

Chapter II

Uncertainties, risks and policy challenges

Uncertainties and risks

While many of the fragilities from the global financial crisis have eased, a number of uncertainties still loom on the horizon, with the potential to derail the recent upturn in global economic growth. Despite the recent uptick, the pace of global growth remains imbalanced and insufficient to make rapid progress towards achieving the ambitious targets set out in the 2030 Agenda for Sustainable Development. If downside risks to the outlook were to materialize, global growth rates could slow, with more setbacks towards achieving the Sustainable Development Goals (SDGs), particularly those of eradicating extreme poverty and creating decent jobs.

Rising trade protectionism and prolonged policy uncertainty

Amid growing discontent with globalization, a rise in trade protectionism could pose a risk to the global trade outlook, with potentially large spillovers to global growth. In the aftermath of the global financial crisis, the use of trade-restrictive measures rose considerably across both developed and developing regions. These measures include new or higher tariffs, quantitative restrictions, and a range of custom procedures. As of October 2016, only 740 of the 2,978 trade-restrictive measures introduced following the global financial crisis by World Trade Organization (WTO) members had been removed (WTO, 2016).

More recently, however, the introduction of trade restrictive measures has slowed. Between October 2016 and May 2017, WTO members introduced an average of 11 new trade-restrictive measures a month, which is the lowest monthly average in almost a decade (WTO, 2017). While this is a positive development, the high existing stock of trade restrictions and the prospects of trade policy adjustments in several major countries could hamper progress towards deeper global trade integration.

In 2017, the United States of America began to renegotiate the terms of the North American Free Trade Agreement (NAFTA) which has governed trade relations between Canada, Mexico and the United States since 1994. It also initiated an investigation into China's policies and practices that may impact exports from the United States. While the review of existing trade agreements could potentially benefit all parties, for example by improving regulatory transparency, and addressing labour and environmental issues, there is a risk that a strong focus on bilateral trade balances may result in rising trade barriers.

Meanwhile in Europe, considerable uncertainty remains over policy frameworks that will govern trade, financial and migration arrangements between the United Kingdom of Great Britain and Northern Ireland and its European Union (EU) and non-EU partners post-March 2019. This prolonged period of high policy uncertainty itself may significantly dampen investor sentiments and real economic activity.

Trade protectionism remains an important risk for global growth

Prolonged uncertainty over trade policy could weigh on investor sentiment

A move towards a more restrictive and fragmented international trade landscape will hinder a stronger and more sustained revival in the global economy, given the deep and mutually reinforcing linkages between trade, investment and productivity growth. A recent study by the Organisation for Economic Co-operation and Development (OECD, 2017c) found that for the OECD countries, a more rapid increase in trade openness was associated with higher total factor productivity (TFP) growth in the medium and long run.

In addition, Didier and Pinat (2017) showed that insertion into the middle of global value chains is associated with stronger growth. A significant rise in trade barriers by a major economy would disrupt intricate cross-border production networks, adversely affecting trade and growth prospects of all countries involved. This could be further exacerbated by retaliatory measures, leading to a prolonged period of weak global trade with spillovers to investment activity and productivity.

A more restrictive global trade environment could disproportionately affect the most vulnerable countries

Importantly, a sharply more restrictive global trade environment could disproportionately damage the most vulnerable countries. Nicita and Seiermann (2016) cautioned that large and increasing non-tariff measures pose specific challenges for the least developed countries (LDCs), including through trade distortions that affect their export competitiveness. The study estimated that eliminating these trade-distorting effects of non-tariff measures would increase LDC exports to G20 countries by about 10 per cent. An alternative measure by Evenett and Fritz (2015) estimates that foreign trade distortions reduced exports of the LDCs by 31 per cent between 2009 and 2013, thus hurting their development prospects.

Renewed stress in global financial markets

Global financial markets have been remarkably buoyant in 2017, as reflected by the increase in stock prices to historical highs, low volatility in both the equity and bond markets, and a rebound in portfolio flows into emerging economies.

Benign financial market conditions mask several lingering risks and vulnerabilities

The increase in investor risk appetite, however, masks several lingering risks and vulnerabilities in the global financial system. Notably, the prolonged period of abundant global liquidity and low borrowing costs has contributed to a further rise in global debt levels and a buildup of financial imbalances. Near-zero interest rates have also eroded the profitability of financial institutions in a few developed countries. Meanwhile, in commodity-exporting countries, persistently subdued global commodity prices continue to weigh on private and public balance sheets.

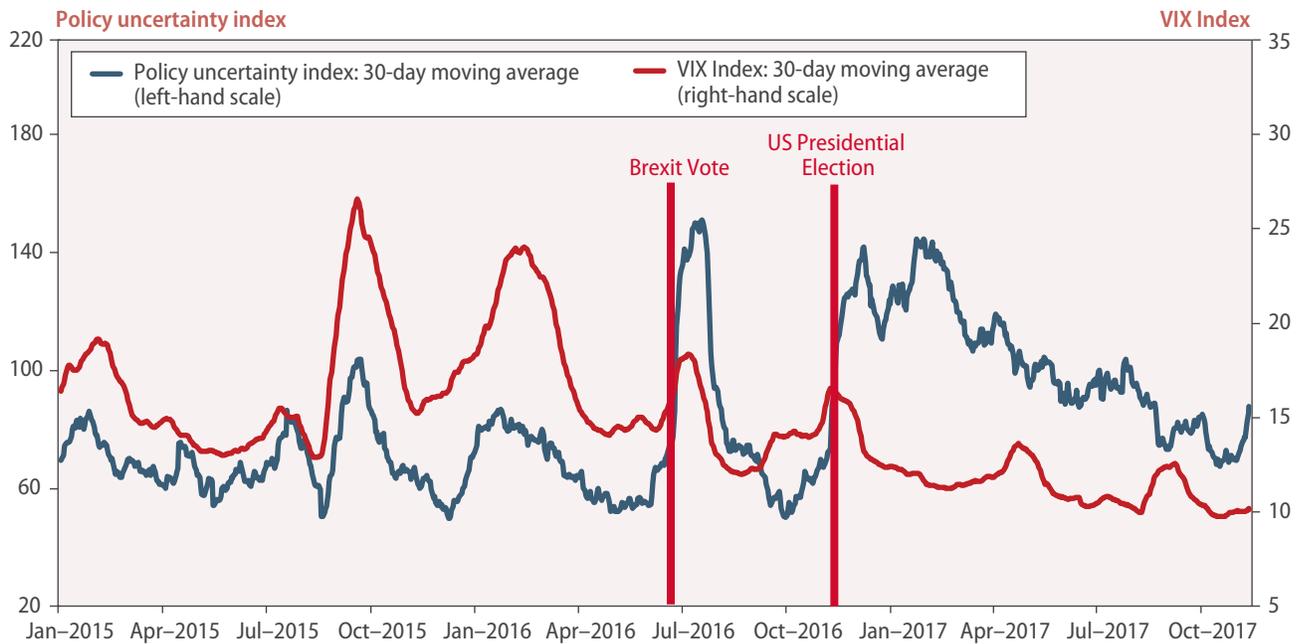
The decline in global financial market volatility is taking place against a backdrop of elevated policy uncertainty (figure II.1). This disconnect between economic policy risks and investor behaviour suggests a certain degree of underpricing of risk and market complacency.

Moreover, the rise in cyclically-adjusted price-earnings ratios to multi-year highs (figure II.2) raises concerns that stock market valuations may be overstretched. In this current environment, financial markets are susceptible to sudden shifts in investors' perception of market risk, which could in turn trigger a sharp correction in asset prices and an abrupt tightening of global liquidity conditions.

Monetary policy normalization could trigger a sudden adjustment in global financial conditions

The monetary policy normalization process in developed economies has the potential to trigger a sudden adjustment in global financial conditions. Amid improving growth and labour market conditions, the United States Federal Reserve (Fed) announced in September 2017 that alongside the gradual normalization of policy rates, it will begin to reduce the

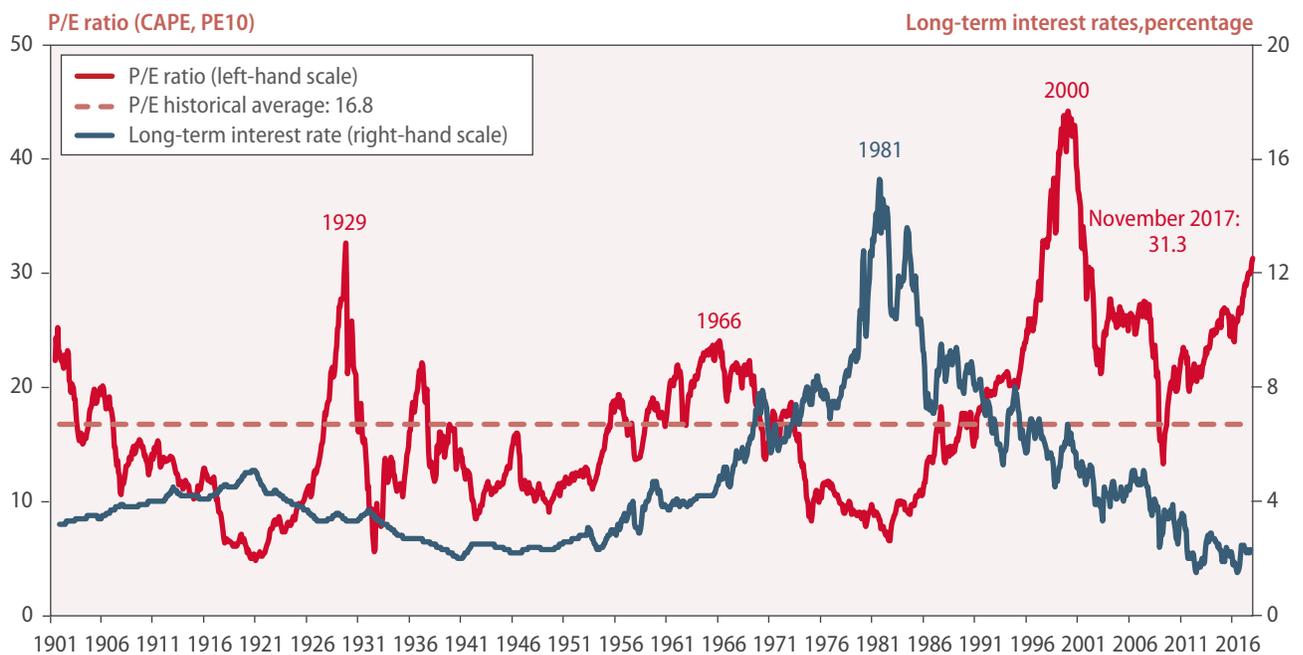
Figure II.1
Policy uncertainty index vs Cboe volatility index (VIX)



Sources: Cboe Global Markets and Economic Policy Uncertainty Index.

Note: The Cboe Volatility Index (VIX Index) is a measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

Figure II.2
Price-earnings ratio of S&P 500 index vs long-term interest rates



Source: Robert J. Shiller.

Note: CAPE, PE10 refers to the cyclically-adjusted price-earnings ratio applied to the S&P 500 Index. It uses 10 years of real earnings to smooth income fluctuations arising from business cycles. Long-term interest rates refer to 10-year US Treasury rates.

size of its balance sheet. This will be conducted through the introduction of monthly caps on the rolling off of its mortgage-backed and United States Treasury securities holdings. Meanwhile, in October 2017, the European Central Bank (ECB) announced a scale-back of its bond buying programme from 60 billion euros to 30 billion euros a month.

While the rest of the world will benefit from improved aggregate demand in developed economies, the unwinding of their central bank balance sheets entails several downside risks. Any uncertainty surrounding the pace and magnitude of normalization would mean that future policy decisions could trigger large financial market movements. The “taper tantrum” episode in 2013 is an example of the strong adverse reaction of markets to a poorly communicated policy announcement.

Central banks in developed economies operate in largely uncharted territory

Furthermore, the risk of policy mistakes is high. Central banks in developed economies are currently operating in largely uncharted territory, with no historical precedent as guidance. Following the large-scale asset purchase programmes of the past decade, central bank asset holdings are at record levels. As of September 2017, the Fed, the ECB and the Bank of Japan (BoJ) owned a total of \$14.2 trillion in assets, compared to just \$3.2 trillion in mid-2007 (see figure I.A.4 in the Appendix to Chapter I).

Interest rates and inflation remain extraordinarily low, while global debt has continued to rise, reaching record highs. In addition, the weakening, and even breakdown, of fundamental macroeconomic relationships — particularly the link between unemployment and inflation — presents a huge challenge for policymakers. This unique set of conditions makes any adjustment of financial markets less predictable than during previous recoveries and could amplify the impact of policy errors.

A key area of uncertainty is the extent to which the unwinding of central bank balance sheets in developed countries will induce portfolio rebalancing in the private sector, thus pushing up term and risk premia. A sudden increase in risk premia would cause significant adjustments to the value of risky assets, which could, in turn, lead to a sharp reversal of portfolio flows to emerging economies. This could disrupt domestic financing conditions, increasing risks to financial stability in countries with large external financing needs.

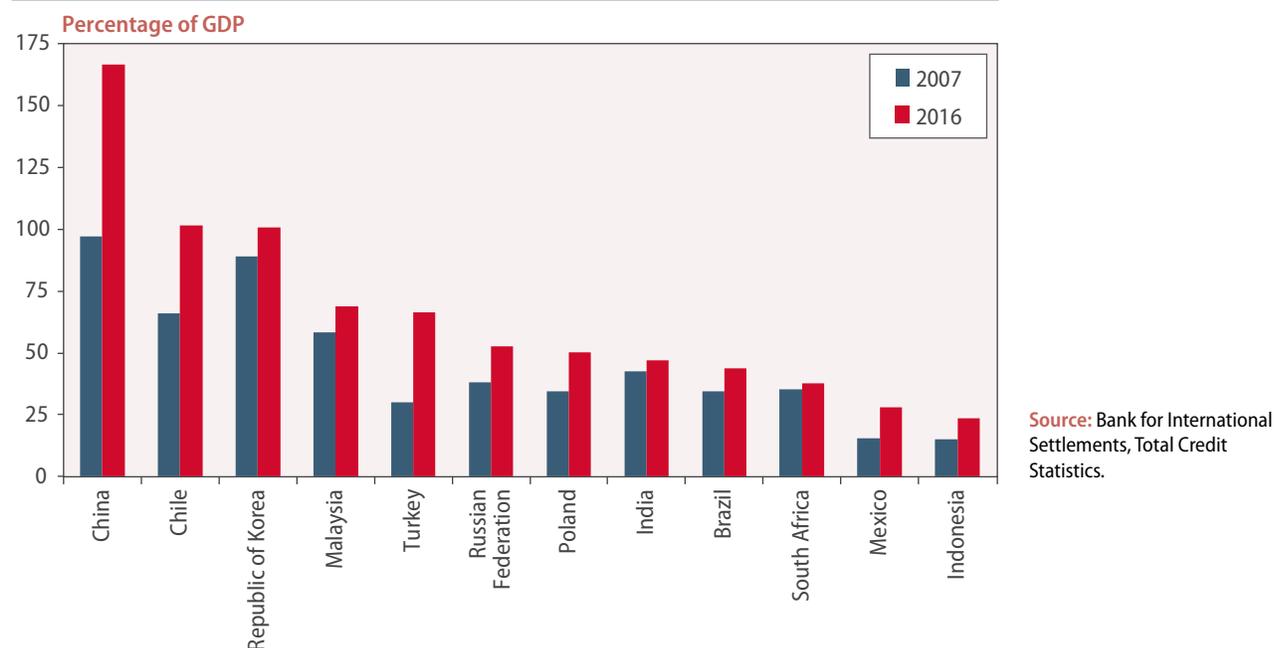
Corporate leverage has increased significantly in emerging economies

The slow withdrawal of stimulus by the Fed has thus far not led to a significant tightening of global financial conditions. Financing costs remain low, and spreads have narrowed in many emerging markets, reflecting a decline in risk premia. Nonetheless, as monetary policy normalization in the developed economies progresses, corporates may face higher borrowing costs, which will weigh on their investment capacity. For emerging economies, high corporate leverage not only constrains capital expenditure, but also poses a risk to financial stability. Recent data from the Bank for International Settlements (BIS) shows that corporate debt of non-financial emerging market corporates increased from 60.7 per cent of GDP in 2008 to 102.1 per cent of GDP in 2016.

Among major emerging economies, China has seen the sharpest increase in corporate debt in the past few years, with debt levels standing at over 160 per cent of GDP in 2016 (figure II.3). An abrupt tightening of global liquidity conditions could force corporates to deleverage suddenly in emerging economies, with adverse spillovers on banks and real economic activity.

The fragility of corporate balance sheets, particularly in several emerging economies, has also been exacerbated by the rise in post-crisis dollar-denominated debt. Although the dollar has depreciated since early 2017, as interest rates in the United States rise relative to those in other major developed economies, the dollar is likely to gain in strength. This would raise debt servicing costs and currency mismatch risks for both corporates and governments that have a high dollar-denominated debt burden. For many emerging econo-

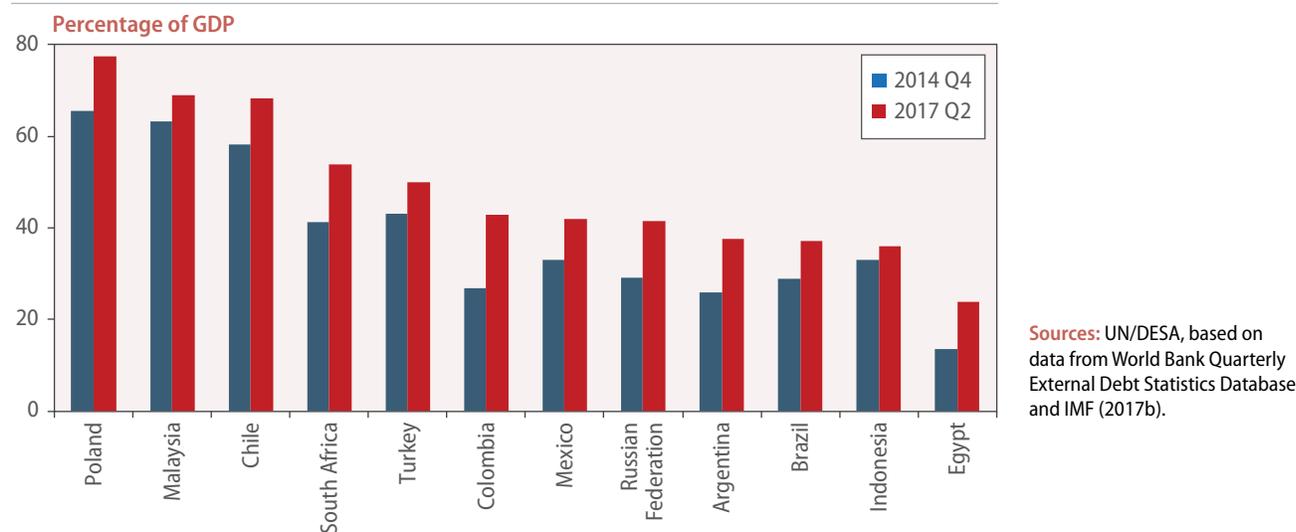
Figure II.3
Outstanding credit to non-financial corporates in selected emerging economies



mies, the broad-based strengthening of the dollar from 2014 to 2016 contributed to a rise in gross external debt as a share of GDP (figure II.4). A further strengthening of the dollar may increase the risk of corporate distress and raise fiscal sustainability concerns.

International commodity price movements also pose a risk to global financial stability. A renewed downturn in commodity prices would exacerbate fiscal and corporate sector vulnerabilities in many commodity-dependent economies, particularly in Africa, Latin America and Western Asia.

Figure II.4
Gross external debt in selected emerging economies

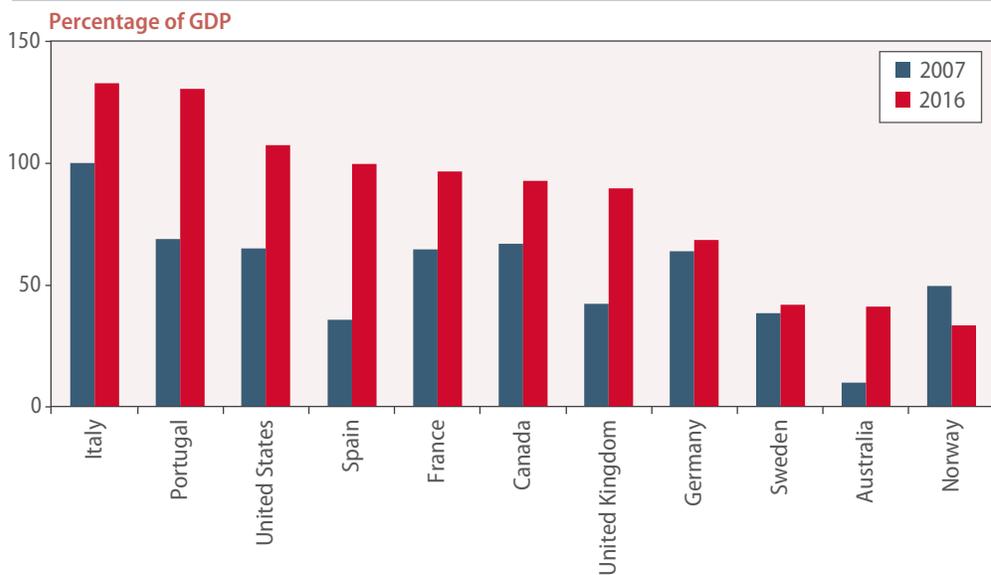


Public and private debt levels remain elevated in many developed economies

Among developed economies, many financial vulnerability indicators, including credit-to-GDP gaps, debt service ratios and non-performing loans have declined compared to the pre-crisis period. However, this benign environment could easily be reversed in response to an adverse shock given prevailing structural weaknesses. Notably, public and private sector debt remains high in most developed countries. In the public sector, government debt has continued to rise in most countries post-crisis (figure II.5), limiting the ability of policymakers to embark on large fiscal stimulus measures in the event of another financial or economic shock. In several countries, this is compounded by increasing or high gross government financing needs going forward (figure II.6).

In the private sector, both household and corporate leverage in many developed economies is higher than before the global financial crisis. In some countries such as Australia and Canada, household debt has risen in tandem with strong growth in house prices, raising the risk of a housing market correction, should liquidity conditions tighten sharply.

Figure II.5
General government gross debt in selected developed countries



Source: IMF (2017b).

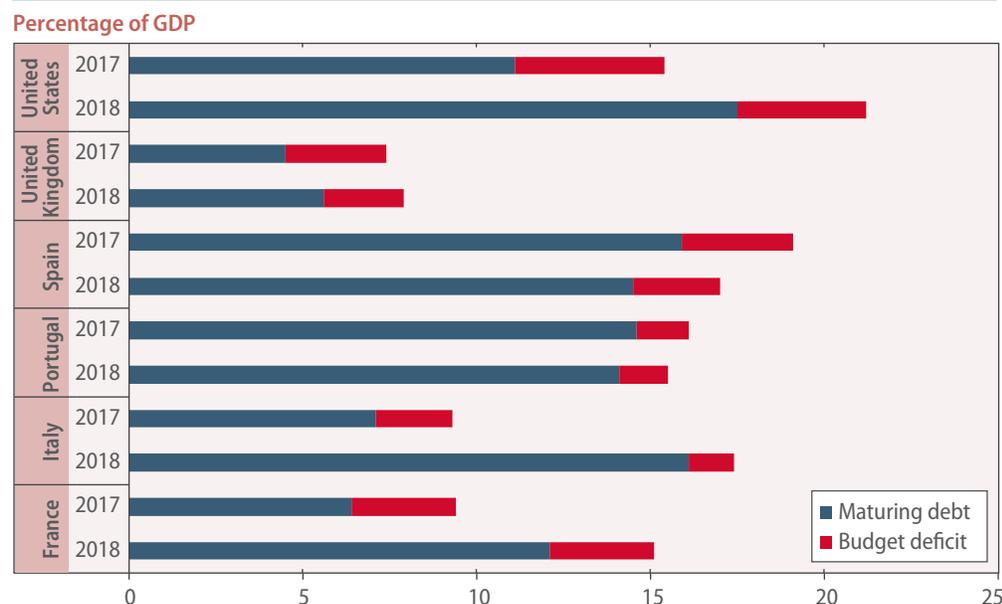
Rising geopolitical tensions and natural disasters

Increased tensions on the Korean Peninsula and in the Middle East pose risks to global growth

Rising geopolitical tensions in several areas of the world and an increased frequency of weather-related disasters pose downside risks to the world economy during the outlook period. From a global perspective, potential escalations of the Democratic People's Republic of Korea crisis and of tensions in the Middle East, especially between the Islamic Republic of Iran and Saudi Arabia, are of particular concern.

The tensions on the Korean Peninsula intensified considerably in 2017. While the probability of a large-scale military escalation appears to remain low, fears of an escalation could severely impact investor sentiment around the globe and cause greater financial volatility. The risks associated with such a scenario are particularly relevant to East Asian economies. However, a sharp rise in risk aversion among investors could have adverse consequences worldwide.

Figure II.6
Gross government financing needs of selected developed economies



An escalation of tensions in the Middle East could disrupt the region's energy exports, potentially triggering a spike in the oil price. While the relationship between oil prices and economic growth in oil-importing countries has weakened significantly over the past few decades, a sharp increase in the oil price would likely be associated with lower-than-projected global growth in 2018 and 2019.

In many other parts of the world, the continuation of violent conflict or political instability prevents meaningful progress towards sustainable development. The needed humanitarian assistance associated with violent conflict has more than doubled in the past five years, with conflict situations in many countries and regions either worsening or unchanged in 2017. In cases such as the Democratic Republic of the Congo, Nigeria, Somalia, South Sudan and Yemen, armed conflict — often in combination with famine — has resulted in the most severe humanitarian crises in decades, including large-scale displacement. Similarly, the extended crises in parts of North Africa and Western Asia continue to prevent any meaningful prospects for growth or long-term development in impacted areas, with significant spillovers to neighbouring countries. Without significant progress toward conflict prevention and resolution, prospects for economic development remain limited.

Meanwhile, weather-related shocks continue to intensify, as shown by the frequency of statistically unlikely events in the last few years alone, highlighting the urgent need to build resilience against climate change and contain the pace of environmental degradation. The number, frequency, scale, and geographic span of weather extremes continue to increase, and these factors are shaping and driving macroeconomic prospects in many countries. Climate change impacts are projected to worsen in coming decades, with most of the losses and damage falling on developing countries, in particular small island developing States (SIDS) and LDCs. Additional policy challenges faced by SIDS are discussed in Box II.1.

In many countries, violent conflict or political instability impede progress towards sustainable development

Higher frequency of weather-related disasters poses risks, especially for many developing countries

Policy challenges

Raising the potential for sustainable growth

Policymakers have greater scope to reorient policy towards longer-term potential for sustainable growth

Despite stronger growth in 2017, a number of deep-rooted issues continue to hold back more rapid global progress along the economic, environmental and social dimensions of sustainable development. As headwinds from recent crises subside, the world economy has strengthened, offering policymakers greater scope to tackle these longer-term issues.

The last decade has been punctuated by a series of broad-based economic crises and negative shocks, starting with the global financial crisis of 2008–2009, followed by the European sovereign debt crisis of 2010–2012 and the global commodity price realignments of 2014–2016. Reacting to these crises understandably put policymaking in a reactive, emergency mode, often focused on avoiding an implosion of the global or national financial system. At the same time, this emergency mode tended to crowd out more intense and concerted efforts regarding the long-term sustainability of growth.

While a number of risks and uncertainties remain, what stands out in the current economic environment is the alignment of the economic cycle among the major economies, stability in financial market conditions, and the absence of negative shocks such as commodity price dislocations. As conditions for more widespread global economic stability solidify, as illustrated by the onset or planned reversal of the accommodative monetary policy stances in major developed economies, there is less need to focus policy efforts on stabilizing short-term growth and mitigating the effects of economic crises. Coupled with improving investment conditions, this creates greater scope to reorient policy towards longer-term issues, such as strengthening the environmental quality of economic growth, making economic growth more inclusive, and tackling institutional deficiencies that hold back development.

Deep-rooted challenges remain obstacles to sustainable development

Numerous longer-term challenges persist across the world that continue to hold back more rapid progress towards sustainable development. Weak governance structures, inadequate basic infrastructure, high levels of exposure to weather-related shocks and natural disasters, as well as challenges related to security and political uncertainty are prevalent. Declining or stagnant wage growth, and high levels of unemployment, vulnerable employment and working poor afflict numerous economies across the globe.

The quality of economic growth continues to be undermined by rising inequality, unremitting environmental degradation, and persistently high levels of poverty in some regions. As a consequence, policymakers should use the current macroeconomic backdrop in order to address four key areas: (1) increasing economic diversification; (2) creating a supportive environment for long-term investment in key areas; (3) reducing inequality; and (4) improving the quality of institutions.

Policymakers need to take meaningful action to achieve more economic diversification

Among these endemic issues, economic diversification must be developed in countries that remain heavily dependent on a few basic commodities. Commodity exporters remain vulnerable to steep boom and bust investment cycles, as volatile prices pass through to macroeconomic conditions. This is clearly evidenced by the heavy economic costs faced by many commodity exporters as a result of recent commodity price realignments.

Without diversification, countries are much more vulnerable to external shocks, seriously complicating macroeconomic policy management and impacting their capacity for stable growth. Expanding less volatile sectors of the economy should be accompanied by fiscal reforms to restructure and broaden the revenue base in order to reduce fiscal dependency on short-term commodity revenue. The planned introduction of a value-added tax in

Cooperation Council for the Arab States of the Gulf (GCC) countries is a recent example of such fiscal reforms (see Box III.4).

Investments in human capital, creating more transparent governance and institutions, closing infrastructure gaps and investing in environmental resilience can also help support economic diversification, while spurring the creation and diffusion of technology and support social progress.

Better investment conditions have led to a modest revival in productive investment in some large economies. However, this revival is relative to a very low starting point, following a prolonged episode of lacklustre global investment, that has allowed the capital stock in developed economies to stagnate. This legacy of weak investment and low productivity growth since the global financial crisis continues to weigh on medium-term growth prospects. Reinvigorating global productivity and raising the longer-term capacity for sustainable growth remain key global policy challenges, in order to accelerate progress towards the SDGs.

Investment patterns play a crucial role in stimulating productivity growth through a myriad of channels. Investing in research and development spurs innovation activities and the creation of knowledge, which drives advancements along the technology frontier.

Meanwhile, investment in machinery and equipment plays a crucial role in improving firms' capacity to adopt existing technology and processes, promoting growth through knowledge diffusion. Investment in infrastructure not only provides the basic enabling conditions for economic growth and development, but also for the creation and strengthening of competitive advantages and promotion of product specialization. Crucially, investment in human capital and expanding healthcare access support the productive capacities of the labour force, including their capacity to exploit new and existing technologies.

In this regard, concrete policy measures include investment in the quality of education, broadening access to education and upskilling or reskilling of the workforce. Policies can also be designed to create financial incentives, via tax breaks and subsidies, to encourage private sector firms to invest in innovation and infrastructure.

Promoting private sector involvement in areas that raise the long-term sustainable growth path is an essential element of garnering the financial resources to support sustainable development. A range of measures can support this process, including public investments that crowd-in private investments and public-private partnerships, better institutional capacities in the public sector, regulatory changes and structural reforms.

It is also important, as a prerequisite for achieving the 2030 Agenda for Sustainable Development, to ensure that investment is channeled towards longer-term sustainable and resilient infrastructure. With recent economic growth comes greater risks to environmental sustainability. At a time when many developing countries continue to suffer from severe shortages of energy supply, there is enormous potential to lay the basis of environmentally sustainable growth in the future through smart policies and investments today. The same can be said for investment in other basic infrastructure, especially where developing countries can benefit from the chance to leapfrog technologies.

High impact weather-related shocks and climate extremes are rising. Disruption to water, electricity, transportation and communication networks in the wake of disaster events severely impacts communities' well-being, security, social welfare and health. Diffusion of best-practice network design, predictive tools, outage identification and crisis response must be ramped up for disaster preparedness. South-South cooperation in the transmission of clean and resilient technologies should be fully explored, as the technology and skills of

Targeted investments are needed for higher productivity and potential growth

Investing in resilient and sustainable infrastructure is crucial to adapt to climate change

Box II.1

**Foreign direct investment in the small island developing States:
Trends and policies**

Growth in the small island developing States (SIDS) is projected to rise modestly from an estimated 2.6 per cent in 2017 to 2.7 per cent in 2018 and 2.8 per cent in 2019. These growth projections reflect a relatively subdued outlook for the SIDS, particularly when compared to the LDCs, which as a group are expected to grow by 5.4 per cent in 2018 and 5.5 per cent in 2019.

For commodity exporting SIDS, revenues will be supported by the gradual recovery in global commodity prices. In the aftermath of devastating natural disasters, reconstruction efforts will provide a temporary boost to growth in a few Caribbean and Pacific SIDS. In addition, many SIDS are expected to benefit from an improvement in remittance inflows and tourism earnings,^a amid the continued expansion in global income. The short-term growth outlook for the SIDS, however, remains highly susceptible to natural catastrophes and weather-related shocks. For the SIDS with poorly diversified economic structures, growth remains vulnerable to large swings in commodity prices.

From a medium-term perspective, the SIDS continue to face significant challenges in their access to development finance. A worrying trend for the SIDS is the recent decline in foreign direct investment (FDI). In 2016, aggregate FDI flows into the SIDS fell for the second consecutive year, declining by 6.2 per cent to \$3.5 billion (UNCTAD, 2017c). For many SIDS, FDI represents an important external source of development finance, accounting for more than 10 per cent of GDP annually.

Given rich marine biodiversity, FDI flows into the SIDS over the years have been largely concentrated in the tourism and fishing sectors. Several countries have also experienced strong FDI in the mining sector, thanks to large endowments of commodities such as oil and gas, gold and bauxite. The provision of various incentives for foreign companies to establish financial and trading operations have also boosted FDI in business process and offshore financial services (UNCTAD, 2014). More recently, FDI flows into many Caribbean and Pacific SIDS have increasingly been channeled into the telecommunications sector.

The SIDS face considerable structural headwinds in attracting stronger FDI flows. The small market size of these economies prevents gains from economies of scale, leading to higher production costs. This is compounded by remoteness from international markets, inadequate infrastructure and high transport costs.

Foreign investors also face risks arising from the high exposure of SIDS to global environmental challenges, including to a large range of effects of climate change and potentially more frequent and intense natural disasters.^b Hurley (2015) highlights that climate adaptation costs are among the highest in the world for the SIDS.

These long-term factors have been exacerbated by the generally weak economic performance of SIDS since the global financial crisis. Slow GDP growth and large fiscal imbalances have created a macroeconomic environment that is not conducive to FDI (De Groot and Ludeña, 2014).

(continued)

^a See <http://media.unwto.org/press-release/2017-09-07/international-tourism-strongest-half-year-results-2010>

^b For more information, please see <https://sustainabledevelopment.un.org/topics/sids>

Stemming and redressing the rise in inequality is crucial for ensuring balanced and sustainable growth

multinational firms from other developing countries are often a closer match. Developed and developing countries alike must accelerate the transition to sustainable energy.

Closing crucial infrastructure gaps will not only bring wider macroeconomic productivity gains, it will also advance the social dimensions of sustainable development and poverty alleviation. In order to eradicate extreme poverty by 2030, an environment must be fostered that will both accelerate medium-term growth prospects and tackle poverty through policies that address inequalities in income and opportunity. Stemming and redressing the rise in inequality in both developed and developing countries is crucial for ensuring balanced and sustainable growth going forward. This requires a combination of short-term policies to raise living standards among the most deprived, and longer-term policies that address inequalities in opportunity.

In the short term, introducing a more progressive system of taxation and benefits to strengthen the redistributive role of fiscal policy and social safety nets will not only spur

In several Caribbean SIDS, public debt levels exceed 100 per cent of GDP, implying a need for fiscal consolidation and raising financial distress risks. In fact, over the past decade, many SIDS had to restructure their debt in an effort to reach more manageable levels. Persistently weak fiscal positions have also limited governments' ability to provide much-needed infrastructure. These conditions have resulted in a low level of profitability of FDI in SIDS, compared to other regions.

In efforts to attract more FDI flows, several SIDS have introduced a range of policy strategies, including:

Policies to improve the overall business climate	<ul style="list-style-type: none"> • Reducing bureaucratic hurdles • Guaranteeing property rights
Policies to reduce challenges specific to foreign investors	<ul style="list-style-type: none"> • Liberalizing migration policies for foreign workers • Guaranteeing non-discrimination in (government) procurement between domestic and foreign suppliers • Concluding Double Taxation Agreements (DTAs) with other countries
Setting up investment promotion agencies	<ul style="list-style-type: none"> • Opening foreign trade offices aimed at providing information to potential investors
Financial incentives	<ul style="list-style-type: none"> • Tax holidays or exemptions from import and export duties • Grants or subsidies for the initiation or continuation of certain investments (costly option)

Policymakers need to bear in mind that what matters for sustainable development is not only the quantity of FDI inflows, but also the quality. Some FDI activities create very limited positive spillovers in national economies. Hence, strategies should be tailored towards attracting quality FDI in line with long-term national development plans. This includes FDI that promotes greater economic diversification, supports domestic industries through backward linkages and promotes the adoption and diffusion of technology. Importantly, policymakers need to ensure that FDI activities do not cause environmental damage, which would further exacerbate the structural weaknesses of the SIDS.

While important, FDI represents only one area of financing for development. In fact, the past decade has seen changes in the financing landscape, with new actors and financing sources gaining importance, including donors that are not members of the Development Assistance Committee of the OECD.

These include non-government organizations, climate funds, innovative financing mechanisms and South-South cooperation initiatives. Private portfolio capital has also become a more important source of financing, as well as workers' remittances and voluntary private contributions. These changes have broadened the options for financing activities in the context of the 2030 Agenda. Nevertheless, a major challenge is to coordinate these new sources of financing and mechanisms within a coherent financing for a development framework at the national level.

Box II.1 (continued)

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domestic demand, but also contribute to more sustainable and inclusive growth. Active labour market policies can broaden access to the labour market, especially for women. Addressing urgent cases of need to protect the most vulnerable, especially in conflict-affected areas, remains a global priority.

Over the longer term, investment in tackling inequalities in opportunity will not only improve the quality of growth but increase its longer-term potential. This includes, for example, investment in early childhood development, building and ensuring universal access to functioning healthcare systems, broadening access to education, and investment in rural roads and electrification. Creating opportunities to retrain and acquire new skills, as well as programmes to help match available jobs to available skills, are crucial complements to social safety nets, aiding displaced workers and young people to integrate into the job market. These programmes can help tackle the widespread global challenge of youth unemployment. In addition, they can provide security against job displacement related to

Strengthening governance and improving the quality of institutions must move to the forefront of policy objectives

ongoing and future structural change in production that may be associated with deeper trade integration or technological change.

Weak governance and political instability remain fundamental obstacles to achieving the 2030 Agenda for Sustainable Development. Strengthening legal institutions and administrative capacities, coupled with progressive reform in the regulatory environment and the business environment, can increase transparency in administrative processes, support effective protection of property rights and improve capacities for redistributive fiscal policy.

Addressing some of these barriers is essential to ensure that available finance is channeled towards productive investment. It may also strengthen business confidence, help reduce country risk perceptions, and support inflows of capital in some countries. Tackling the institutional deficiencies that underpin many of these obstacles must move to the forefront of policy objectives.

Reorienting policy to deal with these challenges and maximizing co-benefits between development will bring both short-term and long-term benefits. Current investment in education, expanding access to healthcare, building resilience to climate change, improving the quality of institutions, and building financial and digital inclusion will support economic growth and job creation in the short-term, accelerate progress along the social and environmental sustainable development dimensions, and raise the longer-term potential for sustainable growth.

Making the international financial system work for sustainable development

A new framework for sustainable finance is needed to channel available finance towards socially beneficial investment

A well-designed global financial architecture is at the heart of a dynamic global economy promoting sustainable development. A sound financial system is essential to ensure smooth international financial flows from the developed to the developing economies, and to channel available financial resources towards socially beneficial investment. Despite the current buoyant financial market sentiment, there are lingering risks and vulnerabilities that could derail global growth and hamper progress towards the SDGs. In addition, more resources should be mobilized to finance the large investment needs required to achieve the SDGs.

In this context, policymakers face three interconnected sets of challenges. *First*, they must tackle the short-term financial risks outlined above. Most importantly, this means steering the world economy through monetary policy normalization in developed economies and a potential tightening of liquidity conditions.

Second, policymakers must accelerate efforts to make the international financial system more stable and resilient to crisis. Much has been done in this regard since the global financial crisis, but as significant flaws in regulatory and supervisory frameworks persist, the international financial system is still prone to boom and bust cycles, which can entail large economic and social costs in the short- and medium-term. *Third*, they must redouble their efforts to realign the global financial architecture with the 2030 Agenda for Sustainable Development and the Addis Ababa Action Agenda (AAAA), in order to support investment in areas that will enhance productivity gains and progress towards social and environmental goals. This requires creating a renewed framework for sustainable finance and shifting away from short-term profit towards long-term value creation (Schoenmaker, 2017).

Managing the ongoing monetary policy normalization in the United States — and then in Europe — encompasses significant challenges not only for the authorities that

Developing countries are better prepared to navigate sudden changes in global financial conditions than in previous decades

decide on the pace and timing of decisions, but also for policymakers in developing countries that could face abrupt shifts in financing conditions.

In particular, the Fed, the ECB and the Bank of England will need to strike a delicate balance in raising policy rates and unwinding their massive balance sheets. On the one hand, they must support real economic activity and maintain price stability. On the other hand, they need to prevent financial market turbulence and avoid a further buildup of the financial vulnerabilities that have accumulated over the prolonged period of ultra-loose monetary conditions. Finding the adequate balance will require accurate assessments of underlying economic and financial conditions and trajectories, appropriate decisions on the timing and pace of monetary normalization, and well-communicated plans that anchor market expectations.

Meanwhile, developing countries, especially emerging economies with large external financing needs, should prepare themselves for a period with potentially lower and more volatile capital flows, tighter liquidity conditions and a more constrained monetary policy space. The majority of large emerging economies appear to be in a better position to navigate turbulent global financial conditions than in previous decades. This is due to greater exchange rate flexibility, relatively high levels of international reserves and, in some cases, improved macroeconomic management. While appropriate measures depend on country-specific conditions, policymakers should generally try to contain corporate leverage, which will help enhance resilience to external shocks.

The past decade witnessed far-reaching reforms to tackle legacies from the global financial crisis and to make the international financial system more stable. Efforts have been centred on regulatory and supervisory measures to strengthen the banking sector, particularly the global systemically important banks (G-SIBs), which are located in China, Europe, Japan and the United States. The main objectives were to strengthen the balance sheets of large banks by improving their capital, liquidity and risk management positions, and to address the “too-big-to-fail” problem by establishing viable resolution frameworks for internationally operating banks.

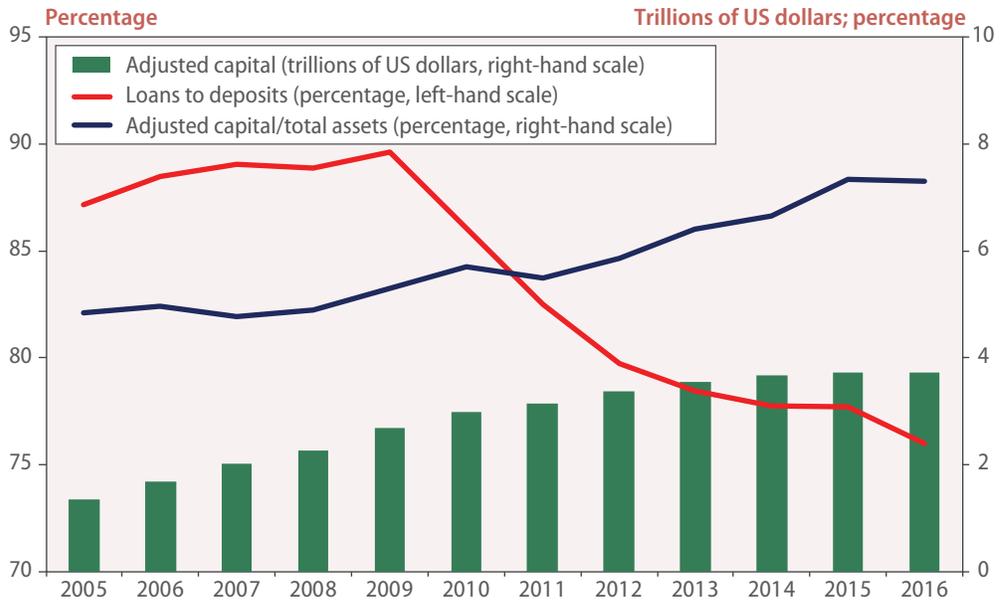
Economists largely agree that balance sheets of large, internationally operating banks have strengthened since the global financial crisis. For instance, capital ratios and liquidity indicators in G-SIBs have risen considerably (figure II.7), while capital shortfall has almost disappeared (BIS, 2017b). In addition, banks have made progress in addressing overhanging issues of the crisis, especially in writing off bad loans. Despite visible improvements, it is unclear how vulnerable balance sheets of large globally operating banks are to a combination of higher interest rates and significantly lower asset prices. Progress has also been uneven, with several European banks still struggling to reduce the amount of non-performing loans. With respect to the “too-big-to-fail” problem, the progress has been slow, underscoring the need to further strengthen national resolution mechanisms, while also developing cross-border resolution plans.

Against this backdrop, financial stability risks appear to have shifted from the banking sector to non-banking institutions, which often do not face the same regulatory restrictions as banks. For instance, in developed economies some concerns have been raised regarding the financial strength of life insurers (IMF, 2017a). At the same time, the non-bank financial sector has grown rapidly in several emerging economies in recent years. According to some estimates, shadow banking represents up to 35–40 per cent of the financial sector in some countries of East Asia (Ghosh et al., 2012). A vital role in promoting financial stability and containing these risks is played by macroprudential policies. Macroprudential policy measures can reduce excessive credit growth and curb leverage, as well as limit

The issue of “too-big-to-fail” remains largely unresolved

Financial risks seem to have risen in non-banking institutions, which are usually subject to less restrictive regulations

Figure II.7
Global systemically important banks: capitalization and liquidity indicators



Source: UN/DESA, based on data from IMF (2017a).

liquidity risks and address structural vulnerabilities in the financial sector. This is especially important in countries with greater financial openness, larger financial markets and more complex financial instruments. Looking ahead, it is important to coordinate macroprudential policies with monetary policies, so that the objectives of price and financial stability reinforce each other, strengthening a more sustainable growth trajectory (Box II.2).

Financial sector incentives need to shift from the current focus on short-term profit towards a target of long-term value creation

Aligning the international financial sector's framework and incentives towards long-term investments and sustainable development is a key issue moving forward. The financing needs for SDGs are enormous. The current international financial system does not allocate enough financial resources towards long-term sustainable development, including significant gaps in areas such as infrastructure, healthcare, education and renewable energies. Therefore, achieving the SDGs requires an increase in the mobilization of long-term public and private resources and a new set of policies and regulatory frameworks that incentivize investment patterns that are consistent with sustainable development. Crucially, this includes a shift from the current focus on short-term profits towards a target of long-term value creation.

Currently, there are several practices that reinforce a short-term approach, including quarterly financial reporting by firms, monthly or quarterly benchmarks for performance, fee structures with asymmetric returns, and mark-to-market accounting. Institutional investors have been widely identified as a potential source of financing for sustainable development, because of the size of assets under their management and their long-term liability structure. For example, infrastructure investment could be particularly attractive to these investors because of its low-risk and stable real return profile.

Yet, a shift of even a minor fraction of these vast resources towards sustainable development is enormously challenging. Promoting this requires designing and enacting a new set of policies and capital market regulations along the investment chain that are aligned with long-term performance indicators.

Box II.2

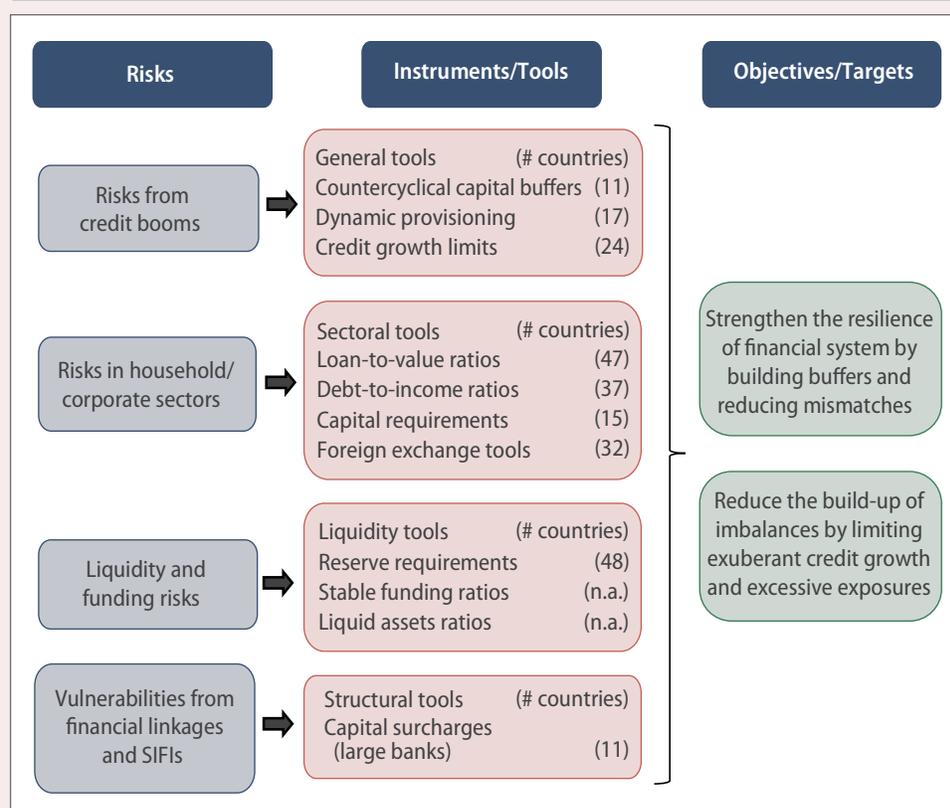
The initial and learning stages of macroprudential policies in emerging economies

A clear lesson for policymakers that arose from the global financial crisis is that price stability does not ensure macroeconomic stability, contrary to the neoliberal views that have been advocated in previous decades. Thus, in the wake of the crisis, there have been stronger calls for the use of stricter financial regulations to contain macro-financial risks. It also became apparent that credit and asset price boom-and-bust cycles can entail large economic and social costs in the short and medium-term.

Given the high degree of interconnectedness between financial institutions, a shock could spread rapidly across the entire system. Hence, there has been a growing consensus that financial regulation should move from a “micro” approach based on individual institutions towards a “macro” framework, with an emphasis on systemic risks of the financial system as a whole. In fact, the tendency of financial markets to be highly procyclical and to go through recurring cycles of “*manias, panics and crashes*,” as described by Kindleberger (1978), coupled with macro-financial feedback mechanisms, increases its exposure and vulnerability. In this regard, the implementation of macroprudential policies has visibly risen in emerging economies in recent years, with the objectives of strengthening financial sector resilience and curbing the build-up of imbalances. While some policy tools in this area are certainly not new, the macroprudential framework is clearly a recent phenomenon.

Figure II.2.1 provides an overview of the various financial risks that policymakers face, the macroprudential instruments that are available and their objectives. Importantly, evaluating financial vulnerabilities and imbalances requires consideration of the time dimension (credit growth, risks in corporate

Figure II.2.1

A panorama of macroprudential policies in emerging economies

Source: UN/DESA based on Arregui (2016) and Vazquez (2016).

Note: SIFIs: systemically important financial institutions.

(continued)

Box II.2 (continued)

and household sectors) as well as structural characteristics (interlinkages between financial institutions). In brief, operationalizing macroprudential policies requires translating systemic risk assessments into policy measures. This entails the design, implementation, calibration and activation/deactivation mechanisms, evaluation of potential leakages, and evaluation of impact (IMF/FSB/BIS, 2016). Recent examples of macroprudential measures in emerging economies are the introduction of loan-to-value ratio targets in Hong Kong SAR, sectoral capital requirements in Brazil and Poland, dynamic provisioning in Colombia and Peru, caps to foreign exchange loans in the Republic of Korea, liquidity ratio and countercyclical reserve requirements in Colombia, and reserve requirements in Brazil, Peru and Turkey, among others.

Assessing the recent experiences of the emerging economies in their usage of macroprudential tools is complex. However, it is possible to derive a few stylized facts. *First*, a “one-size-fits-all” approach is not suitable in the case of macroprudential policies. Country-specific circumstances, including diverse institutional frameworks, affect not only the capacity to implement certain policy measures, but also their effectiveness. *Second*, emerging economies are currently undergoing a learning path, characterized by experimentation and trial and error processes, regarding not only the policy tools but their institutional frameworks. In fact, there is a wide range of macroprudential instruments, and in many cases the optimal arrangements entail the use of several tools. In addition, macroprudential measures need to be calibrated through activation and deactivation rules that should be refined over time. *Third*, a better understanding needs to be developed regarding the interaction and the complementarities of macroprudential policies with other policies. This is particularly the case with monetary policy, as the feedback mechanisms between the objectives of price stability and financial stability encompass several challenges. It is also the case with capital controls, where the objectives of managing the size and composition of capital flows sometimes overlap with macroprudential policies. Interestingly, capital controls have re-emerged as a policy tool since the global financial crisis, as emerging economies have gained more independence to implement them, while new and less dogmatic views regarding their effectiveness have arisen in academia and international organizations.

Against this backdrop, the evidence concerning the effectiveness of macroprudential policies is still in its infancy, and remains largely aggregate and preliminary. Thus, it is not possible to derive strong policy conclusions nor to extrapolate successful policy measures. Yet, incipient evidence suggests that macroprudential measures do play a role in containing procyclical pressures and promoting financial stability. For example, restrictions on loan-to-value and debt-to-income ratios are associated with a reduction in credit growth, most notably in the emerging economies’ household sector (Cerruti, Claessens and Laeven, 2015). Also, macroprudential tools targeting liquidity risks tend to restrain leverage and growth in house prices. In addition, some studies emphasize that the impact of these measures is contingent on aspects such as the development of financial markets, potential for domestic and cross-border leakages and the coordination with monetary policy (Galati and Moessner, 2017). New questions are also arising. For example, a crucial issue for emerging economies is how to assess financial vulnerabilities when the financial sector is deepening. Overall, it is apparent that this is a crucial policy area and will be even more so in the decades to come.

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More generally, long-term investments require investors’ time horizons to be protracted enough to finance long-duration assets and, importantly, require that investors are able to hold a position throughout the business cycle, including downside events. This was a critical issue during the global financial crisis, as many firms were unable to hold illiquid assets, with severe consequences for investment in sustainable development.

Using trade integration as an engine for global growth and development

Concerted international efforts are needed to advance a global SDG-oriented trade agenda that increases the development impact of trade. The trade integration process of the last decades has created vast opportunities for countries to enhance and implement their

economic and social development strategies. Still, the uneven distribution of the benefits of trade integration — both between and within countries — threatens to undermine the development potential of trade, to further increase inequalities and to hamper the achievement of the SDGs.

These challenges call for a proactive, holistic and coherent policy mix that recognizes the evolving nature of trade in response to technology, connectivity and new business models, promotes positive structural transformation, and facilitates competitiveness, diversification and upgrading of production structures.

Mainstreaming trade policies into development frameworks can help promote poverty reduction, industrialization, job creation, food security, gender equality and environmental sustainability. In addition, the risks, costs and trade-offs associated with trade liberalization measures, including constraints on national regulatory autonomy and policy space, must be addressed. This requires adjusting the content, pace and sequencing of liberalization so that regulatory and institutional frameworks retain the possibility to respond to new challenges.

The challenges associated with trade integration also call for promoting skills development, expanding social safety nets and introducing adjustment mechanisms, including by allowing countries to adequately revise commitments (UNCTAD, 2017d). In this context, support to developing countries, and in particular the LDCs, remains critical, for example through inclusive rules of origin, preferential treatment, capacity building initiatives and aid for trade.¹

A universal, rules-based, open, transparent, non-discriminatory and equitable multilateral trading system is a key element of a global partnership for sustainable development. United Nations Member States have repeatedly committed to promoting the multilateral trading system, in line with the internationally-agreed development goals, as provided by target 17.10 of the SDGs² (Box II.3).

Rising uncertainty over the direction of trade policies has reinforced the importance of revitalizing the multilateral trading system as a global public good and a cornerstone of the global governance framework. Multilateral rules and disciplines are the best guarantee against protectionism, and fundamental to transparency, predictability and stability of international trade. These rules and disciplines are underpinned by the WTO's dispute settlement mechanism, which ensures the smooth flow of panel proceedings and remedial actions in case of non-compliance. The importance of the multilateral trading system is also supported by the fact that membership has become almost universal. Since 1995, 36 countries — including 9 LDCs — have acceded to the WTO, bringing the total number of members to 164. Against this backdrop, a positive outcome at the Eleventh WTO Ministerial Conference in December 2017 in Buenos Aires, Argentina (MC11) is critically important as it would enhance the relevance and effectiveness of the multilateral trading system.

Fully delivering on existing mandates is critical, including those emerging from the Tenth WTO Ministerial Conference in December 2015, Nairobi, Kenya (MC10) to redress existing imbalances and uphold the development dimension. This is, however, complicated by the fact that the outcome of MC10 revealed a lack of consensus on the mandate. While many WTO members reaffirmed the Doha Development Agenda, others did not,

Linking trade to development requires a coherent policy mix, adequate liberalization and support to developing countries

The multilateral trading system is a global public good and needs to remain a cornerstone of the global governance framework

The upcoming Eleventh WTO Ministerial Conference aims to address a range of key issues

¹ UNCTAD's toolkit on trade and services policy supports developing countries' engagement in the trading system, including in preparation for the Eleventh WTO Ministerial Conference and its follow-up.

² For instance, see General Assembly resolution 70/187 of 22 December 2015 and 71/214 of 21 December 2016. See also United Nations, General Assembly (2015; 2016).

saying that new approaches are necessary to achieve meaningful outcomes in multilateral negotiations.

Several countries held the view that the lack of consensus opened the door to unbundle a single undertaking and to address new issues. Many others argued that, without a consensus decision to the contrary, the Doha Round remained in force. This disagreement is also reflected in the implementation of some MC10 decisions, which remain issues in the run-up to MC11.

Priority issues of MC11 include the following: (a) elements of domestic support in agriculture, based on updated notifications; (b) a mandated permanent solution for public stockholding for food security purposes; (c) the multilateral process on fishery subsidies; (d) domestic regulations in services including trade facilitation; (e) special and differential treatment and issues of particular relevance for the LDCs, including cotton, and; (f) a set of new issues such as e-commerce, micro, small and medium enterprises and investment facilitation. Market access in agriculture and services, non-agricultural market access (NAMA), rules other than fishery subsidies, and other key issues to the Doha Round are put on hold in the absence of major progress.

The domestic support pillar is central for MC11 in the face of persistent agricultural subsidization by major economies

Important subsidization in agriculture by major economies persists, especially in the EU and the United States, but also in China and India. Major economies have shifted most of their support to the so-called green box, which is meant to be minimally or non-trade-distorting. However, given the scale of the support, there are de facto major trade-distorting effects.

The absence of meaningful agricultural policy reform since the beginning of the Doha Round and the persistence of distorted markets, largely seen as penalizing most developing countries, makes the domestic support pillar a central issue for MC11. This includes proposals to give greater scrutiny to, and possibly capping, the amount of trade-distorting support.

Of particular relevance is the case of cotton. The so-called Cotton-4 countries (Benin, Burkina Faso, Chad and Mali) have proposed a progressive phasing out of all forms of trade-distorting domestic support for cotton and its by-products. The MC11 will also aim for a package of commitments prohibiting subsidies that contribute to overfishing and overcapacity, and addressing illegal, unregulated and unreported fishing as a means to support the implementation of target 14.6 of the SDGs. Developing countries relying on fish for food security, livelihood and export earnings have emphasized the need to retain flexibility.

Food security is also at the centre of the MC11 agenda

There is also growing attention among major developed and several developing countries given to obtaining a permanent solution for trade-related measures that are taken for food security purposes, particularly for public stockholding programmes. An interim peace clause was agreed at the Ninth WTO Ministerial Conference and reaffirmed at MC10, protecting developing countries that buy stocks of food from their farmers from legal challenges. The Special Safeguard Mechanism (SSM) is also relevant for food security measures subject to negotiations, as it is considered an important tool to counteract against sudden import surges or price falls to protect the local production of staple food.

Domestic regulation of services remains a controversial issue

Multilateral discussions on services are focused on domestic regulation disciplines, which emerge from the General Agreement on Trade in Services (GATS) to ensure that licensing, technical standards, qualification requirements and procedures do not constitute unnecessary barriers to trade. The debate has shifted to a set of specific elements of domestic regulation, including administration and development of measures as well as transparency.

Box II.3

The multilateral trading system and the 2030 Agenda: Insights from trade agreements

International trade can be used as a way to implement the 2030 Agenda for Sustainable Development. To harness its potential, trade policies need to be coherent with and supportive of the Sustainable Development Goals. Trade liberalization can foster economic growth, but we need to ensure that it does not lead to lower labour or environmental standards for the sake of competitiveness.

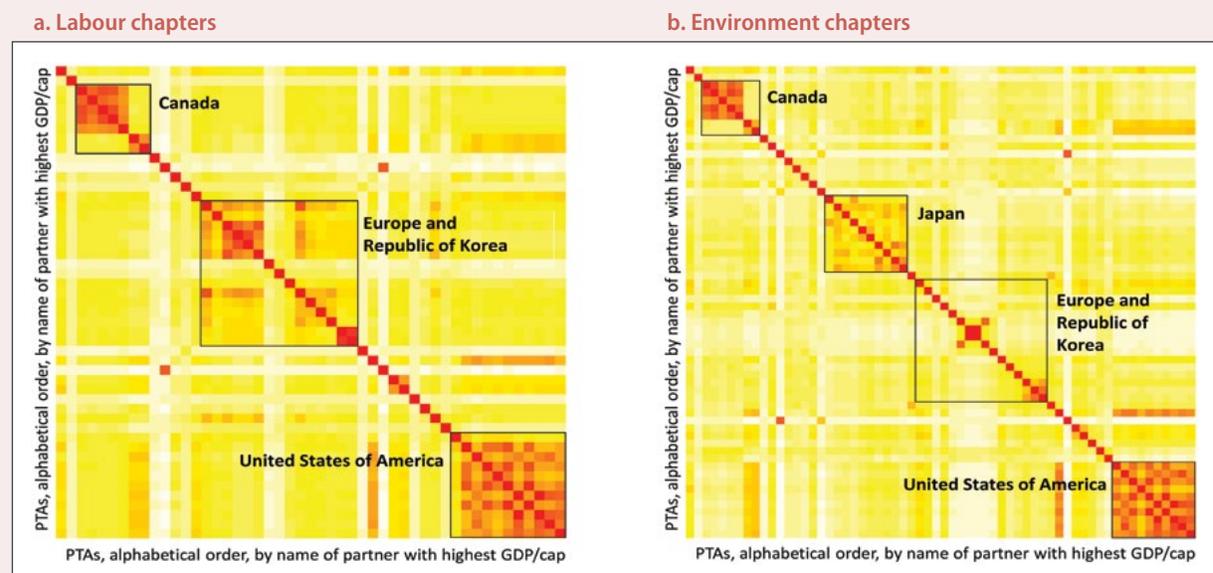
In the multilateral trading system, negotiations on sustainable development issues can be slow, as epitomized by the World Trade Organization (WTO) Doha Development Round. At the same time, bilateral and regional preferential trade agreements (PTAs) have recently made rapid advances towards addressing sustainable development concerns. For example, including stricter obligations on labour standards and environmental protection in PTAs has become increasingly common over the last years. That said, PTA provisions in both fields vary in terms of enforceability and aspirations.

Can countries build upon the experience of PTAs when addressing sustainable development concerns in multilateral trade negotiations? Comparing the texts of labour and environmental provisions across PTAs allows us to assess to what extent these can serve as building blocks for future WTO commitments.

To this end, we extract labour/environment chapters and labour/environment-related provisions from PTAs and compute an indicator of textual similarity between different treaties known as a Jaccard similarity (Alschnner, Seiermann and Skougarevskiy, 2017). The results of this exercise are displayed in heat maps, where each cell represents the textual similarities between one pair of treaties. It is coloured red to identify similar textual patterns and bright yellow to identify differences.

Agreements are ordered along the axes according to the name, in alphabetical order, of the signatory party with the highest 2015 GDP in each respective agreement. For example, the first row and column in each graph represents the degree of similarity between the Free Trade Agreement (FTA) between Australia and the Republic of Korea and another treaty. The solid red diagonal reflects the perfect

Figure II.3.1

Heat maps of textual similarity of PTA chapters on sustainable development

Source: Author's computations.

Note: Red = high similarity, bright yellow = low similarity.

(continued)

Box II.3 (continued)

overlap between identical treaty pairs (i.e., the top left corner simply represents the overlap between the FTA between Australia and the Republic of Korea with itself). The graph is symmetrical along the diagonal, as treaty pairs follow the same order along the vertical and horizontal axes. Within each figure, the treaties along the horizontal and vertical axes are the same and identically ordered. However, the included treaties differ between the two figures, as only treaties that contain provisions on labour are included in figure a, and those with provisions on environment are included in figure b. This explains why the location of treaty groups may differ between the two figures.

The key message to take away from the figure is that it is possible to identify certain countries that have considerable overlap on provisions related to labour standards and environmental protection among their bilateral and regional agreements. Canada and the United States have a relatively consistent treaty network concerning both labour and the environment. Different European groupings (the European Free Trade Association and the EU) and the Republic of Korea have concluded PTAs with similar labour provisions with different partners, but are heterogeneous in terms of environmental provisions. Japan's environmental provisions resemble each other across different treaties. Commonalities demonstrate that the content and formulation of these provisions is accepted across several partner countries, which can make it easier to introduce them at a multilateral level.

A large and growing number of recent agreements between other countries includes labour and/or environmental provisions. For example, more than 200 agreements stipulate the right to apply technical barriers to trade measures related to the environment (Morin, Pauwelyn and Hollway, 2017). PTAs with labour and/or environmental provisions include North-North, South-South and North-South agreements, regional and interregional, and with the participation of countries from different continents.

This broad willingness to consider sustainable development issues in the context of trade agreements by a wide range of countries is a promising precedent for multilateral negotiations. As stated by the ILO (2016) in a report on labour provisions, "regardless of the approach [...], the objectives of countries are shared". While no single template of labour/environmental provisions has yet emerged, there is some evidence of convergence, such as between environmental clauses in agreements signed by the EU and the United States (Morin and Rochette, 2017). Sets of provisions that have already been accepted by several countries from different world regions may have a larger chance of being multilateralized. Where two or more templates exist, their texts need to be compared in more detail to determine whether the textual differences also reflect fundamental differences in the content and purpose of the provisions that need to be bridged to achieve a multilateral agreement. Hence, mapping similarities and differences between agreements can help policymakers and negotiators identify ways to build on the PTA experience in the multilateral arena.

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Some topics are especially controversial, with proponents stating that such topics are required to avoid disproportionate and unduly burdensome regulation. However, many countries feel that the same issues undermine their right to regulate or cannot be considered due to resource constraints. E-commerce is a growing industry with immense potential to spur growth, particularly in developing economies. There is, however, lack of agreement on how best to address the policy issues affecting the digital economy. These include border measures such as tax rebates, transparency issues, infrastructure, consumer protection, privacy and intellectual property rights.

In this context, it would be necessary to ensure sufficient scope for regulation without excessive burden on trade. Discussions on investment facilitation could also impact the GATS. These discussions have sought to achieve greater coherence in trade and investment policy as well as in issues such as transparency, domestic regulation, special and differential treatment and technical assistance.

The development dimension of the trading system relies heavily on special and differential treatment. This remains a central but also longstanding issue, where the implemen-

Special and differential treatment remains a central and longstanding issue in the multilateral trading system

tation of past decisions continues to be an important concern. This includes the Duty Free and Quota Free market access and the preferential Rules of Origin for LDCs.

In this context, it is important to ensure the effective operationalization of the LDC services waiver and preferential treatment of LDC services and services suppliers. International support is required to address supply capacity constraints of LDCs, including infrastructure, skills, and technology, and should contribute to pro-development regulatory and institutional frameworks (Mashayekhi, 2017).