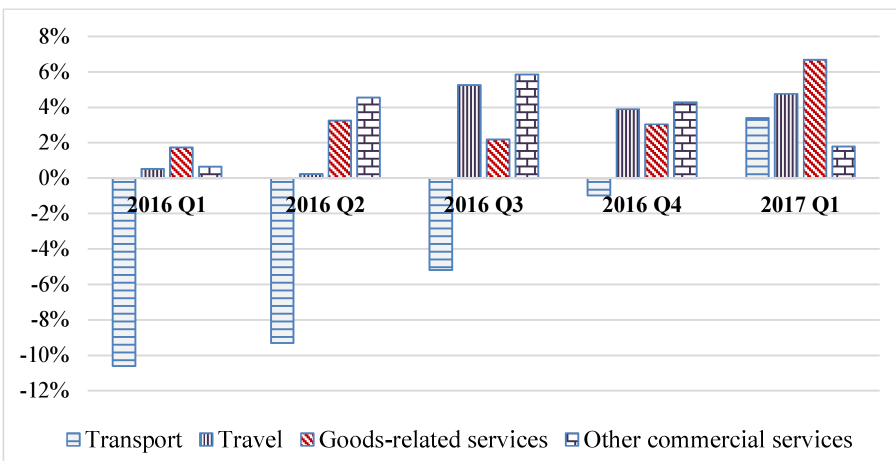
14. However, there will continue to be heterogeneity in the trade prospects for individual Asia-Pacific countries, highlighting their different characteristics. While commodity-exporting countries and developing countries tied to China through global value chains are expected to face more uncertain economic conditions, the projected economic and trade recovery of Japan may gain momentum, which would provide a much needed boost to regional trade. In addition, the adverse impacts from trade policy uncertainties may be less harmful to economies that have close political ties with advanced economies outside the region, such as Bangladesh, Malaysia, the Philippines and Viet Nam.

B. Commercial services trade: modest improvement

15. The region's commercial services trade increased moderately in 2016 from the previous year. Exports were valued at $1.328 trillion, up 0.1 per cent from the previous year, and imports climbed by 1.3 per cent to $1.549 trillion, resulting in a widening of the trade deficit at the regional level. At the same time, global exports of services were almost static, climbing by 0.4 per cent, while imports of services inched higher, by 1.1 per cent.

16. The trade results for the first quarter of 2017 continued to show signs of a full recovery in the Asia-Pacific region, with trade increasing by a healthy 3.2 per cent year-on-year, exceeding the world average of 2.6 per cent. As the transport sector contributes about 20 per cent of all service exports of the region, its significant improvement towards the end of 2016 has been one of the main factors driving the recovery (figure I).

Figure I
Year-on-year percentage change of the Asia-Pacific service exports



Source: WTO, "Short-term trade statistics". Available at www.wto.org/english/res_e/statis_e/short_term_stats_e.htm (accessed 5 August 2017).

17. The share of global trade in services of the Asia-Pacific region in 2016 rose by 30.3 per cent year-on-year, up from 28.3 per cent in 2010 and 24.9 per cent in 2005. The largest economies of Asia and the Pacific are the greatest contributors to these results. For instance, exports from China, India, Japan and Singapore represent more than half of the region's total exports, while imports from six economies, namely China, India, Japan, the Russian Federation, Singapore and Hong Kong, China comprised almost three quarters of the region's imports.

18. In terms of trade performance in 2016, the exports of commercial services deteriorated in several Asia-Pacific economies, including Turkey (-19.6 per cent); Hong Kong, China (-5.7 per cent); Republic of Korea (-5.0 per cent); and China (-4.3 per cent). As for imports, India, China and Japan registered strong growth (8.4 per cent, 3.8 per cent and 3.4 per cent respectively). However, some other relatively large importers in the region experienced a decline in the services imports: Republic of Korea (2.0 per cent); Russian Federation (16.3 per cent); and Turkey (1.7 per cent).

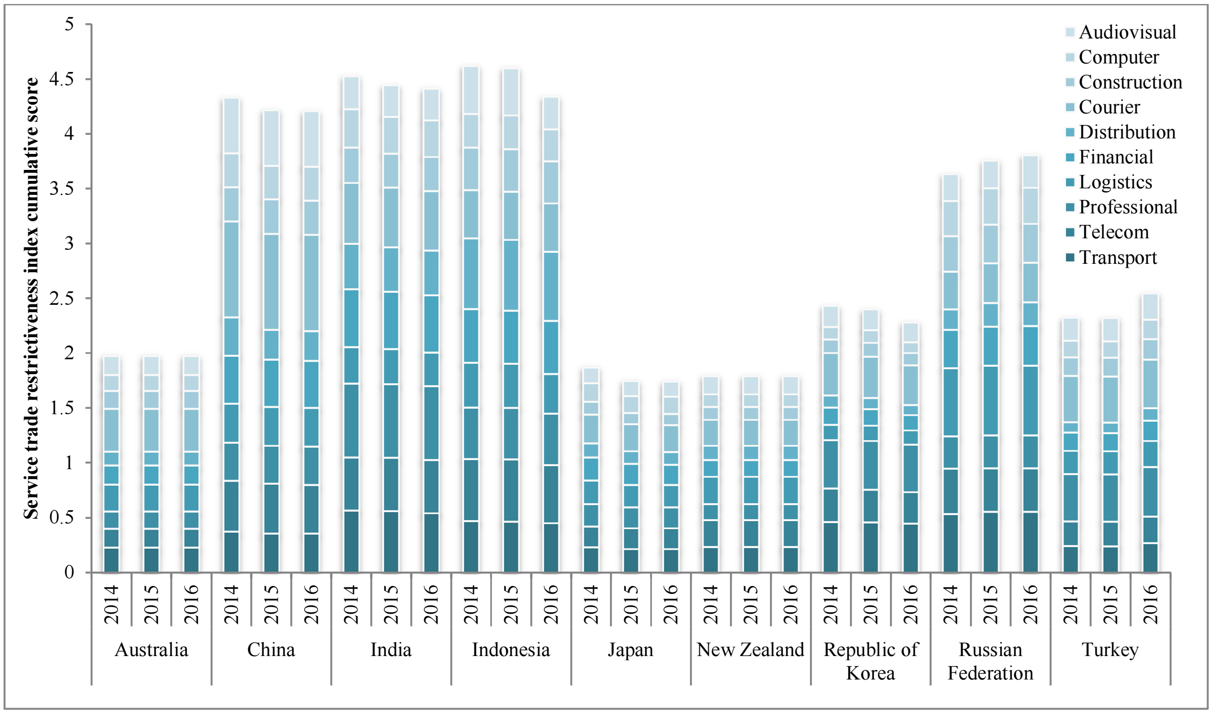
19. The 2016 breakdown of the four broad categories of commercial services trade in the region was as follows: "transport" (19.9 per cent of regional exports and 24.5 per cent of regional imports; "travel" (29.9 per cent and 32.8 per cent); "goods-related services" (3.5 per cent and 2.7 per cent); and "other commercial services" (46.7 per cent and 40.1 per cent). The "other commercial services" category comprises seven subcategories, and within Asia and the Pacific, the three main subcategories of "other commercial services" are: "telecommunications,computer and information services" (15 per cent); "charges for the use of intellectual property" (13 per cent); and "other business services" (49 per cent).

20. Between 2005 and 2016, the region's exports of commercial services increased by 2.3 times, with the "other commercial services" category growing the most rapidly (181.7 per cent). It was followed by "travel" (141.0 per cent), "goods-related services" (105.4 per cent) and "transport" (54.8 per cent). These four categories have all performed better in Asia and the Pacific as compared with the global average during this period, implying that the service sector is becoming an increasingly significant source of foreign exchange. Unfortunately, lack of detailed intraregional data inhibits analysis of intraregional trade patterns, but anecdotal evidence suggests that the export destinations are still primarily in developed markets, in member countries of the European Union and the countries in North America.

21. Data on international tourism show that the Asia-Pacific region received 29.8 per cent of global tourist arrivals in 2016; the region recorded 368 million arrivals, an increase of 3.3 per cent from 2015 and 38.9 per cent from 2010. China was the most popular tourist destination (receiving 16.1 per cent of all arrivals in the Asia-Pacific region), followed by Thailand (8.9 per cent), Turkey (7.7 per cent), Malaysia (7.3 per cent) and Hong Kong, China (7.2 per cent).

22. Economic uncertainty and the imposition of protectionist measures discussed in chapter 1 of the *Report* affect goods and services trade. It is difficult to compare developments in use of restrictive policies in goods and services trade, given the different set of instruments applied on the related transactions. However, the services trade restrictiveness index developed by the Organization for Economic Cooperation and Development (OECD) can be used to gauge the level of openness in this sector in selected economies, including nine from the Asia-Pacific region, namely Australia, China, India, Indonesia, Japan, New Zealand, the Republic of Korea, the Russian Federation and Turkey. In 2016, the most restricted sectors in these countries were courier, transport and professional services, while computer, construction and distribution services were the most open. Furthermore, the nine countries can be divided into three groups: Australia, Japan and New Zealand are the least restrictive with regard to trade in services; the Republic of Korea and Turkey are more restrictive; and China, India, Indonesia and the Russian Federation are the most restrictive. In terms of trends, Indonesia, Japan and the Republic of Korea are becoming less restrictive, while Turkey and the Russian Federation are moving in the opposite direction (figure II).

Figure II
Cumulative service trade restrictiveness index scores of selected Asia-Pacific countries



Source: ESCAP calculation based on Organization for Economic Cooperation and Development, Services Trade Restrictiveness Index data set. Available from www.oecd.org/tad/services-trade/services-trade-restrictiveness-index.htm (accessed 15 July 2017).

C. The Asia-Pacific region maintains its leading role in global foreign direct investment

23. The Asia-Pacific region continues to be the leading global destination for inward FDI, even though the total amount contracted by 3 per cent to $541 billion in 2016, as compared with the previous year. Despite the decline, which can be attributed to weakening economic growth and low commodity prices, the region still accounted for 31 per cent of global FDI inflows. Asia and the Pacific also remained the world's largest source of FDI outflows, which increased by 10 per cent to $495 billion in 2016 from 2015 and accounted for 34 per cent of global outflows.

24. Also in 2016, greenfield FDI inflows to the Asia-Pacific region increased by 11.7 per cent from the previous year to $395 billion, which accounted for 43 per cent of global greenfield FDI inflows. Greenfield FDI outflows from the region also increased significantly, by 20.3 per cent in 2016 to $315 billion.

25. Continued economic integration efforts and the relocation of investment are expected to provide further impetus to intraregional FDI. Such flows from the economies of Asia and the Pacific have steadily increased over the last 10 years. However, intraregional greenfield FDI inflows stagnated in 2016, increasing by only 0.3 per cent. The countries comprising the Association of Southeast Asian Nations (ASEAN) have continued to attract a significant amount of intraregional FDI inflows, with intra-ASEAN FDI inflows accounting for more than 18 per cent of total FDI inflows to the region.

26. Among the most noteworthy sectoral trends related to FDI inflows to the Asia-Pacific region is the rise of FDI in the services sector. The greenfield FDI to the subregion in the services sector increased by 31 per cent in 2016 from the previous year to $155 billion. On the other hand, FDI in the manufacturing sector was stagnant. Despite this, the sector continues to be the largest recipient of FDI inflows. Notably, the small and less developed economies in South-East Asia have benefited from FDI in the manufacturing sector, which can be attributed to the industrial reconfiguration affecting the subregion's value chains.

27. In 2016, national investment policies in the Asia-Pacific region on balance continued to promote liberalization of the sector and encourage investment. Nineteen countries in the region adopted 52 investment policies affecting FDI, accounting for 42 per cent of the global figure. Forty-three of the policies were related to liberalization, promotion and facilitation of investment, while nine of them introduced new restrictions or regulations on investment. National policy changes have focused on relaxation of foreign ownership requirements, privatization and promotion and facilitation of FDI. In addition, economies in the Asia-Pacific region continued to expand their involvement in global international investment agreements with the signing of 20 agreements and five agreements entering into force in 2016.

28. Regional integration agreements that include deep and wide commitments in FDI are expected to contribute to strengthened business and investment climates among the members of such agreements. Some examples of this are the ASEAN Comprehensive Investment Agreement, the Treaty on the Eurasian Economic Union and the Regional Comprehensive Economic Partnership.

II. Channelling trade and investment into sustainable development

A. From trade and investment to sustainable development: a framework

29. International trade and investment have been identified as a key means of implementation of sustainable development in the 2030 Agenda for Sustainable Development. However, rising public concerns about globalization in major developed economies, as recently evidenced by Brexit in Europe and the withdrawal of the United States of America from the Trans-Pacific Partnership, have heightened the need for policymakers to recognize that not everyone benefits from trade and investment liberalization, even as the overall economic pie expands as a result.[2] The increase in economic activity associated with international trade and investment, with all other things being equal, tends to put more pressure on the environment and the limited stock of natural resources, making it essential for policymakers to channel trade and investment into activities and sectors that can help mitigate the environmental impact while still capturing the economic and social benefits.

30. The Sustainable Development Goal framework identifies a number of trade- and investment-related targets (table 1). However, many of these targets provide limited guidance on how developing economies should adjust their trade and investment policies towards sustainable development, considering

[2] See, among others, the recent report by International Monetary Fund, World Bank and WTO, "Making trade an engine of growth for all: the case for trade and for policies to facilitate adjustment", Working paper No. 114123 (Washington, D.C., World Bank, 2017). Available from http://hdl.handle.net/10986/26389.

the complex interlinkages between international trade and FDI, on one hand, and between international trade and FDI and domestic social and environmental policies, on the other hand.

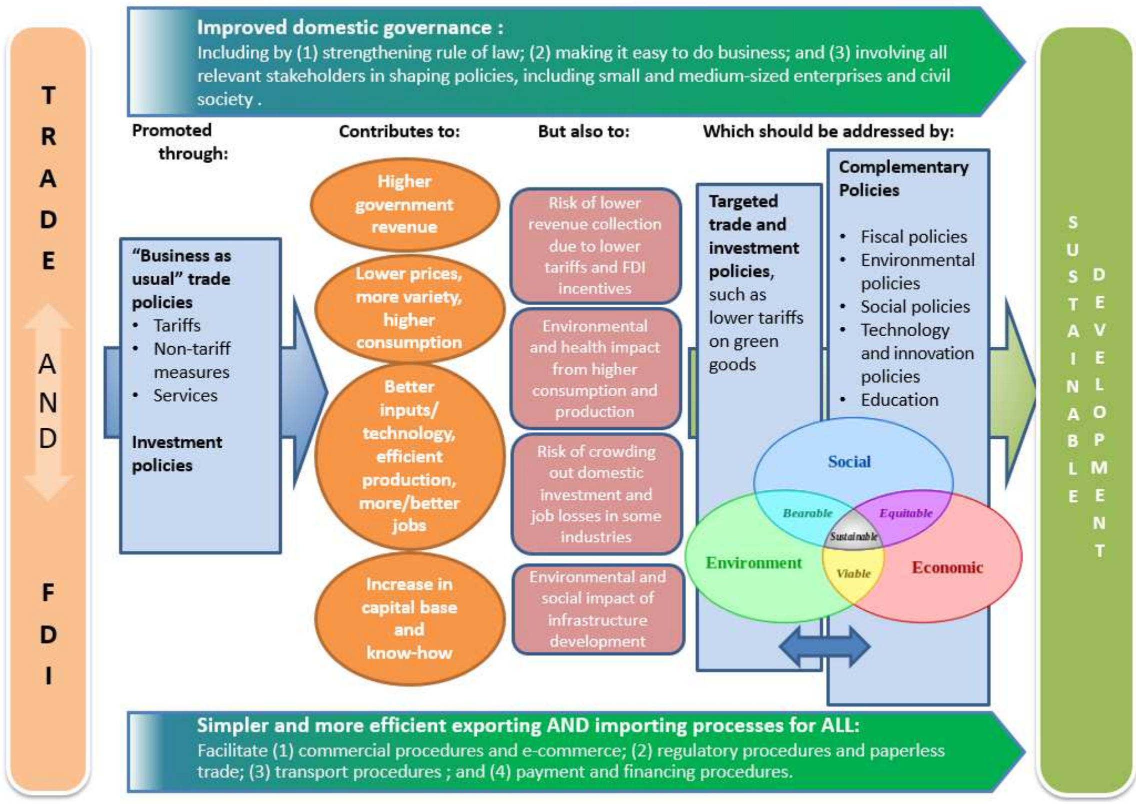
Table 1
Selected trade- and investment-related targets and goal-specific means of implementation specified in the 2030 Agenda for Sustainable Development

	Goal
Goal 2	**End hunger, achieve food security and improved nutrition and promote sustainable agriculture**
2.a	Increase investment, including through enhanced international cooperation, in rural infrastructure, agricultural research and extension services, technology development and plant and livestock gene banks in order to enhance agricultural productive capacity in developing countries, in particular least developed countries
2.b	Correct and prevent trade restrictions and distortions in world agricultural markets, including through the parallel elimination of all forms of agricultural export subsidies and all export measures with equivalent effect, in accordance with the mandate of the Doha Development Round
Goal 3	**Ensure healthy lives and promote well-being for all at all ages**
3.b	(…) provide access to affordable essential medicines and vaccines, in accordance with the Doha Declaration on the TRIPS Agreement and Public Health, which affirms the right of developing countries to use to the full the provisions in the Agreement on Trade-Related Aspects of Intellectual Property Rights regarding flexibilities to protect public health and, in particular provides access to medicines for all
Goal 7	**Ensure access to affordable, reliable, sustainable and modern energy for all**
7.a	(…) promote investment in energy infrastructure and clean energy technology
Goal 8	**Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all**
8.a	Increase Aid for Trade support for developing countries, in particular least developed countries, including through the Enhanced Integrated Framework for Trade-related Technical Assistance to Least Developed Countries
Goal 10	**Reduce inequality within and among countries**
10.a	Implement the principle of special and differential treatment for developing countries, in particular least developed countries, in accordance with World Trade Organization agreements
10.b	Encourage official development assistance and financial flows, including foreign direct investment, to States where the need is greatest, in particular least developed countries, African countries, small island developing States and landlocked developing countries, in accordance with their national plans and programmes

	Goal
Goal 14	**Conserve and sustainably use the oceans, seas and marine resources for sustainable development**
14.6	By 2020, prohibit certain forms of fisheries subsidies which contribute to overcapacity and overfishing, eliminate subsidies that contribute to illegal, unreported and unregulated fishing and refrain from introducing new such subsidies, recognizing that appropriate and effective special and differential treatment for developing and least developed countries should be an integral part of the World Trade Organization fisheries subsidies negotiation
Goal 15	**Protect, restore and promote sustainable use of terrestrial ecosystems […] and halt biodiversity loss**
15.c	Enhance global support for efforts to combat the poaching and trafficking of protected species, including by increasing the capacity of local communities to pursue sustainable livelihood opportunities
Goal 17	**Strengthen the means of implementation and revitalize the Global Partnership for Sustainable Development**
17.3	Mobilize additional financial resources for developing countries from multiple sources
17.5	Adopt and implement investment promotion regimes for least developed countries
17.10	Promote a universal, rules-based, open, non-discriminatory and equitable multilateral trading system under the World Trade Organization, including through the conclusion of negotiations under its Doha Development Agenda
17.11	Significantly increase the exports of developing countries, in particular with a view to doubling the least developed countries' share of global exports by 2020
17.12	Realize timely implementation of duty-free and quota-free market access on a lasting basis for all least developed countries consistent with World Trade Organization decisions, including by ensuring that preferential rules of origin applicable to imports from least developed countries are transparent and simple, and contribute to facilitating market access

31. To provide an overall yet succinct and balanced understanding of the impact of trade and FDI and how they can be channelled towards achieving sustainable development, a simple framework is introduced (figure III). The framework highlights that "business as usual" market-driven trade and investment policies, typically designed with aggregate-level economic impacts in mind, can effectively contribute to the overall economic development of an economy. Trade can provide a greater variety of goods to consumers at lower prices. By enabling access to better technology and inputs, trade and FDI can increase production efficiency and lead to more and better-paying jobs. FDI can also help build the capital base and know-how often lacking domestically for large infrastructure or industrial development projects. Overall, the increase in economic activity and growth would boost duty and tax revenue for the government, which may, in principle, be used to deal with social and environmental concerns.

Figure III
Channelling trade and investment into sustainable development: a simple framework



32. However, as the framework explicitly shows, while at the aggregate level trade and FDI are likely to result in the above-mentioned benefits, the liberalization of trade and investment also has some potential downsides. For example, lowering tariffs or extending too many FDI incentives in the form of tax breaks may adversely affect government revenue if not managed carefully. More intensive economic activity can have potentially damaging environmental impacts and be associated with harmful health effects, for example through increased amounts of waste generated and greenhouse gas emissions. In addition, foreign investors may crowd out domestic investment, affecting the development of the small and medium-sized enterprise sector, and cheaper imports may lead to job losses in some industries or the disappearance of some activities or even sectors. Accelerated infrastructure development or industrialization through FDI may also negatively affect the livelihood of certain communities or their cultural heritage and also result in significant environmental degradation.

33. In the framework put forward in the present report, four key elements for ensuring that trade and investment can be more effectively channelled into sustainable development are presented. The first is that general opening policies should be accompanied by targeted trade and investment policies aimed at achieving specific Sustainable Development Goals. Some of them are already specified in the Sustainable Development Goal targets and indicators, while some are not. For example, developed economies are expected to provide preferential treatment and tariff exemptions to least developed countries (targets 10.a and 17.11) and to establish policies that promote FDI to these economies (target 17.5). However, achieving quality education for all (Goal 4) may also involve liberalization of certain education services, and cutting tariffs

on imports of water and sanitation equipment are key to the sustainable management of water (Goal 6). Along the same line, incorporating a targeted sustainable development criteria in the selection of FDI projects, such as potential for women employment generation (in relation to Goal 5), may be very effective in channelling trade and investment into sustainable development.

34. The second and possibly most important element in this framework refers to complementary policies in the form of domestic policies. These policies do not specifically apply to trade or FDI, but more generally to all products, services, firms and people in the country regardless of origin. Domestic policies to lower trade adjustment costs for those that are adversely affected by them in the short term are particularly important, such as policies that make it easier for workers to move across industries or regions and to acquire new skills (a combination of labour market, education and public transport policies in this case). Domestic environmental regulations are also essential, as they can help ensure that foreign investors do not see a country as a pollution haven from which they could manufacture products without regard for the environment.

35. The third component, good domestic governance, is also a fundamental element in channelling trade and investment into sustainable development. It is needed to ensure that the various policies mentioned above are actually implemented on the ground and efficiently. Improving domestic governance implies that sufficiently strong public institutions are in place in order to strengthen the rule of law, make it easy to conduct business and involve all relevant stakeholders, including small and medium-sized enterprises and civil society, in shaping policies. This is essential to ensure effective revenue collection and subsequent use towards sustainable development.[3]

36. The fourth element, simple and efficient trade procedures, is key to ensure that trade is inclusive, and that the transaction process itself creates as little environmental impacts as possible. A broad approach to trade facilitation, covering (a) commercial procedures, including e-commerce; (b) regulatory procedures, including paperless trade; (c) transport procedures; and (d) payment procedures, will yield the best results. Importantly, both import and export procedures should be facilitated to enable participation in regional and global production networks.

B. The links between foreign direct investment, trade and growth

37. Over the past 25 years, the world witnessed an unprecedented wave of globalization efforts that often took the form of regional trade agreements and deeper integration agreements, including numerous bilateral investment treaties. The Asia-Pacific region has played a central role in these integration efforts with regard to trade and FDI. While the impact of trade liberalization has been studied extensively in the academic world, the effect of FDI (because of lack of data and the need for theoretical foundations that reflect the changing nature of FDI) is less understood.

38. Indeed, despite the significant efforts made to liberalize trade and promote FDI in the Asia-Pacific region, and the great expectations for positive economic outcomes as a result of the integration efforts in this area and around

[3] See *Economic and Social Survey of Asia and the Pacific 2017: Governance and Fiscal Management* (United Nations publication, Sales No. E.17.II.F.8). Available from www.unescap.org/publications/economic-and-social-survey-asia-and-pacific-2017.

the globe,[4] there is little quantitative evidence of the economic impact of FDI in the Asia-Pacific region and, specifically, of the relationship between FDI, international trade, domestic investment in physical capital and real gross domestic product (GDP).

39. In order to evaluate the relationship, the structural computable general equilibrium (CGE) model of Anderson, Larch and Yotov (2017, ALY henceforth) was employed. This model quantifies and decomposes the relationships between trade, domestic investment (through physical capital accumulation) and FDI (in the form of non-rival technology capital) within a comprehensive and unified framework.

40. The key channel through which trade liberalization affects growth in ALY is capital accumulation, which is consistent with a series of empirical studies. The studies demonstrate that accumulation of capital and other production factors is responsible for the large increase in trade in response to moderate trade cost reductions, such as small tariff cuts. The links between domestic investment and trade in ALY operate in both directions, which is also consistent with the empirical literature: trade affects growth through changes in consumer and producer prices, which, in turn, stimulate or impede physical capital accumulation. At the same time, domestic investment affects trade directly, through changes in country size, and indirectly, through altering the incidence of trade costs on the consumers and on the producers.

41. In turn, FDI can take the form of technology capital, which is non-rival, namely a country can use its technology capital not only at home but at the same time in all other countries in the world. One can think about the technology or knowledge capital as, among other things, patents, blueprints, or management skills or practices. Modelling FDI as technology capital is consistent with the fact that "[t]oday, FDI is […] about technology and know-how, [...] International patterns of production are leading to new forms of cross-border investment, in which foreign investors share their intangible assets such as know-how or brands in conjunction with local capital or tangible assets of domestic investors."[5] This is particularly appropriate for the Asia-Pacific region because, while the technological gap between many of the investing developed countries and many of the host Asia-Pacific economies remains wide, the level of skill, infrastructure and education in the region is

4 For example, the role of foreign investment and the expectations for a positive impact of FDI featured prominently during the negotiations of the Comprehensive Economic and Trade Agreement between Canada and the European Union, in which one of the main goals was the removal and/or alleviation of barriers to foreign investment among members. Specifically, the Agreement assures that European Union investors in Canada and Canadian investors in the European Union are to be treated equally and fairly (see http://ec.europa.eu/trade/policy/in-focus/ceta/). As pointed by the structural computable general equilibrium (CGE) model of Anderson, Larch and Yotov, European Union analysts have shared similar expectations about the impact of FDI during the negotiations of the Trans-Atlantic Trade and Investment Partnership, which would "liberalize trade and investment between the European Union and the United States and will result in more jobs and growth and assist Europe in its long-term recovery from the economic crisis." See European Commission, "EU-US trade talks: EU and US announce 4th round of TTIP negotiations in March: stocktaking meeting in Washington, D.C. to precede next set of talks", 28 January 2014. Available from http://trade.ec.europa.eu/doclib/press/index.cfm?id=1020.

5 Christine Qiang, Roberto Eschandi and Jana Krajcoviaova, World Bank, "Foreign direct investment and development: insights from literature and ideas for research", 24 November 2015. Available from www.blogs.worldbank.org/psd/foreign-direct-investment-and-development-insights-literature-and-ideas-research.

sufficiently high in order to complement the incoming knowledge capital. Modelling FDI in this fashion is also consistent with the earlier market-seeking, resource-seeking and efficiency-seeking motives for FDI,[6] as well as with the argument in one body of research that vertical FDI is more prominent among countries with different relative factor endowments.[7]

42. The results of the empirical analysis show that the contributions of FDI to trade, investment and growth in the Asia-Pacific region are large.[8] Specifically, FDI has increased exports of the region by 7 per cent and physical capital accumulation by 3.1 per cent. Most importantly, FDI has contributed to enhancing aggregate welfare of the region, accounting for 7.1 per cent of GDP per capita on average.

43. The impact of FDI on the economies of the Asia-Pacific region has been quite heterogeneous. The economies that have benefited the most from FDI are Hong Kong, China (with a 151 per cent increase in exports, 90 per cent increase in physical capital, and 132 per cent increase in real GDP per capita) and Singapore (with an 80 per cent increase in exports, 64 per cent increase in physical capital, and 93 per cent increase in real GDP per capita), while those that benefited the least are Bangladesh (with a 5 per cent decrease in exports, 0.1 per cent decrease in physical capital, and 0.2 per cent increase in real GDP per capita) and Uzbekistan (with a 0.5 per cent increase in exports, 0.1 per cent increase in physical capital, and 0.3 per cent increase in real GDP per capita because of FDI). The economies that have benefited the most from FDI are those with the most bilateral investment treaties and the largest FDI share, while the countries that have benefited the least are those that have tended to be outsiders to the globalization process over the past 25 years.

44. In addition to showing that the impact of FDI on real GDP per capita in the Asia-Pacific region has been positive for all economies in the sample, the results confirm that FDI and exports are complementary rather than substitutes in most of the observed economies. This latter finding is in line with the growing participation of Asia-Pacific countries in regional and global production networks, where FDI in various countries provides the capital and management know-how needed to develop the network through which trade in raw materials, as well as higher-value added parts and components, can flow efficiently for processing and assembly into final products.

45. The results provide support for a more coordinated and integrated approach to trade and FDI policies to channel their joint impacts on sustainable development.

C. Modelling impacts of trade policy changes on sustainable development

46. To better understand how different types of trade policy changes may affect sustainable development, the Global Trade Analysis Project model and its extensions to empirically measure the impact of various policy scenarios on economic, social and environmental indicators in Asian and Pacific economies are applied. The economic impact is captured through GDP growth,

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[6] John H. Dunning, *International Production and the Multinational Enterprise* (London, Allen and Uwin, 1981).

[7] James R. Markusen and others, "A unified treatment of horizontal direct investment, vertical direct investment, and the pattern of trade in goods and services", NBER Working Paper, No. 5696 (Cambridge, Massachusetts, National Bureau of Economic Research, 1996). Available from www.nber.org/papers/w5696.

[8] Based on a data set for the year 2011 covering 20 key ESCAP Asia-Pacific economies.

social impact through changes in inequality and environmental impact through greenhouse gas emissions.

47. Under the baseline scenario ("business as usual"), which accounts for moderate growth in GDP, population and labour force as projected by the United Nations and the International Institute for Applied Systems Analysis and only policy changes that have already been in place as of 2015, the results show that, owing to the expansion of economies across the world, economic activities increase. Inequality across countries reduces over time, as poorer countries have greater growth prospects in general. However, income inequality broadly increases across labour categories, essentially because the more rapid growth of sectors that are skill and capital intensive; in other words, skill-biased technological progress worsens income inequality in various countries. Mixed results are found in terms of food security: while most of the countries may see a fall in undernourishment, owing to the expansion of food supply and production, some countries may be faced with reduced food security, owing to the displacement of agriculture and food industries by other industries. Looking at the environmental pillar of sustainable development, the increase in economic activities under this status quo scenario leads to an increase in greater greenhouse gas emissions, which rise by up to 4 per cent per annum in different countries.

48. Considering the current global economic policy uncertainties and the strong trade protectionism rhetoric in a few key economies (see E/ESCAP/CTI(5)/2 for more details), the new protectionism scenario is reviewed under which every country in the world increases its applied tariffs to the level of their bound tariffs (not breaching their WTO commitments). As a result of this tariff war, economies across the world contract (GDP reductions range from 0.5 per cent to 2 per cent per annum) and economic activities decrease. Inequality across countries increases, as poorer countries are more exposed to trade shocks and hence respond more extremely to their tariff hikes. Income inequality also broadly increases between the different types of households, essentially because sectors that require extensive skills and capital are relatively less affected by the general rise in tariffs. Most countries witness a fall in food supply and food production, and poorer countries would need to deal with increasing levels of undernourishment. On the environmental side, the slowdown in economic activities leads to fewer emissions, which fall slightly at a rate of 0.1 to 0.5 per cent per annum. However, they do not fall as much as GDP because the economic slowdown and tariff hikes have also affected the growth of the renewables sector.

49. Turning to a more optimistic trade cost reduction scenario, the impact from Asian and Pacific countries cutting tariffs and implementing trade facilitation measures is evaluated. In this case, economies across the world tend to expand (GDP growth ranges from 1 per cent to 3 per cent per annum), and economic activities increase. Inequality across countries increases, as poorer countries face greater tariff reductions, resulting in more imports that may reduce domestic production in some cases. Such effects, however, are outweighed partly in some sectors by greater cost reductions in production and consumption in poorer countries. Income inequality also broadly increases between the different types of households. The impact of the lower trade costs on food security is positive across the board, and all countries witness a rise in food supply and production and a consequent fall in undernourishment. In terms of greenhouse gas emissions, the trade costs reduction scenarios typically lead to a slight rise of 0.5 to 2 per cent per annum, lower than the increase seen in the business as usual scenario. The reason for the smaller increase in emissions is that the renewable sectors expand as a consequence of the reductions in tariff and other trade costs.

50. Under the investment liberalization scenario, the outcome is similar to that of the trade cost reduction scenarios: significant economic growth and greater food security but greater inequality and emissions.

51. Recognizing that trade or investment liberalization will also negatively affect certain groups, at least in the short term, a review is conducted on the impact of a complementary policy added to the trade and investment liberalization scenarios, allowing for income transfers and international aid across countries. As a result, inequality is almost unaffected, as income or GDP losses are addressed by transferring income from households in sectors and labour categories that benefit from the liberalization to those are affected negatively by it. The income transfer actually leads to greater economic expansion than what would be experienced under the standard trade and investment liberalization scenarios (GDP rise range from 1.5 per cent to about 4 per cent per annum), contributing to a slight increase in emissions, from 1 to 3 per cent per annum. The positive impact on food security remains the same.

52. The Paris Agreement and the set of commitments made by the countries who signed it are an example of a complementary policy, which can, in principle, help ensure that trade and investment is channelled into sustainable development. When an emission constraint in line with the recent Paris Agreement[9] is put in place, emissions fall as per the Agreement, but the GDP of most countries imposing the constraint tend to also fall slightly as a result – by 0 to 0.5 per cent per annum.[10] As opposed to trade policy that supports aggregate economic growth, this environmental policy increases costs to emission-intensive sectors, encouraging the expansion of (and, therefore, investment in) emission-free and renewable sectors. While overall growth may slow or decline, income inequality broadly decreases across households, as the sectors that are more skill and capital-intensive are, in general, also more emission-intensive. Inequality across countries also decreases, as poorer countries typically have lower emission intensity, as well as lower emission reduction commitments as per this Agreement. Food security is not affected.

53. All in all, the economic, social and environmental impacts associated with the various policy scenarios examined highlight the complexity and significance of the trade-offs among the three dimensions of sustainable development. Trade and investment policies directly support the economic dimension, including poverty reduction (Sustainable Development Goal 1) and food security (Goal 2). At the same time, it also appears that trade and investment liberalization tends to increase inequality across different types of households (Goal 10), as well as, to a lesser extent, inequality among countries. Similarly, trade and investment liberalization policies generally lead to increases in greenhouse gas emissions (Goal 13), unless complementary policies are set.

54. However, the results also make it clear that (a) raising barriers to trade and investment is not effective in reducing social inequalities within and between countries, as there are other more powerful forces at play, such as technology and existing distribution of resources within the country among households and sectors, driving income inequality; and (b) trade protectionism typically results in less food security and greater undernourishment.

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[9] FCCC/CP/2015/10/Add.1, annex.

[10] If positive GDP growth constraints are included as in the baseline model, then the emission constraint leads to significant losses in emission-intensive sectors and increasing dependence of the economy in emission-free and renewables sectors, through which the targeted GDP growth is achieved.

55. In contrast, the trade-offs between trade and investment as economic growth engines and the need to protect the environment appear to be much clearer and stronger overall than the socioeconomic trade-offs. An increase in economic activities will lead to greater environmental degradation unless cleaner and more efficient production (and consumption) technologies are put in place in parallel. Trade and investment policies promoting trade and investment in such technologies may be the best way to protect the environment while not sacrificing growth and its socioeconomic benefits.

D. Way forward and issues for consideration of the Committee on Trade and Investment

56. In the present report, the secretariat offers a concise toolkit for Asia-Pacific policymakers by identifying measures, policies and initiatives that can be undertaken at the country level or the regional and/or global level to promote trade and investment as key drivers of economic growth and channel them into sustainable development through various targeted and complementary policies.

57. Based on the analysis conducted and taking into account the targets already specified in the 2030 Agenda, many trade- and investment-related actions that may be taken at the regional level are identified in the present report. They are the following:

(a) Facilitate the adoption of investment promotion regimes for least developed countries in the Asia-Pacific region, identifying specific actions and criteria that may be used by more developed regional economies to encourage FDI investment into least developed countries. This may be supported through the existing Asia-Pacific Foreign Direct Investment Network.[11]

(b) Identify environmentally friendly products and services for tariff reductions by Asia-Pacific countries.[12] This approach of identifying lists of products and services for liberalization whose trade would greatly contribute to the achievement of sustainable development may be extended to the various sectoral Sustainable Development Goals, such as health (Goal 3) or education (Goal 4).

(c) Promote harmonization and the use of international standards in setting sanitary and phytosanitary measures and product standards. Such non-tariff measures play important functions in efforts to protect human and animal health, safety and the environment. Ensuring that they are harmonized among the Asia-Pacific countries would reduce compliance costs and their effects as barriers to trade, while preserving their social and environmental benefits.[13]

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[11] As envisaged in Sustainable Development target Goal 17.5. See also https://unohrlls.org/custom-content/uploads/2015/07/Strengthen_Invest_Promotion_Regimes_FDI_LDCs.pdf.

[12] This is in addition to further reducing tariffs applied to imports from least developed countries, as specifically envisaged in Sustainable Development Goal target 10.A. The Asia-Pacific Economic Cooperation, the Organization for Economic Cooperation and Development, WTO and others have developed various lists of environmental goods. See, for example, www.intracen.org/uploadedFiles/intracenorg/Content/Publications/AssetPDF/EGS%20Ecosystems%20Brief%20040914%20-%20low%20res.pdf.

[13] See http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=1474.

(d) Build capacity for negotiation of preferential trade agreements with sustainable development provisions. Preferential trade agreements – including economic partnership agreements – increasingly include environmental and social (labour) provisions. While this is important in channelling trade and investment into sustainable development, capacity of developing economies in negotiating these complementary provisions is often lacking.[14]

(e) Develop guidelines and model preferential trade agreement provisions on how to mitigate and share trade adjustment costs among those that benefit from them and those that are adversely affected by them within and between trading economies. Evaluating the socioeconomic costs involved in new trade and investment agreements from the beginning, and incorporating compensatory measures in agreements would lower overall costs and boost public trust in the benefits of trade and investment.[15]

(f) Share good practices and lessons learned in streamlining regulatory procedures related to import, export and transit, including but not necessarily limited to those envisaged in the WTO Agreement on Trade Facilitation and the ESCAP Framework Agreement on Facilitation of Cross-border Paperless Trade in Asia and the Pacific.

(g) Develop a regional trade finance mechanism to facilitate the integration of micro and small and medium-sized enterprises into regional and production networks. Access to credit remains the number one barrier mentioned by small and medium-sized enterprises as to the why they do not engage in international trade.

(h) Collaborate on the collection of more accurate trade- and investment-related and corresponding socio-economic and environmental data, such as firm-level gender-disaggregated data on ownership, production, trade and emissions in order to further deepen understanding of the trade-offs between trade, FDI and the three dimensions of sustainable development.

58. The Committee may wish to deliberate on these and other recommendations contained in the present report, in particular with regard to the role of ESCAP in implementation of them.

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[14] See http://e15initiative.org/wp-content/uploads/2015/09/RTA-Exchange-Sustainability-Provisions-Draper-et-al.-Final.pdf.

[15] See https://www.wto.org/english/news_e/news17_e/igo_10apr17_e.htm.