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MACROECONOMIC PERFORMANCE AND POLICY CHALLENGES AT THE SUBREGIONAL LEVEL

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Economic growth momentum and the macroeconomic situation vary widely among the countries in Asia and the Pacific, in line with the diversity across the region. Several of the trade-dependent countries are likely to perform better in 2014, as the global economic recovery gains traction. Their macroeconomic performances thus depend on the implementation of appropriate policy measures to deal with spillovers from developed economies. This requires careful examination of the underlying reasons for changes in the macroeconomic aggregates and the likely impact of policy measures. On the other hand, a number of countries, mostly those with large domestic markets, are poised to experience either a growth slowdown or stagnation in 2014 due to diverse structural challenges. These countries need to accelerate structural reforms to deal with long-term impediments, while at the same time, address short-term macroeconomic issues. The macroeconomic performance of commodity-exporting countries varied widely in 2013. This group of economies faces the prospect of slowing growth in 2014. To counteract this, they should undertake policies to accelerate economic diversification.

This chapter presents a more disaggregated analysis of macroeconomic performance in 2013 and the prospects for 2014 at the subregional level, with some discussion centred on the country level, given their policy challenges. In the *Survey*, the Asia-Pacific region is divided into five geographic subregions: East and North-East Asia; North and Central Asia; the Pacific; South and South-West Asia; and South-East Asia. An overview of macroeconomic and policy developments in these subregions is followed by more detailed discussions on each subregion.

The **East and North-East Asian subregion** comprises: China; Democratic People's Republic of Korea; Hong Kong, China; Japan; Macao, China; Mongolia; and the Republic of Korea. In this highly trade-dependent subregion, growth picked up in most of the economies by mid-2013, as global growth prospects improved. In particular, a recovery in exports to the United States led to increased economic activity. Notable economic-related trends in the subregion were as follows. First, the deceleration of growth in China in recent years has come to a halt, but as mentioned in chapter 1, the prospects for the Chinese economy to return to pre-global crisis growth rates are unlikely unless the economy is rebalanced to be more consumption-led. On the positive side, stimulus announced by China in early April 2014 should help contain a deceleration in growth. Second, China, Japan and the Republic of Korea have formulated a range of structural reforms to tackle long-term impediments. In the case of China, some path-breaking announcements were made to push the economy more towards a market-based system. Japan has been pursuing an aggressive and exceptional monetary policy stance coupled with strong fiscal stimulus to pull the economy out from deflation. This appears to be working as indicated by recent signs of higher growth and inflation. The country also intends to reform its tax system to address its growing public debt. The Republic of Korea launched sizeable stimulus measures that focused on promoting corporate investment through tax reductions and job creation by initiating public projects. Third, on the external side, despite an increase in the second half of 2013, exports for the year decelerated, which had a negative impact on current account surpluses in some economies. Fourth, although the net impacts of structural reforms are yet to be seen, the strengthening of the global recovery should help maintain the subregion's growth momentum in 2014.

The **North and Central Asian subregion** covers Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, the Russian Federation, Tajikistan, Turkmenistan and Uzbekistan. Among these countries, there are net energy exporters and non-energy commodity exporters. Subdued global demand for energy, gold and non-precious metals has impeded growth in the resource-based economies, particularly in the Russian Federation, which accounts for 80% of the subregion's GDP. Thus, the economies of the subregion as a group grew at a slower pace in 2013 than in 2012. Few important trends are worth highlighting. First, the growth performance within the subregion was diverse, ranging from 1.3% in the Russian Federation to 10.5% in Kyrgyzstan. Similarly, the inflation rates also varied from 2.4% in Azerbaijan to 12.1% in Uzbekistan. Second, in net energy-importing and remittance-dependent economies, output growth declined as household spending moderated due to a deceleration in workers' remittances, a direct result of the economic slowdown in the Russian Federation, the largest host of migrant workers in the subregion. Third, upward adjustments in administered prices pushed inflation higher in several of the economies in the subregion and applied further pressure on household spending. In response to inflationary pressures, monetary policy was tightened in some economies, with the Russian Federation hiking the interest rate by 200 basis points. Fourth, a number of the countries in the subregion increased public spending, especially on social programmes, to sustain domestic demand. This led to deteriorations in their fiscal balances. Fifth, on the external side, current account balances generally deteriorated owing to subdued global commodity demand. Despite an expected rebound in the global economy in 2014, output growth in the subregion is not likely to pick up as the economy of the Russian Federation further decelerates on the back of conflict with Ukraine. In the medium term, diversification of economic growth drivers remains a major challenge for the countries that continue to be highly dependent on commodity exports.

The **Pacific subregion** includes the Cook Islands, Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Palau, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu. Australia and New Zealand are also part of this subregion. The Pacific island developing economies face unique challenges, including small populations, a poor resource base (except in a few exceptional cases), remoteness from their more developed trading partners, frequent natural disasters and the adverse impact of global climate change. These economies, as a whole, experienced lower economic growth in 2013, mainly due to an economic slowdown in the resource-rich economies of Papua New Guinea and Solomon Islands. Natural disasters also constrained output growth in Fiji and Samoa. Moderating global food and fuel prices helped limit inflation in several of these economies in 2013, although overall inflation increased modestly on high price rises in Papua New Guinea amid its weakening currency. Budgetary deficits were generally not very large in 2013 despite some increases in the larger economies. Heavy reliance on imported food and fuel together with limited export capacity generally led to sizeable external current account deficits. Some improvement in the growth performance of this subregion is expected in 2014, in line with the more positive outlook for the global economy and an increase in mineral output in Papua New Guinea.

Australia and New Zealand, the two developed economies of the subregion, experienced slower growth in 2013. Inflation remained low, although New Zealand was the first developed country globally to raise interest rates in March 2014 in anticipation of a trend towards higher rates in the United States. Both of these countries are committed to fiscal consolidation in the coming years. In 2014, growth is expected to remain relatively sluggish in Australia on weak mining investments, while New Zealand should record a rebound due to ongoing reconstruction activities, better prospects for diary industry and higher net immigration.

The **South and South-West Asian subregion** comprises Afghanistan, Bangladesh, Bhutan, India, the Islamic Republic of Iran, Maldives, Nepal, Pakistan, Sri Lanka and Turkey. Economic growth in the subregion picked up slightly in 2013, as the economies of Bhutan, India, Maldives, Sri Lanka and Turkey expanded at a more rapid rate, aided by increased household spending stemming from steady farm incomes and workers' remittances. Energy shortages have constrained economic activities in several of these economies and political tensions and security issues capped growth in Afghanistan, Bangladesh, Nepal and Pakistan. Large fiscal deficits limit fiscal manoeuvrability within the subregion. Some deceleration in the overall inflation rate occurred, but food inflation remained elevated. Meanwhile, the prospects of quantitative easing tapering in the United States triggered capital market volatility in India and Turkey. This underscored weak macroeconomic fundamentals, such as large current account deficits financed by short-term external borrowings. The large current account deficits are partly a reflection of large fiscal deficits in the subregion. Monetary policy has been tightened to stem capital outflows and combat financial market volatility. Despite this, economic growth in the subregion is projected to further increase in 2014 due to a stronger global economy. Tackling supply-side constraints, especially energy shortages, remains vital for achieving medium-term growth.

The **South-East Asian subregion** covers Brunei Darussalam, Cambodia, Indonesia, the Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, Timor-Leste and Viet Nam. Growth momentum in the subregion slowed somewhat in 2013. The sluggish global economic recovery held back exports, particularly in the first half of the year. Growth in domestic demand also decelerated in the large emerging economies, such as Indonesia, due to monetary tightening in response to higher inflation and capital flight. Domestic demand in Thailand was adversely affected by rising household debt and political uncertainty. In contrast, the economy of the Philippines grew rapidly, despite the extensive damage caused by Typhoon Haiyan, which struck in late 2013. The least developed countries in the subregion, namely Cambodia, the Lao People's Democratic Republic, Myanmar and Timor-Leste, maintained high growth rates, underpinned in part by steady inflows of foreign investment, especially in the resource sector. Modest inflation enabled the economies of the subregion to ease monetary policy, which supported domestic demand amid weak external demand. Fiscal reforms moved forward in several economies in an attempt to restore fiscal sustainability following large-scale stimulus measures taken during the global economic downturn. As for 2014, growth is generally expected to moderate, especially in economies with large domestic markets. Financial market volatility, which could arise from monetary policy normalization in the United States, is a downside risk.

EAST AND NORTH-EAST ASIA

Recovery under way as the external environment improves

Growth in the subregion increased to 4.2% in 2013 from 4% in 2012 (see table 2.1). In most of the economies, growth picked up gradually in midyear as the global economy rebounded and domestic demand gained traction. However, subregional growth remained below pre-crisis levels, largely due to the slowing growth rates in China in recent years. The Chinese economy grew by 7.7% in 2012 and 2013 compared to more than 9% during the period 2009-2011.

Slower growth in China is having a negative impact on other economies in the subregion. However, there are far greater long-run potential benefits if the slowdown is resulting from the process to rebalance the economy. By reducing the economy's dependence on exports, efforts will be made to spur more rapid growth in domestic demand. As a result, China will increase its imports of higher value-added final goods. Also, the country's graduation from being a supplier of low-skilled manufacturing jobs may free up nearly 100 million labour-intensive jobs for less developed countries.[1] It is also interesting to note that in 2013, the services sector made up 46.2% of GDP, overtaking the manufacturing sector. With the services sector's contribution to GDP expanding, the Chinese economy would be on its way to growth diversification. In line with the Government's policy direction, going forward, growth in the country is likely to be driven by developments in the services sector. Similar to China, many other economies in the subregion have witnessed an expansion in output

Table 2.1. Rates of economic growth and inflation in selected East and North-East Asian economies, 2012-2014

(Percentage)

	Real GDP growth			Inflation[a]		
	2012	2013	2014[b]	2012	2013	2014[b]
East and North-East Asia[c]	**4.0**	**4.2**	**4.1**	**1.4**	**1.5**	**2.9**
East and North-East Asia (excluding Japan)[c]	**6.4**	**6.6**	**6.6**	**2.6**	**2.4**	**3.0**
China	7.7	7.7	7.5	2.6	2.6	3.1
Democratic People's Republic of Korea	..	..	..	..	..	..
Hong Kong, China	1.5	2.9	3.5	4.1	4.3	4.6
Japan	1.4	1.5	1.4	0.0	0.4	2.8
Macao, China	9.1	11.9	11.3	6.1	5.5	6.0
Mongolia	12.4	11.7	10.0	14.3	10.5	12.0
Republic of Korea	2.3	3.0	4.0	2.2	1.3	2.1

Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

a Changes in the consumer price index.
b Forecasts (as of 15 June 2014).
c GDP figures at market prices in United States dollars in 2010 (at 2005 prices) are used as weights to calculate the subregional aggregates.

from their services sector. The share of the industrial sector in GDP decreased in Japan, Hong Kong, China and Macao, China, and remained largely stable in China and the Republic of Korea. With the exception of Mongolia, which is promoting agricultural output in an effort to diversify the economy and reduce dependence on the mineral sector, the agriculture sector in all of the export-oriented economies in the subregion continued to shrink in recent years.

In 2013, the deceleration of growth over the past few years came to a halt in China, as the economy expanded by 7.7%, unchanged from the previous year. Growth in 2013 was driven by consumption and investment, while private consumption remained relatively low, at only one-third of GDP, compared to an average of 55% of GDP in other emerging Asia-Pacific economies. In contrast, investment levels remained high as a number of infrastructure projects were initiated around midyear. Investments in the property market were also robust, helped by rapid credit expansion from the shadow banking sector and off-balance sheet commercial banks' transactions. Rising pressures on credit growth resulted in higher interbank lending rates, though it was encouraging that liquidity in non-housing sectors was not affected. Nevertheless, rapid growth in shadow banking and off-balance sheet activities in recent years, as well as the possible property bubble are matters of concerns. The authorities in China are cognizant of this and have taken measures to curb the risks arising from rapid growth of the sector. It should also be mentioned that the nature and content of shadow banking in China differ from western countries. Shadow banking in China, which is mainly composed of trust funds, is typically used to finance riskier borrowers and transactions that banks cannot undertake due to regulations. Thus, shadow banking potentially could support the real economy. Moreover, shadow banking finances only a small part of total credit in China.

Gross national savings in China remained exceptionally high, at 51.4% of GDP, in 2013. Even though private consumption during the past two decades expanded about 8% per annum, it was outstripped by growth in savings. The high savings, in turn, funded rapid capital formation. Meanwhile, gross investment expanded by more than 12% annually in the past few decades and as a result, its share of GDP increased from about 38% in the early 1990s to 48.9% in 2013 (see figure 2.1). The high savings and investment in China has been a topic of much debate as it is closely linked with transforming the economy to be more consumption-oriented. Many attribute the excessive saving behaviour to rising housing prices and an inadequate social protection system. In this regard, access to affordable financing options and stronger social safety measures would help relieve the need for high savings and boost private consumption.

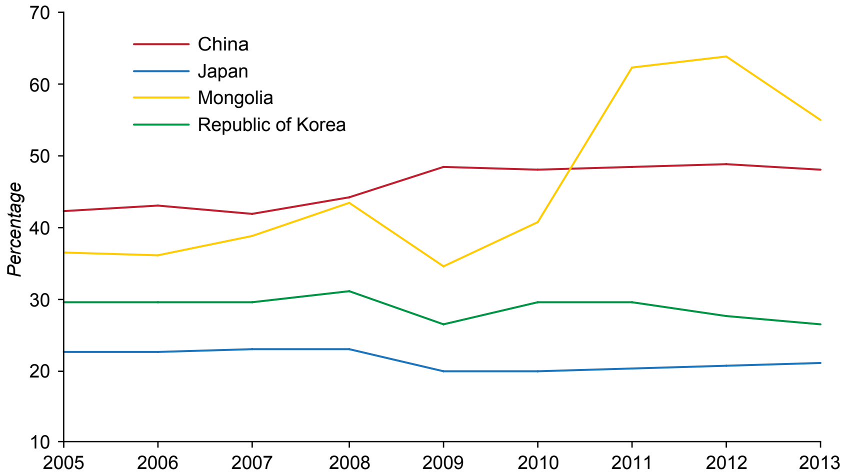
Access to affordable financing options and stronger social safety measures would help relieve the need for high savings and boost private consumption

Hong Kong, China enjoyed a stronger growth performance of 2.9% in 2013, as compared with 1.5% in 2012. Robust private consumption remained a key driver of the expansion, although inbound tourism was also an important factor. Merchandise exports were weak, as shipments to Japan and the United States declined. Wage pressures increased, but inflation remained stable, thus boosting household real incomes. Although the overall labour market appeared strong, the youth unemployment rate remained greater than 8%.

Growth in Macao, China accelerated to 11.9% in 2013. Strong tourism growth spurred economic activities, with both arrivals and spending per visitor rising by about 5%. Private consumption expanded steadily, while fixed investment, mainly in the construction sector, jumped by 15.1% and contributed markedly to the overall growth of the economy.

The Democratic People's Republic of Korea releases limited official economic data. Its economy is highly dependent on the agriculture sector and exports of light industry products and minerals. Favourable

Figure 2.1. Investment-to-GDP ratio in selected East and North-East Asian economies, 2005-2013



Source: ESACP, based on International Monetary Fund, World Economic Outlook Database, April 2014.

weather conditions in 2013 are likely to have supported agricultural activities. A slowdown in China, the country's largest trading partner, could have dampened exports, although much of the bilateral trade is agreed on a barter basis. Special economic zones in the country potentially help support economic growth, but tensions with the Republic of Korea have led to temporary shutdowns in large-scale industrial complexes.

The economic recovery of Japan gained momentum in the early part of 2013 on the back of aggressive monetary easing, which buoyed exports and corporate profits by weakening the yen. The growth momentum, nevertheless, slowed towards the end of the year. In response, the Government announced further stimulus measures amounting to 0.9% of GDP in October 2013. These included additional public sector projects and tax reductions for corporate investment. GDP growth for the year reached 1.5% in 2013, up marginally from 1.4% in 2012. The end of deflation should benefit the economy by lowering the real value of debt, and hence encouraging household consumption and corporate spending. High household savings have enabled the Government to accumulate debt amounting to nearly 230% of GDP at relatively low interest rates. With the fall in overall domestic savings, the economy's current account balance recorded the smallest surplus in 2013 since the 1980s despite weakened currency. Currently, 95% of government debt is held domestically, with Japanese government bonds making up 20% of total assets of domestic financial institutions. However, as a result of the current trend of dissaving among the ageing population, it will be increasingly difficult to finance government deficits domestically. It is therefore critical that the Government policies succeed in reviving the economy to allow for fiscal consolidation.

Mongolia sustained high growth of 11.7% in 2013. Strong agricultural output, rising government expenditure and the start of copper production at a large mine propelled the overall expansion. Investment in the mining sector rose sharply in recent years. The official unemployment rate in midyear dropped to 7.3% and the solid economic performance in the past years has contributed to poverty reduction, with the poverty rate declining from 38.7% in 2010 to 27.4% in 2012.

The economy of the Republic of Korea expanded by 3% in 2013 compared with 2.3% in 2012. This was attributed to robust domestic demand, as both public and private consumption increased. To support the economy, the Government enacted a 17.3 trillion won ($980 million) supplementary budget in 2013, which focused on supporting small and medium-sized enterprises (SMEs), with the ultimate aim to create more employment. The property market remained flat despite repeated attempts by the Government to prop it up. Export growth was weak during the first half of 2013, partly attributable to eroded export competitiveness in line with the weaker Japanese yen. Meanwhile, gross national savings and total investment remained unchanged at about 31% and 27% of GDP, respectively, in 2013, as compared with the previous year. Household savings have trended downward over the past decade due to mounting household debt and the ageing population. Higher household debt levels may be a symptom of rising income inequality and could become a source of financial sector instability and constrain domestic demand growth.

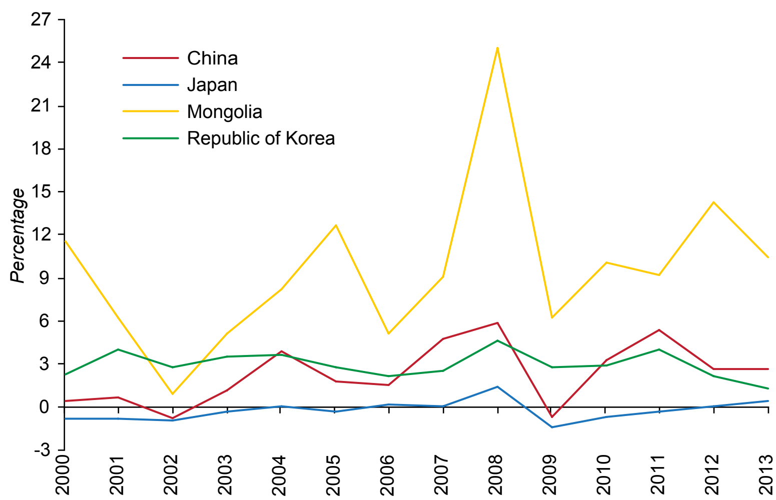
Lower commodity prices kept inflation in check

Inflation rates in the subregion were low, with the exception of the rate in Mongolia, which fell but remained in double digits (see figure 2.2). The slow global economic recovery, particularly during the first half of 2013, led to weak external demand and falling commodity prices, which, in turn, limited inflationary pressures. Government measures in some countries also influenced inflation outcomes.

In China, inflation remained unchanged in 2013, at a low rate of 2.6%, due to moderate wage growth, lower commodity prices and stronger control of credit expansion. In Hong Kong, China, the inflationary pressures from the tight labour market conditions and rising property prices were partly offset by weak external demand and stable energy and food prices. As a result, inflation increased modestly to 4.3% in 2013. Meanwhile, moderating global food and fuel prices trimmed the inflation rate in Macao, China to 5.5%. Softer price increases were also observed in the Republic of Korea, where inflation fell to 1.3% in 2013 from 2.2% in 2012, despite higher public utility prices, including for transportation and heating.

In Japan, inflation turned the corner following efforts to stave off deflationary pressures for many years. The dramatic loosening of monetary policy and a 2% inflation target helped push up inflation to 0.4% in 2013 from zero inflation in 2012 and an average rate of deflation of 0.8% during the period 2009-2011. Another factor that spurred inflation was higher import prices, a direct result of the weaker yen.

Figure 2.2. Inflation in selected East and North-East Asian economies, 2000-2013



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Mongolia, the only economy in the subregion with persistently high inflation, succeeded in softening its inflation rate to 10.5% in 2013 from 14.3% in 2012. In addition to falling food and energy prices globally, the implementation of a price stabilization programme helped reduce the inflation rate. To deal with rising prices, the Government opted to implement a price stabilization programme rather than tighten monetary policy. The programme was aimed at tackling supply-driven inflation by subsidizing suppliers of imported food and fuel. It also helped sustain high economic growth in 2013.

Mixed performance on current account balances

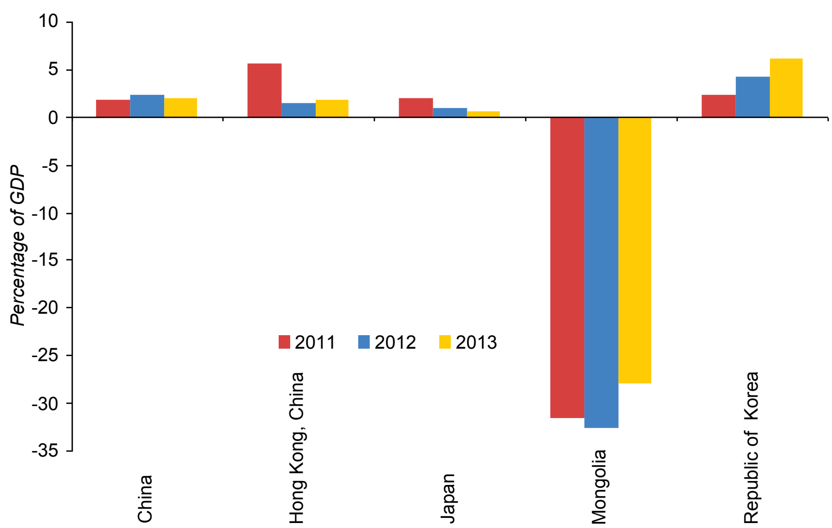
In China, rising export prices and friction with key trading partners, such as Japan, resulted in slower export growth. The current account surplus also narrowed on the back of increasing outbound tourism and a growing service account deficit (see figure 2.3). The current account surplus of Japan also shrank. Although export earnings grew, the value of imports also increased and overseas income declined due to the weaker yen.

In Mongolia, coal exports fell by nearly a half as demand from China weakened. Subdued prices of primary commodities resulted in less favourable terms of trade, which led to a current account deficit equivalent to a quarter of GDP.

Meanwhile, the current account surplus rose slightly in Hong Kong, China on an increase in the service account surplus despite tepid merchandise exports. In the Republic of Korea, the current account surplus reached a record high level in 2013. While exports started to recover in midyear, both import volume and prices continued to decline.

The picture was also mixed on the capital and financial account side. China witnessed a recovery in FDI, reversing the downward trend in 2012. Foreign direct investment in Hong Kong, China also increased. In contrast, investment inflows to Mongolia plunged by more than 40%. This was due, in part, to the completion of the first phase of a large-scale copper and gold mine and also uncertainty associated with a foreign investment law, which required parliamentary approval for large investment plans in strategic sectors, such as

Figure 2.3. External current account balance in selected East and North-East Asian economies, 2011-2013



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

minerals and finance. While the Government has since introduced a new investment law that reduces the uncertainty associated with the approval process, the balance between protecting long-term interest in key industries and attracting foreign investment needs to be carefully pursued.

Currencies in the subregion also moved in different directions. The Korean won appreciated against the United States dollar in 2013 as the country's trade surplus increased, but trading in the currency was volatile due to heightened global financial market uncertainty arising from potential changes in the United States monetary policy. Recently, the Chinese yuan has been trending higher, partly due to the liberalization of the exchange rate. The Japanese yen fell to a four-year low as the currency depreciated by 22% against the United States dollar by end of 2013 as a result of extraordinary monetary easing.

Policy responses and structural reforms: promotion of sustained growth

With slower growth relative to the past trend and continued global economic uncertainty, macroeconomic policies in the subregion focused on supporting growth through different means.

As discussed in chapter 1, in China, a bold reform package was released in November 2013 with an underlying theme to make the economy more balanced, sustainable, market-oriented and efficient. These reforms include accelerating the pace of interest rate liberalization and convertibility of the Chinese yuan. Also, many of the long-standing issues related to state-owned enterprises are addressed in the reform package, such as allowing private investors to take part in State investment projects and breaking all forms of administrative monopolies, while increasing the State's contribution to public services. Measures to tackle increasing inequality between rural and urban areas are also part of the reforms.

The two-decade battle Japan had with sluggish economic growth and deflation appeared to have turned the corner in 2013 as the Government's three-pronged approach to revive the economy took effect. As highlighted in chapter 1, massive fiscal stimulus, more aggressive monetary easing and structural reforms resulted in positive inflation and improved growth. The initial positive results of monetary easing and fiscal stimulus packages will be followed up with structural reform measures to increase the growth trajectory. These measures are aimed at, among other things, addressing labour market rigidities and deregulating the public utilities. The Japanese economy still faces many challenges, including mitigating the impact of the consumption tax hike introduced in April 2014.

Japan's battle against sluggish growth and deflation has turned the corner

The Republic of Korea pursued policies aimed at reducing its dependence on exports and raising productivity in the services sector. Under an overall plan to raise the economy's potential growth rate to 4%, increase annual per capita income to $40,000 and boost the share of employed persons in working-age population to 70% by 2017, the Government adopted three strategies: (a) to strengthen economic fundamentals; (b) to promote creativity and dynamism; and (c) to boost domestic demand. Specific policies include rolling back regulations, particularly those that are applicable to the services sector, shoring up the tax base while giving more tax benefits to startups and providing incentives to hire more women and youth.

Monetary policy remained accommodative in most economies in the subregion. However, in China, growing concerns over shadow banking led to a hike in interest rates during which the 7-day repo rate jumped to a record 12% and the overnight repo reached 25% in mid-2013. Interest rates declined in early 2014 as the central bank injected more than $42 billion into the economy to meet cash demand.

The Bank of Japan continued its money market operations, which raised the money base by 60 trillion-70 trillion yen ($430 million-$500 million) per year. This quantitative easing seeks to achieve a 2% inflation target and boost economic activities in general. Monetary authorities in Mongolia also embarked on monetary easing in 2013 in response to slowing credit growth. Similarly, the Bank of Korea cut its policy interest rate by 25 basis points in May 2013 to 2.5% to stimulate domestic demand.

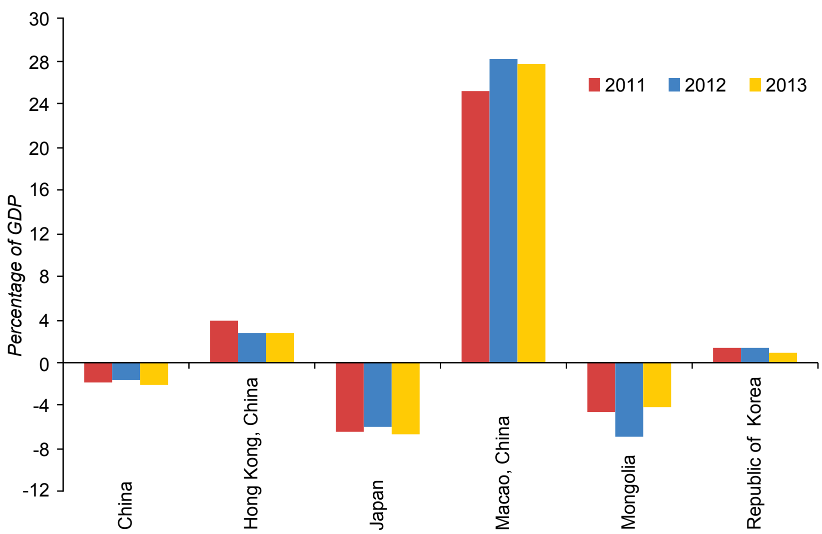
Fiscal balances deteriorated in several economies in the subregion in 2013 due to rising expenditures and lower-than-expected tax revenues (see figure 2.4). In China, the fiscal deficit increased to 2% of GDP in 2013, from 1.5% of GDP in 2012. Since 2012, the Government has been focusing on reforming the tax system. In a pilot scheme carried out in Shanghai, the Government replaced a business tax with a value-added tax for the transportation, asset leasing and modern services sectors. This shift is designed to promote the services sectors as part of the twelfth five-year national plan.[2,3]

In Japan, the fiscal deficit amounted to 6.7% of GDP in 2013 and gross public debt was equivalent to about 2.3 times that of GDP. The Government of Japan reformed its tax regime in order to tackle the growing public debt burden. Rather than issuing additional bonds, it increased the sales tax rate from 5% to 8% in April 2014. The Government also introduced measures to relieve the short-term impact of the tax hike. Over the medium term, higher sales tax revenue should help reduce the level of public debt. In Mongolia, an extensive amount of off-budget spending occurred using proceeds from the mining-sector bond sales, despite attempts by the Government to contain the budget deficit and meet the requirements of the Fiscal Stability Law.[4]

Outlook for 2014 and policy challenges

The subregion is expected to experience slightly slower growth in 2014, mainly due to lower economic growth in China and Japan. The economy of Japan is projected to decelerate marginally to 1.4% in 2014 from 1.5% in the previous year, partly due to constrained consumption expenditure as a result of the higher sales tax rate and escalating import prices. Also of note, the shutdown of nuclear power plants will result in higher energy bills. Excluding Japan, growth in the subregion is projected to be stable at 6.6% in 2014. Economic growth in China is forecast to moderate to 7.5% in 2014, as economic rebalancing towards private consumption moves forward. Mini-stimulus measures announced by the Government in April 2014 should help the country achieve its official growth target. Growth

Figure 2.4. Budget balance in selected East and North-East Asian economies, 2011-2013



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

projections for China and Japan are discussed in detail in chapter 1.

The Republic of Korea is projected to grow more rapidly, at 4%, in 2014. A rebound in exports to developed markets should cushion the impact of a slowdown in China. Continued weakness in the real estate market and record levels of household debt are immediate challenges. In the medium term, improving productivity and income growth in the services sector and smaller firms is key to enhancing domestic demand. Most new services jobs are in low value-added sectors, such as retail, real estate and transportation. An incentive structure within a proper regulatory framework that supports high value-added services, such as banking and health care, could be promoted.

Economic growth in Mongolia is expected to moderate to 10% in 2014. The economy faces various challenges, including a sizeable deficit in external balances, resulting from declining FDI and lower coal exports to China. The lack of reliable and efficient rail transport has dented the export competitiveness of primary commodities to China. Export product and market diversification can help boost exports.

Employment for the elderly is becoming important given population ageing

Limited number of quality jobs for the elderly population is one of the growing concerns in the subregion. Due to population ageing, employment in the age group of 55-64 years has been steadily increasing. However, more elderly workers have low-paid jobs, are self-employed or are in the informal sector. As a result, poverty among the elderly is high. According to a recent official survey, nearly a quarter of all Chinese aged over 60 years live in poverty.[5] A report by the OECD also shows that more than 30% of people aged 65 and over in Hong Kong, China earn less than half of the national median income. The elderly poverty rate is higher in the Republic of Korea. It stood at 48.6% in 2011, four percentage points higher than the rate in 2007. Given the rapid growth of the elderly population, there is an urgent need for the subregion to examine the sustainability and effectiveness of national pension schemes.

The subregion also faces a number of environmental challenges due to, among other things, its rapid industrialization and urbanization in the past decades. In box 2.1, the role of urban planning in achieving more sustainable development is highlighted.

NORTH AND CENTRAL ASIA

Slower economic growth due to subdued commodity prices

Growth in the North and Central Asian subregion as a whole slowed to 2.1% in 2013 from 3.8% in 2012 (see table 2.2). Many of the economies in the subregion were affected by the sluggish global economic recovery due to their high dependence on exports of oil, gas, metals and other commodities. Also, as a result of strong economic linkages, particularly through remittances received from the Russian Federation and to a lesser extent from Kazakhstan, the slowdown in net energy exporters adversely affected consumer spending and GDP growth in the energy-importing and remittance-dependent economies in which the services sector comprised the largest share of the economy.

In Armenia, growth declined to 3.5% in 2013 from a high base of 7.2% in 2012. Softer international metal prices largely underpinned the slowdown. Construction activities continued to shrink, as the sector has yet to recover from the slump resulting from the global financial crisis. On the demand side, the contribution of private consumption to growth slowed in line with higher prices for imported gas and declines in real wages. A survey conducted by the central bank suggests that consumer confidence was at its lowest level since 2009.

Economic growth in Azerbaijan strengthened to 5.8% in 2013 from 2.2% in 2012. Non-oil sectors,

Box 2.1. The role of low-carbon cities to promote sustainable development in East and North-East Asia

China, Japan and the Republic of Korea are among the world's top importers of fossil fuels. Together, they account for about a quarter of global greenhouse gas emissions. Enhancing energy consumption efficiency is thus vital in East and North-East Asia. This box discusses how low-carbon cities help promote sustainable development in the subregion.

Cities are home to about half of humanity or around 3.5 billion people worldwide.[a] The share of urban population in East and North-East Asia is estimated to rise to more than 70% by the next decade.[b] By 2030, China alone is likely to have an additional 400 million city dwellers. About 220 Chinese cities will have more than one million residents.[c] The damaging effects on climate change can be significant since cities emit around 70% of total greenhouse gas emissions, while they occupy only 2% of the global land area.[d]

Despite these grim statistics, cities are uniquely positioned to tackle climate change by achieving greater efficiencies through better urban planning and greater citizen participation. Furthermore, many cities in the Asia-Pacific region are at a crossroads in developing and expanding infrastructure in support of economic growth. These choices made in urban infrastructure development will have a major influence on climate change.

Some of the key factors influencing energy use and carbon dioxide emissions are the compactness of urban settlements, nature of transportation systems, income and lifestyle, industrial process, construction technologies and waste disposal methods. In East and North-East Asia, income and lifestyle changes, such as the rapid increase in the number of vehicles, are cited as a major factor.[e] There are various ways cities can contribute to climate change mitigation, including by developing urban transport systems that support walking and cycling, constructing more eco-friendly buildings, and managing solid waste in a way that maximizes recycling and reuse. Structured tax incentives and emissions trading programmes can also be used to reduce the carbon intensity of urban industries.

Many cities in China, Japan and the Republic of Korea have set goals and taken steps to reduce greenhouse gas emissions. For example, in Hangzhou, China, the government has announced an ambitious plan to cut emissions by half. At the national level, the twelfth five-year plan targets a reduction in energy and carbon intensity by up to 17%.[f] An example of an initiative on low-carbon cities undertaken by Japan is the Bill of Basic Act on Global Warming Countermeasures. In the Republic of Korea, these initiatives are the Low Carbon, Green Growth Basic Act and Urban Planning Guidelines for Low-Carbon Green Growth.

[a] World Bank (2013a).
[b] United Nations (2005).
[c] Mckinsey Global Institute (2009).
[d] United Nations (2011a).
[e] Dhakal (2004).
[f] China (2011).

which account for about half of GDP, led the upturn. This was especially seen in service activities; for example, the restaurants subsector was buoyed by improving household demand and the construction industry benefitted from government spending on infrastructure projects. Jobs created in the private sector accounted for up to 40% of the new jobs.

Output growth in Georgia slowed to 3.2% in 2013 from a high base of 6.2% in 2012. Domestic demand, particularly government spending and private investment, weakened as a result of political uncertainty related to the general elections held in October 2013. The slowdown was broad-based, affecting such subsectors as agricultural,

Table 2.2. Rates of economic growth and inflation in North and Central Asian economies, 2012-2014

(Percentage)

	Real GDP growth			Inflation[a]		
	2012	2013	2014[b]	2012	2013	2014[b]
North and Central Asia[c]	**3.8**	**2.1**	**1.3**	**5.1**	**6.7**	**5.5**
North and Central Asia (excluding Russian Federation)[c]	**5.5**	**6.5**	**6.1**	**5.3**	**6.0**	**8.2**
Armenia	7.2	3.5	4.5	2.6	5.8	5.0
Azerbaijan	2.2	5.8	5.0	1.1	2.4	4.0
Georgia	6.2	3.2	5.0	-0.9	-0.5	4.0
Kazakhstan	5.0	6.0	5.4	5.1	5.8	9.3
Kyrgyzstan	-0.9	10.5	6.5	2.8	6.6	7.2
Russian Federation	3.5	1.3	0.5	5.1	6.8	5.0
Tajikistan	7.5	7.5	6.0	5.8	5.1	7.2
Turkmenistan	11.1	10.1	10.4	8.5	9.0	11.0
Uzbekistan	8.2	8.0	8.1	13.2	12.1	11.0

Sources: ESCAP, based on national sources; Interstate Statistical Committee of the Commonwealth of Independent States. Available from www.cisstat.com (accessed 15 June 2014); CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014); and Economist Intelligence Unit, *Country Reports*.

[a] Changes in the consumer price index.
[b] Forecasts (as of 15 June 2014).
[c] GDP figures at market prices in United States dollars in 2010 (at 2005 prices) are used as weights to calculate the subregional aggregates.

manufacturing and trade. Despite a general increase in wage levels, weak employment prospects further hampered domestic demand.

Kazakhstan enjoyed more rapid economic growth of 6% in 2013 compared with 5% in the previous year. Better agricultural performance and solid private consumption, supported by accommodative credit policies for consumers, contributed to higher growth. However, consumer loans by commercial banks increased at the expense of credit extended to small businesses. Export earnings were weak on the back of sluggish world demand for oil. On the supply side, services sectors, such as trade and transport, contributed significantly to output growth. Strong economic growth has led to job creation, but youth unemployment remains relatively high.

The economy of Kyrgyzstan staged a turnaround from a contraction of 0.9% in 2012 to 10.5% growth in 2013. Gold production, which accounted for almost half of industrial production, jumped as the production problems and labour tensions that depressed gold output in 2012 eased. The agriculture sector performed better too. The economy also benefited from higher household consumption, resulting from robust employment and rising remittance inflows, albeit at a slower pace. This was reflected in the improved performance of the domestic retail trade sector.

In the Russian Federation, GDP growth decelerated further from 3.5% in 2012 to a four-year low of 1.3% in 2013. Hydrocarbon exports were anaemic and related sectors, such as trade, industry and finance, experienced a slowdown on the back of the sluggish global economy. Although capacity utilization was close to its pre-crisis level, fixed investment remained weak as several public investment projects were completed. The economy was supported mainly by household consumption, which benefited from easy access to consumer loans and higher real wages. Growth performances in other countries in the subregion, especially net energy importers, tend to be strongly linked to that of the Russian Federation through trade and workers' remittances.

Tajikistan sustained high growth of 7.5% in 2013. Remittance inflows, which accounted for nearly half of GDP, propelled household consumption. Similar to a number of other economies in the subregion, agricultural production was strong due to large grain harvests, which helped contain food inflation. Industrial activities were weaker, owing to sluggish aluminium output, which constitutes more than 60% of total exports. The sluggish output was tied to shortages of gas and weak external demand. Meanwhile, the country's aluminium sector is facing productivity challenges as it uses outdated technologies, which are expensive to operate and use an excess amount of energy.

Output growth in Turkmenistan moderated in 2013, but it remained solid at 10.1%. The production of natural gas, which accounts for more than half of total exports, continued to expand. Domestic demand remained strong as private consumption increased in line with higher wage levels. The country also saw greater investments from both the private and public sectors, which were reflected by strong construction activities.

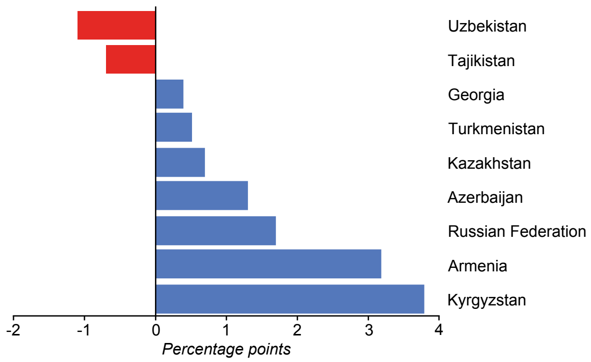
Economic growth in Uzbekistan slowed slightly in 2013 to 8%. Subdued global demand for, and lower prices of, gold adversely affected the country's exports. However, domestic demand remained robust and provided an impetus to growth. Government spending on housing and industrialization programmes increased, while household spending benefited from upward adjustments of minimum wages and social transfers and stable remittance incomes. Industrial activities led the expansion from the supply side, particularly those related to construction and metals.

Inflation edged up on non-food items

Consumer price pressures increased in most of the economies in North and Central Asia, mainly due to higher prices for non-food items (see figure 2.5). Overall, inflation ranged from 2.4% in Azerbaijan to 9% in Turkmenistan and 12.1% in Uzbekistan.

In many of the countries of the subregion, the price increases were partially policy-driven. In Kyrgyzstan, a weaker exchange rate and higher excise taxes on alcoholic beverages and tobacco products contributed to higher inflation. Upward adjustments in administered prices, such as utility tariffs and public transportation fares, were recorded in Armenia, Kazakhstan, Turkmenistan and Uzbekistan. A strong agricultural harvest helped offset part of those policy-induced price pressures in Kazakhstan and Kyrgyzstan.

Figure 2.5. Inflation in North and Central Asian economies, changes in 2013 relative to 2012



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

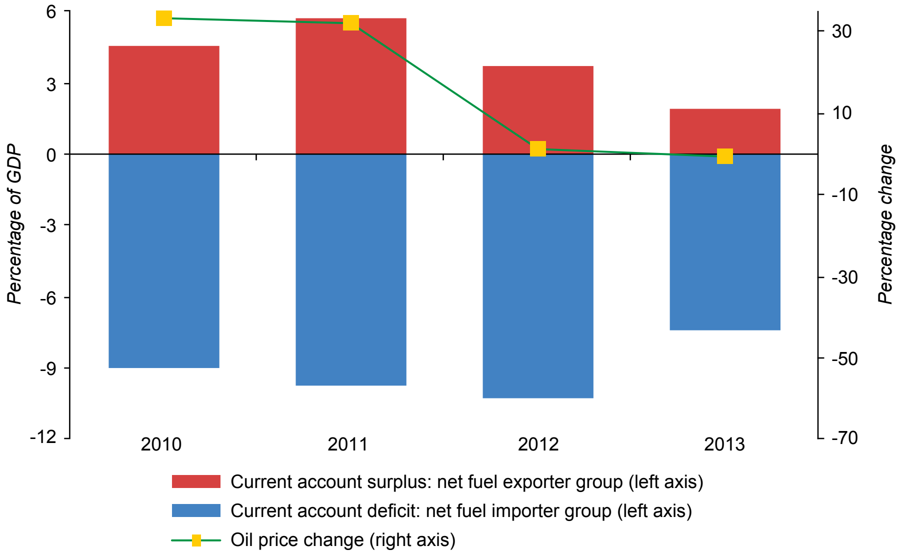
Inflation in Armenia rose to 5.8% in 2013 from 2.6% in 2012 due to higher prices for gas from the Russian Federation, although core inflation remained within the official target range of 2.5-5.5%. In the Russian Federation, inflation rose to 6.8% in 2013 from 5.1% in 2012, partly due to rising wages. In Turkmenistan, the Government's commitment to raise salaries and social spending by 10% annually resulted in upward pressure on prices. Meanwhile, the inflation rates in Tajikistan and Uzbekistan, which are relatively high, decelerated slightly in 2013. Finally, unlike other economies in the subregion, Georgia had experienced deflation since 2012 amid subdued domestic demand.

External current account balances generally deteriorated

Several economies in North and Central Asia experienced a deterioration in their current account balances in 2013. Weak external demand and commodity prices coupled with strong import demand contributed to smaller current account surpluses, especially among net oil exporters (see figure 2.6).

In the Russian Federation, the current account surplus decreased to 1.6% of GDP in 2013. Exports

Figure 2.6. External current account balance in North and Central Asian economies, 2010-2013



Sources: ESCAP, based on national sources; and International Monetary Fund, World Economic Outlook database, April 2014 and Primary Commodity Prices data (accessed 15 June 2014).

Notes: The oil price index (2005 = 100) is a simple average of spot prices of Dated Brent, West Texas Intermediate, and the Dubai Fateh. Net fuel exporters include Azerbaijan, Kazakhstan, Russian Federation, Turkmenistan and Uzbekistan. Net fuel importers include Armenia, Georgia, Kyrgyzstan and Tajikistan.

contracted by 1.3% amid lower export prices of energy, while imports increased on the back of strong household demand, which was fuelled by credit growth. Strong import demand also narrowed the current account surplus in Azerbaijan. In Tajikistan, lower prices for aluminium and cotton, which together accounted for up to 80% of all exports, depressed overall export earnings. The current account deficit stood at 1.9% of GDP in 2013. Meanwhile, an improvement in net current transfers helped trim the current account shortfall of Kyrgyzstan, which, however, remained high at 12.6% of GDP.

In Armenia and Georgia, the current account deficits narrowed on rising workers' remittance inflows, which constituted up to 10% of GDP in these economies. Higher exports of copper in Armenia and lower imports in Georgia as growth in investment and public spending slowed were also factors behind this. Despite the recent narrowing, the current account deficits of those two countries remained high, at 10.5% of GDP in Armenia and 6.1% of GDP in Georgia in 2013.

Although the value of remittance inflows to most of the countries in the subregion has generally risen, the growth rate of these inflows has slowed in recent years. This is in line with the economic slowdown in the Russian Federation, which is the dominant recipient country of migrant workers in the subregion. For example, Armenia, which receives 90% of its remittances from the Russian Federation, has been recording slower growth of inflows since 2010. Migrant workers are particularly affected by an economic slowdown in a recipient economy as many of them are engaged in vulnerable employment.

Some positive developments on the balance of payments were recorded in 2013. In September, Armenia secured $700 million through its first international bond issuance. This allowed the country to repay a bilateral loan that was extended by the Russian Federation and provide financial liquidity to the business sector. Nevertheless, policymakers should be mindful of risks associated with external commercial borrowings arising from sudden shifts in investor sentiment and global macroeconomic conditions. Other economies, meanwhile, have gradually expanded their export baskets beyond traditional shipments of oil and mineral products to include, for example, sugar products in Azerbaijan and live animals in Georgia, but the export values of these products are still relatively small.

Sluggish global demand for commodities was a key factor behind narrowing current account surpluses in several of the subregion's economies. Another contributory factor was strong demand for imported capital goods, especially in Turkmenistan and Uzbekistan. These capital goods could boost future foreign exchange earnings if they are used to enhance production competitiveness and diversification.

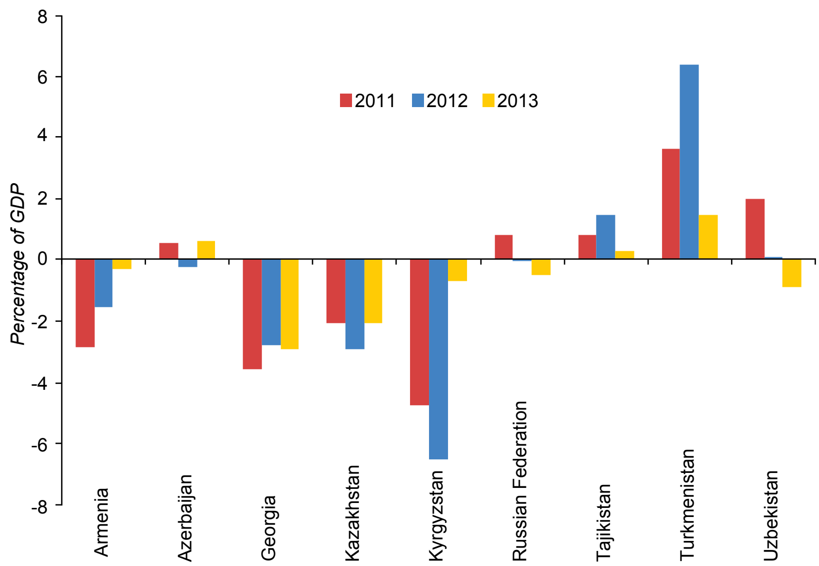
Movements in the external current accounts are reflections of developments in national savings-investment gaps. National savings fell short of domestic investments in several of the economies of the subregion, with the gaps ranging from 0.7% of GDP in Kyrgyzstan to 6.5% of GDP in Armenia during the period 2010-2012. Long-term foreign capital thus played an important role in the subregion, with FDI inflows averaging at a quarter of total investment over the same period.

Policy responses and structural reforms

Several countries in the subregion have implemented supportive policies aimed mainly at increasing the purchasing power of households. These policies had resulted in larger fiscal deficits or smaller surpluses. In other countries in the subregion, particularly those that enjoyed more favourable economic conditions, tax reforms were implemented to restore fiscal sustainability. Monetary policy stances were mixed in the subregion, as they are primarily based on the relevance of inflationary pressures in each country.

In more than the half of the countries in the subregion, fiscal policy in 2013 was expansionary to support growth. Consequently, fiscal balances deteriorated in Georgia, the Russian Federation, Tajikistan, Turkmenistan and Uzbekistan (see figure 2.7). In Georgia, expenditure on social programmes was expanded by about 17% in an effort to introduce universal health care. Similarly, in Tajikistan, Turkmenistan and Uzbekistan, higher social transfers boosted the purchasing power of low-income households. In the Russian Federation, the fiscal deficit widened marginally to 0.5% of GDP due to lower oil revenues.

Figure 2.7. Budget balance in North and Central Asian economies, 2011-2013



Source: ESCAP, based on Economist Intelligence Unit, *Country Reports*.

In several countries of the subregion, fiscal space expanded in line with reforms in revenue collection. In Azerbaijan, for example, stronger economic growth coupled with tax and customs administration reforms boosted government revenues. In Armenia, tax reforms led to greater revenue collection despite an economic slowdown. In particular, the Government launched a fiscal consolidation programme that entailed strengthening the tax and customs administration to increase tax revenues, which are currently among the lowest in the subregion in terms of GDP.

It is important to ensure that declines in public spending and increases in revenue do not adversely affect the poor and vulnerable groups in the population

Some of the countries in the subregion also tried to rebuild sustainable fiscal paths by restraining expenditure. This was particularly the case in Kazakhstan and Kyrgyzstan. In Kazakhstan, public spending on housing and utilities was cut. The country's budget deficit thus narrowed to 2.1% of GDP in 2013; however the impact of this change on the budget allocation on lower-income groups should be closely monitored. In Kyrgyzstan, spending was also rationalized, although education, social security and public health remained priority areas. This led to an improved fiscal performance in Kyrgyzstan, which also benefited from a rebound in the gold mining sector and higher economic growth. Overall, it is important to ensure that declines in public spending and increases in revenue do not adversely affect the poor and vulnerable groups in the population. To this end, coordinating fiscal and monetary policies is critical for stimulating investment and reducing inflationary pressures on households.

Monetary policy stances in the subregion were mixed, with interest rates remaining below the levels recorded during the global financial crisis in several of the economies. In Armenia, the policy rate was increased in August 2013 for the first time in two years as authorities responded to higher inflation resulting in part from rising import prices of gas. However, the policy rate was lowered in late 2013 and early 2014 as a programme to peg Armenian gas prices to Russian domestic prices for a five-year period began. In Azerbaijan and Tajikistan, the policy stance was further eased to stimulate domestic demand. In Georgia, after a series of policy rate cuts over 2013 to combat deflation, policy rate normalization began in early 2014 in line with a rise in inflation. In Uzbekistan, money supply growth slowed, which helped weaken inflationary pressures triggered by a weaker currency, import restrictions and higher public spending. A tighter policy stance was also noted in Kyrgyzstan on the back of robust economic activities.

In the Russian Federation, despite slowing economic growth, the policy interest rate remained unchanged between September 2012 and February 2014 as inflation stayed above the central bank's official target. To contain inflation, the central bank intervened actively in currency markets to limit the depreciation of the Russian rouble against the United States dollar. However, in early 2014, it hiked the policy interest rate by 200 basis points to 7.5% to curb inflationary pressures emerging from continued currency depreciation as capital outflows accelerated.

Changes also occurred in the implementation of monetary policy in the Russian Federation and Kazakhstan. Direct interventions by the Central Bank of Russia in the currency market in 2013 and the increase in the policy interest rate in early 2014 reflected a shift in monetary policy management from exchange rate targeting to inflation targeting. This shift is also backed by the strengthening of the supervisory role of the central bank through key amendments to the Banking Law and by raising the reserve requirements for commercial banks. Indeed, in anticipation of the forthcoming implementation of Basel III, the solvability ratio of Tier 1 common equity is set at 5%, compared to a ratio of 4.5% of Basel III. Moreover, in reaction to an increase in the household debt-to-income ratio from 15% in 2010 to 24% in 2013, the central bank has introduced higher requirements for uncollateralized loans and increased the risk weights for consumer loans.

Kazakhstan shifted from pegging its currency to the United States dollar to a multicurrency basket peg that comprises the Russian rouble, the euro and the United States dollar. This change was initiated partly in reaction to closer economic ties between Kazakhstan and the Russian Federation.

To promote economic diversification, countries, such as Armenia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan, have sought to attract more FDI in non-resource based sectors. The Government of Armenia announced deregulation policies, such as eliminating company registration fees and establishing a single window for public services, to support the country's medium-term growth. The Government of Kazakhstan revised laws related to public-private partnerships (PPPs) to increase the efficiency of public investments. These amendments helped expand the coverage of PPPs and authorized the use of international standards. In addition, the Government launched a programme to diversify exports and boost agricultural output. Under this programme, agricultural subsidies in 2014 will be twice as high as in 2013, which will aid producers who are struggling with higher costs for imported goods.

Outlook for 2014 and policy challenges

In 2014, growth in the subregion as a whole is projected to slow mainly due to expected lower growth in the Russian Federation. The fallout from geopolitical tensions related to Ukraine is expected to further depress already weak economic activity in the Russian Federation, which is projected to grow by only 0.5%. Besides capital outflows, investment in the country is also expected to suffer. Moreover, growth in the medium term is likely to remain well below the pre-crisis pace mainly due to the country's high dependence on oil production, which is likely to remain sluggish. Lower economic growth could eventually dampen the country's currently tight labour market, which would weaken remittance incomes in several neighbouring economies.

The economy of Kazakhstan is projected to grow at a slightly lower rate of 5.4%, as newly imposed restrictions on consumer credit weigh on household consumption. However, the devaluation of Kazakh tenge in February 2014 should boost net exports. Azerbaijan is projected to grow at a slower rate of 5% in line with lower public expenditures and less expansion in the oil industry. In Kyrgyzstan, growth could soften relative to the high base in 2013, but should still remain robust at an estimated rate of 6.5% in 2014. Export earnings are likely to remain sluggish, partly due to weak gold prices. Remittances are also expected to decelerate. Growth in Tajikistan could ease to 6% as higher inflation is likely to constrain private consumption, while cotton and aluminium prices are expected to rise only modestly.

In Turkmenistan, growth is expected to edge up to 10.4%, driven by public investments and private consumption, resulting from higher salaries and social transfers. Growth in Armenia is projected to increase to 4.5% in 2014, helped by an agreement by the Government of the Russian Federation to reduce the price of gas imported by Armenia. As a result, lower domestic prices of gas and electricity should help improve household spending and cut production costs. Economic growth in Georgia is expected to rebound to 5% due to greater political stability and rising public expenditures directed at SMEs. Finally, lower profit and income taxes should support industrial activities in Uzbekistan and help sustain the country's high overall growth rate of 8.1%.

Foreign investment strategies should align more closely with regional cooperation initiatives

The North and Central Asian economies should align their foreign investment strategies more closely with regional cooperation and integration initiatives in order to attract large-scale foreign investment in non-resource sectors, which thus far had been limited. Most North and Central Asian countries are relatively small in terms of population so a more integrated subregion would be critical in reducing fixed business costs.

Reducing trade costs would help foster intraregional trade. Cross-border and transit transport remains hindered by complex and non-harmonized procedures, as well as by limited cross-border transport infrastructure. In this regard, the implementation of regional initiatives aimed at strengthening regional economic cooperation and integration would be an opportunity for the subregion to achieve greater diversification. One possibility is regional connectivity of cities in the subregion (see box 2.2).

Furthermore, Governments may consider PPPs with an appropriate risk-sharing and regulatory framework as an option for cost-effective public service delivery. This is especially important with regard to transport networks, as such endeavours would help reduce

Box 2.2. Urbanization challenges in North and Central Asia

Following the collapse of the Soviet Union, five North and Central Asian countries — Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan — were established as independent States with immediate pressures to restructure their economies. Initially, many urban settlements in the subregion experienced a decline in economic activities with limited local budget revenue and urban infrastructure, and faced capacity challenges in managing urban development under newly introduced free-market mechanisms.

The demise of many urban economies had repercussions for national economic prospects. Recognition that cities are the drivers of national and regional economic growth and broader development opportunities has led to greater focus on urban areas in this relatively under-urbanized subregion. The share of urban population in those five North and Central Asian countries is 47% on average.

In order to evaluate urban development trends in North and Central Asia with a view to policy options, ESCAP and the Center for Economic Research partnered to complete an analytical report entitled “Urbanization in Central Asia: challenges, issues and prospects”. The three main outcomes of the study are as follows:

First, North and Central Asia has substantial potential for economic growth. In managing these prospects, urban policy will be a key factor. However, in many cases, urbanization policies aimed at establishing and maintaining productive, sustainable and inclusive cities are lacking. Though cities are recognized as having a critical role as national and subregional growth poles, urban policy is still evolving. In addition, regional connectivity of cities provides great opportunities for the subregion. By developing their growth poles centred on strategic urban centres, complemented by the development of economic corridors, both national and regional economic prospects can be enhanced, including through cross-border trade routes to distant markets.

Second, the majority of urban areas in North and Central Asia suffer from failing public infrastructure, such as electricity, gas heating, water and sewage. Investments to upgrade and develop urban infrastructure are also lacking. Increasing urban populations will only exert greater pressure on existing urban infrastructure both in terms of quantity and quality of services. Future infrastructure systems policies and projects must take into account opportunities provided by changing technologies. The massive investments required to maintain and modernize urban infrastructure will benefit from planning that is based upon low-carbon and sustainable urban development.

Thirdly, the subregion has implemented different approaches for urban development with the aim to improve the capacities of municipal governance systems, such as municipal budgeting and support for social and economic development in urban areas. However, greater opportunities still lie in streamlining policies and creating broader stakeholder engagement, including with communities, in addressing the future challenges of urban transformation in North and Central Asia.

transport costs. According to World Bank data, in recent years, the number of infrastructure projects involving participation of the private sector ranges from a few projects in Tajikistan, Turkmenistan and Uzbekistan to more than 300 projects in the Russian Federation.

The low level of private investment in non-resource based activities is concomitant with other structural challenges faced by the subregion. The development of the private sector has been impeded by structural problems that affect innovation and entrepreneurship. ESCAP analysis shows that the absence of fair competition undermines the development of innovative products, and that better access to funds could foster innovation. Currently in the subregion, more than 80% of fixed assets are purchased using either internal funds, short-term cash flows, such as credit from suppliers or advances from customers, or unconventional sources, including moneylenders, friends or relatives.

PACIFIC

The Pacific subregion is divided into two distinct groups for analytical purposes. One group consists of Pacific island developing economies and the other of Australia and New Zealand.

Pacific island developing economies

Growth slowed amid lower commodity prices

The weak global economy has resulted in lower commodity prices and contributed to an economic slowdown in Australia. It has also been a key factor behind lower output growth in the Pacific island developing economies, which as a whole fell to 4% in 2013 from 5.3% in 2012 (see table 2.3).

The deceleration of growth was more pronounced in Palau and the resource-rich economies, such as

Table 2.3. Rates of economic growth and inflation in selected economies in the Pacific, 2012-2014

(Percentage)

	Real GDP growth			Inflation[a]		
	2012	2013	2014[b]	2012	2013	2014[b]
Pacific[c]	**3.5**	**2.4**	**2.9**	**1.7**	**2.3**	**2.7**
Pacific island developing economies[c]	**5.3**	**4.0**	**4.9**	**2.6**	**3.7**	**4.9**
Cook Islands	4.4	3.2	2.2	3.0	1.9	2.5
Fiji	1.7	3.6	3.8	3.4	2.9	3.0
Kiribati	2.5	2.0	3.0	-3.0	2.0	2.5
Marshall Islands	3.2	0.8	3.0	4.3	1.6	1.5
Micronesia (Federated States of)	0.4	0.6	0.5	5.8	2.2	2.0
Nauru	4.9	4.5	10.0	-0.5	1.4	5.0
Palau	4.8	-1.0	3.0	5.4	3.0	2.5
Papua New Guinea	8.0	5.1	6.2	1.6	4.7	6.5
Samoa	2.7	-0.5	2.0	6.2	-0.2	2.0
Solomon Islands	4.8	3.2	3.7	5.9	5.6	5.5
Tonga	0.8	1.6	2.0	2.5	0.8	2.0
Tuvalu	0.2	1.1	2.0	1.4	2.0	2.5
Vanuatu	1.8	3.2	3.5	1.4	1.4	2.5
Developed countries[c]	**3.5**	**2.4**	**2.9**	**1.7**	**2.2**	**2.7**
Australia	3.6	2.4	2.8	1.8	2.4	2.8
New Zealand	2.9	2.4	3.3	1.1	1.1	2.0

Sources: ESCAP, based on national sources; Asian Development Bank, *Asian Development Outlook 2014* (Manila, 2014); and CEIC Data (for Australia and New Zealand). Available from www.ceicdata.com (accessed 15 June 2014).

[a] Changes in the consumer price index.
[b] Forecasts (as of 15 June 2014).
[c] GDP figures at market prices in United States dollars in 2010 (at 2005 prices) are used as weights to calculate the subregional aggregates.

Papua New Guinea and Solomon Islands. Domestic factors also affected the growth performance of individual countries. Investment in Papua New Guinea slowed due to the completion of a large liquefied natural gas project and the economy of Samoa was adversely affected by a tropical cyclone. On the other hand, growth in Fiji in 2013 was stimulated by an expansion of government expenditure to rehabilitate and upgrade the country's road network, as well as by increased domestic investment and consumption.

The structure of Pacific island developing economies underwent some changes over the past decade, as the agricultural and industry sectors' shares of GDP declined and the share of services sector increased. In Fiji, for instance, the share of the agricultural sector declined from 18.8% of GDP in 1995 to 12.1% in 2011, while in Samoa, it fell from 18.4% of GDP in 1995 to 9.8% of GDP in 2012. The agriculture share in Papua New Guinea also fell, partly because the share of industry increased from 33.3% of GDP in 1995 to 44.2% of GDP in 2012, reflecting the domination of the mineral resource boom being experienced by the country. In contrast, the contribution of the services sector to GDP has been on the rise, mainly on the back of the large and growing tourism sector in the subregion. The share of the services sector was more than 50% in most of the Pacific island economies in 2011. Despite the decline in agriculture's share in GDP, the agriculture (including fisheries) continues to be the main provider of employment in many of these economies, indicating low agricultural productivity.

Economic growth rates have been slow in Pacific island economies, leading to joblessness, especially among the youth. High levels of unemployment and underemployment are significant problems across the Pacific. The global economic downturn made the situation worse. For example, 53% of Samoan employers had frozen or cut employment in 2009. The country's largest industrial company, an auto parts manufacturer, which provides 16% of all private formal sector jobs, cut its workforce by 70% in the aftermath of the global financial crisis when the automotive market in Australia weakened. In Kiribati, about 2,000 persons enter the labour market each year, while the formal economy generates less than 500 jobs a year. In Vanuatu, the mismatch is also sizeable, with 3,500 new entrants for less than 700 jobs a year. Thus, in these countries, only a fraction of the job seekers find paid employment.[6] Youth and females are particularly disadvantaged. Less than 35% of women aged 20-29 years in the Marshall Islands, Samoa and Solomon Islands are officially employed.

Total investment-to-GDP ratio is much higher than the savings ratio in all Pacific island developing countries, but it is still generally low

While investment needs are large, the levels of national savings in these small economies are very low. In Solomon Islands, gross national savings was only 13.5% of GDP in 2013. It was even lower, at 9.7% of GDP, in Papua New Guinea. Total investment as a share of GDP is much higher than the savings ratio in all of the Pacific island developing countries, but still investment ratios among them generally remain low. However, the investment ratio in Fiji jumped to 28% in 2013 from 17% in 2012, driven by the purchase of airplanes by Fiji Airways. Papua New Guinea attracted large FDI in the mining sector in recent years, which is tapering now with the completion of a major project.

Growth in Fiji strengthened from 1.7% in 2012 to 3.6% in 2013, in line with higher investment. Underpinned by its robust manufacturing and financial sectors, the expansion of the economy was broad-based with positive contributions from all sectors except for the mining and quarrying sector. In addition to increased public investment, tax cuts and higher tax thresholds and inward remittances helped boost domestic demand. Public investment in infrastructure and lower interest rates together with lower corporate tax rates induced private investment, resulting in the highest investment-to-GDP ratio of 28% in more than two decades. The economic rebound was held back somewhat by major floods, which affected agricultural output and tourism revenue. Some of the policy priorities of the Government are to encourage exports and the diversification of the economy, as consumption and investment-led growth may not be sustainable in the medium term.

Key policy challenges are how to manage the windfall revenue from resource projects and promote growth to benefit the wider community

Economic expansion in Papua New Guinea softened to 5.1% in 2013 from 8% in 2012. The deceleration was largely anticipated due to the slowdown in investment as a $20 billion liquefied natural gas project nears completion. As a spillover, growth in construction halved to 12% in 2013 from 24% in 2012, and wholesale and retail trade growth decelerated from 20% in 2012 to 5% in 2013. Meanwhile, the ongoing decline in the operations of a number of older mining and oil fields was more than offset by a rise in output from new nickel project operations. The increased output was the main factor behind growth of 15% in the country's mining and quarrying sector in 2013. Agricultural and mining activities will continue to play a key role in driving the economy, although stronger commodity prices are needed to support future economic growth. Key policy challenges for the country are how to manage the windfall revenue from the gas project and the need to promote growth that benefits a broader section of the population.

The economy of Samoa shrank by 0.5% in 2013. The country is highly vulnerable to natural disasters as witnessed by the extensive damages caused by Tropical Cyclone Evan in many parts of the country in late 2012. The country's medium-term development plan identifies 14 key priorities, including macroeconomic stability, promoting tourism and business development and improved access to essential social services, as well as to safe drinking water, sanitation and transport.

Growth in the Solomon Islands slowed to 3.2% in 2013 from 4.8% in 2012 due to lower output of wood logging, the result of declining forest cover. Despite attempts to diversify the economic base, the country remains dependent on exports of wood logs, fish and more recently minerals. Gold mining could replace logging as the main growth driver in the coming years. Developing potential sectors, such as ecotourism, may broaden the economic base. The country also needs to ensure sustainable forestry and fishing.

In Vanuatu, output growth picked up to 3.2% in 2013, mainly due to an improvement in tourist arrivals. Despite the rebound, growth was held back by slow implementation of major public works projects, such as the country's first fibre-optic cable. The development of seabed mining was also slow. The Government's policy priorities include fiscal and land reforms.

The economy of Nauru expanded by 4.5% in 2013, down slightly from the pace seen in the previous year. Fishery output and phosphate exports supported the expansion. Growth was also driven by activities related to the expansion of the Australian Regional Processing Centre of the asylum seekers, which employs more than 600 Nauruans and is the second largest employer after the Government. Care must be taken so that the rights of the refugees are protected according to the Convention relating to the Status of Refugees.

The Cook Islands recorded more modest economic growth of 3.2% in 2013, as public infrastructure spending and tourism receipts decreased. Growth of the Kiribati economy also slowed, to 2%, even though investment in public infrastructure increased. An economic slowdown was similarly observed in the Marshall Islands, which posted modest growth of 0.8% despite ongoing infrastructure investments. The economy of Palau recorded an economic contraction of 1% due to lower tourist arrivals.

Against this downward trend in several economies, economic growth in Tonga accelerated to 1.6% in 2013. In Tuvalu, growth increased to 1.1%, with ongoing infrastructure upgrades, improved fishery output and remittances supporting the economy. Meanwhile, growth also edged up to 0.6% in the Federated States of Micronesia.

Moderate inflationary pressure

Moderating international food and fuel prices led to lower inflation rates in several Pacific island developing economies in 2013 (see figure 2.8). As a group, however, the average inflation rate increased slightly on the back of steep price rises in Papua New Guinea, the largest economy in the subregion.

In Papua New Guinea, the inflation rate increased to 4.7% in 2013 from 1.6% in 2012. The weaker domestic currency against the United States dollar and the currencies of the country's key trading partners was a major contributing factor.

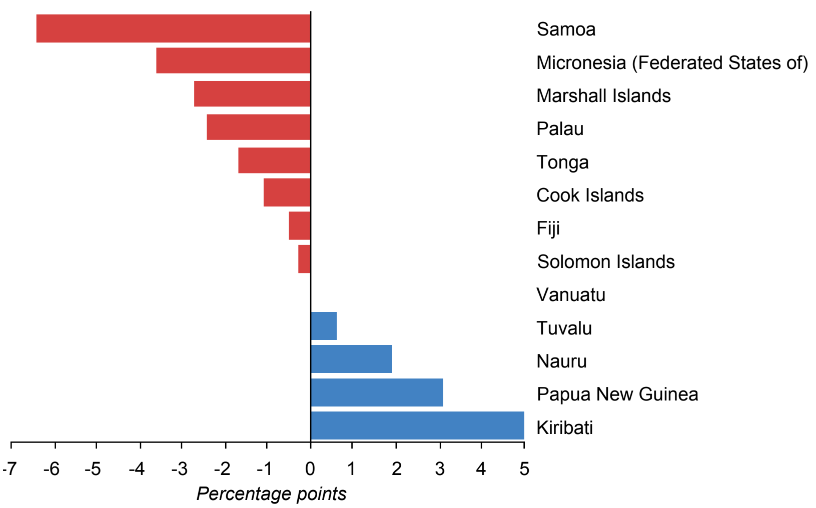
In Fiji, inflation eased moderately to 2.9% in 2013, despite a hike in the salaries of workers in the public sector. Food prices stabilized following supply disruptions early in the year in the aftermath of Cyclone Evan and adverse weather conditions. Meanwhile, inflation in Solomon Islands remained relatively high at 5.6% amid additional spending under the country's supplementary budget in 2012. In Samoa, a strong rebound in agricultural production following Cyclone Evan helped lower price levels after a steep rise in 2012.

Given the moderate inflationary pressures in the subregion, prompt monetary policy reaction may not be needed. However, the central banks should continue to closely monitor price developments and find non-conventional solutions to manage supply-side inflation. Governments should also consider some fiscal support measures to help the poor if price pressures build up.

External current account deficits remained large

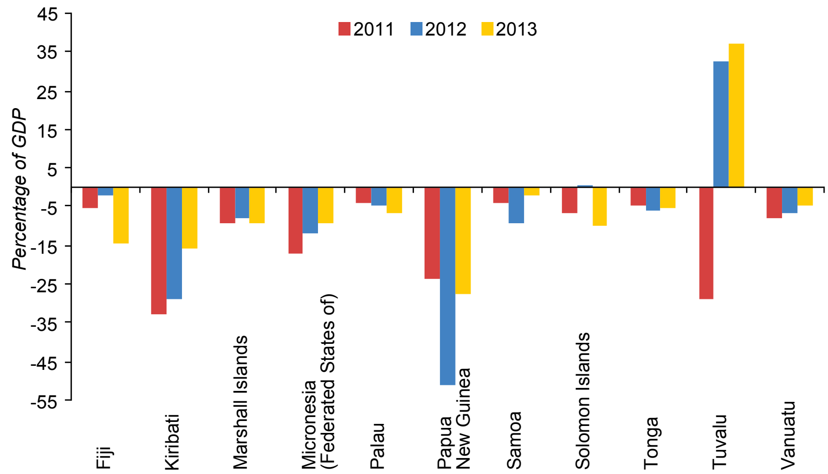
Commensurate with large savings-investment gaps, most Pacific island developing economies continued to register current account deficits. Fiji, Kiribati, Papua New Guinea and Solomon Islands recorded current account deficits of at least 10% of GDP in 2013 (see figure 2.9). Strong import demand and weak export earnings caused by sluggish global prices for their main export items, including agricultural commodities, resulted in trade deficits. Also, workers' remittances softened in some economies. In Samoa and Tonga, remittances constituted more than a quarter of their GDP.

Figure 2.8. Inflation in selected Pacific island developing economies, changes in 2013 relative to 2012



Sources: ESCAP, based on national sources; Asian Development Bank, *Asian Development Outlook 2014 Update* (Manila, 2014); and International Monetary Fund, 2013 and 2014 Article IV Consultations. Available from www.imf.org/external/ns/cs.aspx?id=51.

Figure 2.9. External current account balance in selected Pacific island developing economies, 2011-2013



Sources: ESCAP, based on national sources; Asian Development Bank, *Asian Development Outlook 2014* (Manila, 2014); Economist Intelligence Unit, *Country Reports*; and International Monetary Fund, World Economic Outlook database, April 2014.

Note: Figures for 2013 are estimates.

Declining global commodity prices depressed the export receipts of Papua New Guinea in 2013. Gold and petroleum exports to Australia fell by 32% during the first quarter of the year. Exports of copper, gold and oil accounted for about two thirds of total export earnings. The country recorded a large trade deficit and a double-digit current account shortfall as a percentage of GDP due to increased demand for imported goods to service a liquefied natural gas project.

In Fiji, as the investment-to-GDP ratio shot up, the current account deficit jumped to 15% of GDP in 2013 from only 1.8% in 2012. This occurred despite a rise in private remittance flows in 2013, which was largely underpinned by the significant deployment of Fijian soldiers to international peacekeeping missions. Exports shrank while imports continued to rise on the back of strong domestic demand. Tourism revenues fell in early 2013 following Cyclone Evan, although an estimate for the whole year suggests that they recovered later in the year.

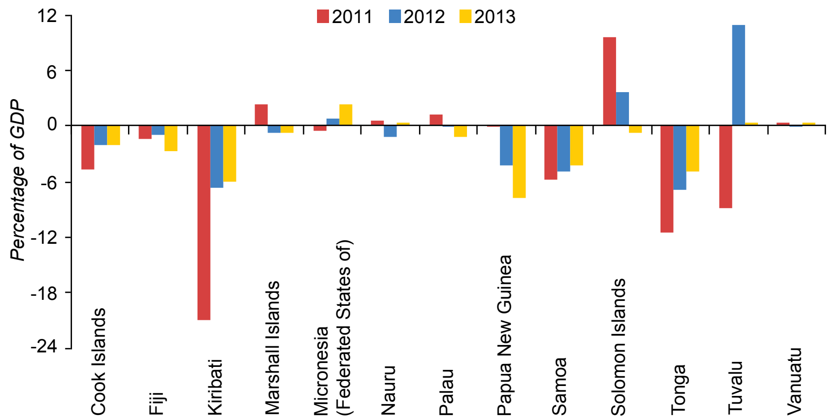
The current account balance of Solomon Islands turned to a deficit of 10% of GDP in 2013 from a small surplus in 2012. Export receipts contracted by 18% on declining commodity prices while import payments fell more modestly. The balance of payments position, nonetheless, improved in the first half of 2013, owing to steady donor support and foreign investment inflows.

Policy responses and structural reforms: fiscal consolidation and private sector promotion

Recent progress in improving fiscal management in some of the countries in the subregion is a welcome development and should be sustained to build fiscal space for responding to economic shocks. To achieve long-term fiscal sustainability, the Pacific island developing economies need to contain the growth of the public sector, rationalize public sector wage bills and initiate broader based tax reforms, including strengthening tax administrations. However, given their small economic base, most Pacific island developing economies will continue to depend on development partnerships for closing their development gaps.

Budget deficits in the Pacific island developing economies were generally moderate in 2013, with the exception of Kiribati, Papua New Guinea, Samoa and Tonga where the shortfalls reached 4.4-7.8% of GDP (see figure 2.10).

Figure 2.10. Budget balance in selected Pacific island developing economies, 2011-2013



Sources: ESCAP, based on national sources; Asian Development Bank, *Asian Development Outlook 2014* (Manila, 2014); and International Monetary Fund, 2013 and 2014 Article IV Consultations. Available from www.imf.org/external/ns/cs.aspx?id=51.

In Fiji, the budget deficit remained low but it widened to 2.8% of GDP in 2013. To support medium-term economic growth, larger public resources were allocated to public works, especially on road maintenance and upgrading. Higher expenditures were also accompanied by stronger government revenue due to more efficient tax collection.

Papua New Guinea recorded a higher budget deficit of 7.8% of GDP in 2013. Nevertheless, as in Fiji, the increased spending focused on growth-enhancing areas. In particular, spending on infrastructure, education, health and internal security rose by 38%. In the 2013 budget, however, it was highlighted that the country faced challenges related to implementation capacity as public agencies struggled to spend growing budgetary resources.

The fiscal deficit in Samoa narrowed to 4.4% of GDP in 2013. Government revenue rose by about 10% due to higher external grants for post-cyclone rehabilitation and reconstruction. Although the shortfall remains above the official target of 3.5% of GDP, there has been some progress in efforts that began in 2010 aimed at achieving medium-term fiscal consolidation.

Vanuatu recorded a small budget surplus of 0.3% of GDP in 2013. Higher revenue collection of value-added taxes and import duties boosted government revenue by 10% in the first half of 2013 while current expenditure fell. In Solomon Islands, the fiscal balance turned to a deficit of 0.7% of GDP in 2013. Tonga also posted a budget shortfall, of 4.9% of GDP, due to lower external grants and a supplementary budget to fund airport development.

Turning to monetary policy, the Reserve Bank of Fiji continued its accommodative stance in 2013, with the overnight policy rate remaining unchanged at 0.5% to support investment and economic growth. In Papua New Guinea, the policy interest rate was stable for most of 2013 after cuts of 150 basis points were made in the period from September 2012 to March 2013.

The public sector plays a major role in most of the economies in the subregion. Public monopolies in water and electricity supply, as well as in port and inter-island shipping services are quite common. Services provided by these public and semi-public monopolies are generally below standard and inadequate. To improve their quality and coverage, Governments need to seek support from development partners for new investment. Private sector participation in utilities could contribute to improved efficiency. However, this has to be balanced with equity and access as private sector involvement may lead to price hikes, especially when the market size is small.

Limited market size may not accommodate enough producers for effective competition and a private monopoly may replace the public monopoly

As part of its reform plans to improve the efficiency of public enterprises, Fiji continued to encourage more private sector participation. A public-private partnership was formed in April 2013 to manage the operations of the country's main ports. This arrangement will improve the efficiency of the port facilities, potentially resulting in higher trade. The Government also plans to divest most of its shares in other key public enterprises in 2014. The deregulation of the energy sector moved forward, which is expected to promote competition and facilitate the provision of efficient and affordable electricity services to the general public. However, the limited market size may not be able to accommodate enough producers for effective competition to occur and a private monopoly may replace the public monopoly. Therefore, this policy would require continuous monitoring. The Government also scrapped the minimum investment value required for foreign investors and reduced the corporate tax rate payable by foreign firms setting up headquarters in the country to 17%. The outcome of this policy also needs to be monitored carefully as experiences elsewhere, especially in the small island economies of the Caribbean, show that lowering taxes does not lead to higher FDI (see chapter 3 for more details). As a result, countries offering lower taxes to foreign investors or corporations end up with a shrunken fiscal space.

Papua New Guinea continued to pursue a national reform agenda that includes supporting greater private sector participation in the economy. Some of the key reform strategies include developing more efficient and competitive markets and streamlining business regulations. These reforms have improved the investment climate in the country. The Government also remains committed to public sector reforms. As part of the rightsizing public sector reform, the Government plans to amalgamate government agencies with duplicate functions in 2014.

Outlook for 2014 and policy challenges

The expected global economic recovery in 2014, especially in developed economies, should provide a boost for most Pacific island developing economies. This is especially true for resource-rich countries, such as Papua New Guinea and Solomon Islands, and for the smaller economies dependent on remittances and tourism receipts. As a group, Pacific island developing economies are expected to enjoy more rapid economic growth of 4.9% in 2014.

The Papua New Guinea economy is projected to grow by 6.2% in 2014, an improvement over the previous year. While the construction of a large liquefied natural gas project was almost completed in the first half of 2014, the subsequent production of natural gas will help propel economic growth. The economy should also be buoyed by a rebound in mining output, as major mines return to normal production following disruptions in 2013. The economy of Fiji is projected to grow at a slightly faster pace of 3.8%. Despite an expected fall in public investment, sectors, such as construction and sugar, should support the projected expansion of the economy.

An expected rise in tourist arrivals should help Solomon Islands post a slightly better growth, of 3.7%, in 2014. The economy of Samoa is projected to turn from a contraction in 2013 to expand 2% in 2014, due to an expansionary budget, which is aimed at stimulating growth. In Kiribati, higher growth of 3% is forecast based on expected stronger construction activity, of which much of it is tied to roads and airport projects financed mainly by development partners. Strong tourism revenue and a raft of planned infrastructure projects are likely to support growth of 3.5% in Vanuatu. The implementation of major infrastructure projects, however, is subject to receiving large foreign grants and loans.

Many Pacific island developing economies will continue to face the growing challenge of providing basic services to the poor and vulnerable groups of the society. The situation is compounded by falling levels of official development assistance, lower agricultural productivity, growing populations, high youth unemployment, and low and uneven economic growth.

Pacific island countries face the increasing threat from climate change

Pacific island countries also have to deal with the increasing threat from climate change. Climate change, including ocean acidification and sea-level rise, does not only affect the natural environment, such as coastal resources and land loss, but it also has an impact on economic and social development, particularly for vulnerable populations. According to a recent report,[7] the most significant economic losses related to climate change could be felt in Papua New Guinea where they could amount to 15% of GDP by 2100. The loss is estimated at 4-6% of GDP in Fiji, Samoa, Solomon Islands and Vanuatu. Access to, and timely implementation of, global resources for adaptation and mitigation remain a priority for these small countries.

It is, therefore, vital for Pacific island countries to adopt policies that develop their comparative advantages in sectors such as agriculture, tourism and fisheries in a sustainable fashion, as these sectors enjoy unique biodiversity. These policies also need to promote jobs, particularly for the large pool of unemployed youth. While large informal sectors in the Pacific economies have provided job opportunities, growth of formal sector employment is necessary to raise income levels. Further development of the private sector is also needed, as currently the public sector is a major source of job creation.

To enhance job-rich growth, these economies need more private sector investment, especially in niche markets that can overcome market size and distance disadvantages. They need to create an enabling environment for private sector investments in labour-intensive sustainable ecotourism. This is crucial given the fragile ecological environment and rich biodiversity of the subregion and threat it faces from climate change. The Pacific island economies also need to develop their financial systems, reform their legal and regulatory approaches and revamp their State enterprises.

The development of rural areas and outer islands through the provision of necessary infrastructure and support for leveraging sustainable resource-based sectors will foster improved livelihoods and mitigate rural-to-urban migration. Given the significant potential for small and microenterprises in Pacific island developing economies, appropriate policies should include lowering barriers and costs of doing business. To undertake evidence-based policymaking, countries need to strengthen efforts to improve data collection and analysis, particularly in social areas (see box 2.3).

Given their small size and limited economies of scale, regional cooperation among Pacific island countries has served this group of economies well in such areas as sustainable fishery management. Regional cooperation in other areas, such as liberalizing the aviation sector, could lead to service improvements and efficiencies and thus would benefit export capacity and tourism potential. These small economies should also continue to explore and strengthen their trade and investment links with neighbouring countries and subregions, including the ASEAN, which is set to offer great trade and investment opportunities with the launch of the ASEAN Economic Community in 2015.

Australia and New Zealand

Growth performance weakened

The Australian economy slowed to 2.4% in 2013 from 3.6% in 2012 (see figure 2.11). Mining sector investment, which propelled growth in the past years, has started to wind down. The booming mining sector generally led to a stronger currency and

Box 2.3. Strengthening the evidence base for disability policymaking in the Pacific

Disability in Pacific island developing countries has typically been an invisible issue. There is relatively little accurate official data on the incidence of disability and few services for people living with physical or mental impairments. Disability is low on the policy agenda and receives minimal proportions of national budgetary resources.[a] People with disabilities in these economies are among the poorest and most marginalized members of their communities.[b] Evidence suggests that the number of persons with disability is increasing due to high rates of diabetes-related amputations and blindness, increasing traffic and industrial accidents, and ageing populations.

Although Governments in Pacific island developing countries have been slow to address disability, there have been some positive changes in the past decade. There is increasing awareness of disability issues across the subregion, and enhanced political will to ensure that policies and development plans are disability-inclusive. Development partners and intergovernmental organizations have taken a strong lead in providing technical assistance and resources.

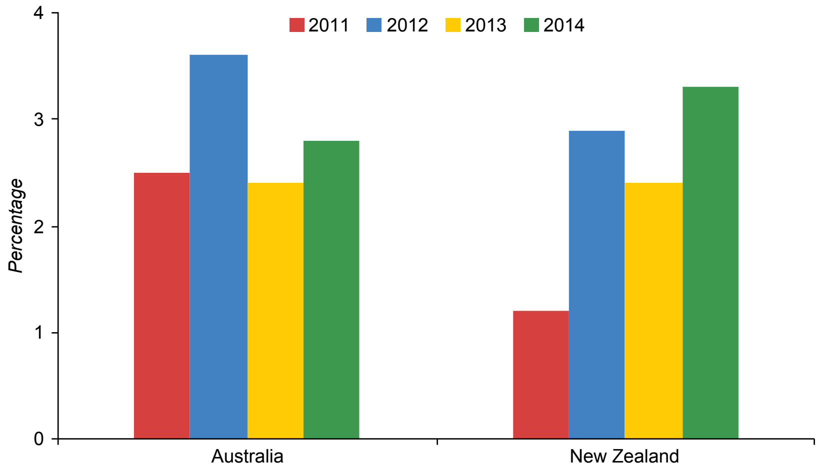
The Convention on the Rights of Persons with Disabilities provides a comprehensive framework for Pacific island developing countries to shape disability-inclusive development. Several economies have demonstrated political commitment to strengthening the protection and promotion of the rights of persons with disabilities by ratifying and implementing the Convention. Australia, New Zealand and Vanuatu ratified the Convention in 2008, followed by the Cook Islands in 2009 and Nauru in 2012. In 2013, Kiribati, Palau, Papua New Guinea and Tuvalu became States Parties to the Convention.

Another important milestone has been the Pacific Regional Strategy on Disability 2010-2015, which was developed based on the Convention. This was endorsed at the First Forum Disability Ministers' Meeting, which was held in October 2009. The Strategy is based on the following: human rights principles; reducing vulnerability and risks of disabilities; and improving care, support and partnerships. It provides achievable guidelines to support national efforts to advance disability issues. The Strategy calls upon Governments and civil society to mainstream disability into all local and national policies and practices, including national censuses, labour force surveys, and household income and expenditure surveys.

Although there are signs that progress has been made, disability prevalence still remains grossly underestimated in most of the Pacific island developing countries. Except for a few countries that have recorded prevalence of 11-18.5%, such as Australia, Federated States of Micronesia, New Zealand and Vanuatu, prevalence for Pacific island countries is below 5%.[c] High reliance on census data with limited space for questions concerning disability and the lack of data collection instruments going beyond severe impairments are the two main reasons for this underestimation. The lack of relevant data collection on persons with disabilities is hampering not only the design, implementation and evaluation of effective policymaking, but more importantly, the quality of the lives of persons with disabilities.

[a] Tavola (2012).
[b] Pacific Islands Forum Secretariat (2009).
[c] ESCAP (2012a).

Figure 2.11. Economic growth of Australia and New Zealand, 2011-2014



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Note: Real GDP growth rates for 2014 are forecasts.

therefore weakened competitiveness in non-resource sectors, a typical manifestation of the Dutch disease.[8] Slower economic growth held back employment and wage growth. The unemployment rate rose to 6% in January 2014, the highest level in a decade. Meanwhile, the housing market continued to rebound, which helped boost dwelling investments.

Growth momentum in New Zealand also slowed, from 2.9% in 2012 to 2.4% in 2013. Weaker investment and a decline in public spending in the latter part of the year dragged on overall growth. Rising construction activities, which were a reflection of the post-earthquake reconstruction efforts in Christchurch, were the main driver of growth. Strong net immigration, the largest increase since 2003, along with the country's low unemployment rate also propped up housing demand and domestic consumption. Following the drought that dampened dairy output in the first half of 2013, the industry recovered strongly in the third quarter.

Inflationary pressure remained modest

Inflation in Australia accelerated slightly to 2.4% in 2013. This was partly due to the one-time impact the introduction of the carbon tax in mid-2012 had on prices. Weak labour market conditions helped contain inflation within the official target range. The depreciation of the Australian dollar, which has been ongoing since mid-2013, has started to have some inflationary pressures on tradable goods. In contrast, the inflation rate in New Zealand remained low, at 1.1%, in 2013. Maintaining a low-inflation environment for an extended period of time may not be desirable as when nominal interest rates are high, a low inflation rate implies high real interest rates, which raise the real burden of debt and potentially dampen household and corporate spending.[9] Very low inflation also pushes up real wages if nominal wages continue to rise. This may adversely impact employment growth. A very low inflation rate also risks deflation.

Stronger exports narrowed current account deficits

The Australian trade balance turned to a surplus in 2013. Despite subdued export prices, high export volumes of metal ore helped boost export revenues. Imports also rose, but only marginally, driven by mining-related capital goods. The current account deficit thus narrowed to 3.2% of GDP in 2013 from 4.2% of GDP in 2012. The current account deficit of New Zealand moderated to 3.4% of GDP in 2013. Although the strong New Zealand dollar dampened export earnings somewhat, the country benefited from favourable terms of trade on rising export prices of dairy products. More broadly, stronger currencies in both economies in recent years held back inbound tourism and the number of foreign students, and generally weakened non-commodity exports.

Policy responses: fiscal consolidation

In Australia, the budget deficit increased to 2.9% of GDP in 2013, as resource tax revenues declined on the back of falling commodity prices. The carbon tax and minerals resource rent tax will be cancelled from July 2014 amid some opposition from environmental activists. It is claimed that such a policy shift should reduce price pressures and boost the economy. A large transport infrastructure project is under way, which should help improve output in the medium term, as well as budget positions. A sustainable fiscal surplus is targeted by 2025. Meanwhile, monetary policy has been accommodative. At the end of 2013, the policy interest rate stood at 2.5%, a total of 225 basis points lower than the level in November 2011.

In New Zealand, strong output growth in the early part of 2013 helped lower the fiscal deficit to 1.1% of GDP in the fiscal year 2013. Despite large spending requirements for post-earthquake reconstruction activities, the Government is targeting to balance the budget by 2015. Meanwhile, more robust economic activities and rising inflation expectations prompted the central bank to hike the policy rate three times in early 2014 to 3.25%. Prior to that, it had been left unchanged since March 2011. The effects of restrictions on the loan-to-value ratio for mortgage lending that were announced in October 2013 have started to ease pressure on the housing market, while rising interest rates are poised to have a further moderating effect.

Outlook for 2014 and policy challenges

Economic growth in Australia is likely to remain sluggish, at 2.8%, in 2014. This is due to falling mining investments, fiscal restraint and fragile private consumption. Weak labour market conditions should help contain inflation. Commodity exports are set to continue to support the economy, but the outlook is constrained by a policy shift in China towards domestic demand-led growth, which will soften demand for the country's commodities. The housing market is likely to strengthen, but the possibility of an asset bubble should be monitored closely. Monetary policy should not react to the orderly depreciation of the Australian dollar in recent months, as this was needed to improve the competitiveness of the non-resource sectors in order to supplement the fall in resources investments.

The Australian economy is likely to remain sluggish due to weak mining investment

The New Zealand economy is projected to grow by 3.3% in 2014. Higher net immigration, better prospects for the diary industry, and the reconstruction activities will continue to support the economy. However, this is conditional on the strength of private consumption and investment, as fiscal consolidation moves forward and monetary policy is tightened. Regarding possible headwinds, the strong New Zealand dollar could hurt export growth, while surging house prices and monetary tightening in the United States may drive up interest rates further and put strains on investments and consumer spending.

SOUTH AND SOUTH-WEST ASIA

Slight pickup in growth

Overall growth in South and South-West Asia picked up to 3.9% in 2013 from 2.9% in 2012 (see table 2.4), but it remained well below the 6.4% pace that was registered in the years prior to the global financial turmoil.

Economic growth in Afghanistan dipped to 3.6% in the fiscal year 2013 after a bumper agricultural harvest in the previous year that helped push the growth rate to 14%. Agriculture accounted for a

Table 2.4. Rates of economic growth and inflation in South and South-West Asian economies, 2012-2014

(Percentage)

	Real GDP growth			Inflation[a]		
	2012	2013	2014[b]	2012	2013	2014[b]
South and South-West Asia[c,d]	**2.9**	**3.9**	**4.7**	**11.9**	**11.3**	**9.3**
Afghanistan	14.0	3.6	3.2	6.4	7.4	6.1
Bangladesh	6.2	6.0	6.1	10.6	7.7	7.0
Bhutan	4.6	6.9	7.1	13.5	8.7	7.6
India	4.5	4.7	5.5	10.2	9.5	8.0
Iran (Islamic Republic of)	-5.8	-1.7	1.5	30.5	35.2	23.0
Maldives	1.3	3.7	4.5	10.9	4.0	5.0
Nepal	4.5	3.6	4.5	8.3	9.9	9.8
Pakistan	3.8	3.7	4.1	11.0	7.4	8.0
Sri Lanka	6.3	7.3	7.6	7.5	6.9	6.0
Turkey	2.2	4.0	4.0	8.9	7.5	7.6

Source: ESCAP, based on national sources.

[a] Changes in the consumer price index.
[b] Forecasts (as of 15 June 2014).
[c] GDP figures at market prices in United States dollars in 2010 (at 2005 prices) are used as weights to calculate the subregional aggregate.
[d] The estimates and forecasts for countries relate to fiscal years, and are defined as follows: 2013 refers to fiscal year spanning 1 April 2013 to 31 March 2014 in India; 21 March 2013 to 20 March 2014 in Afghanistan and the Islamic Republic of Iran; 1 July 2012 to 30 June 2013 in Bangladesh, Bhutan and Pakistan; and 16 July 2012 to 15 July 2013 in Nepal.

quarter of total output and the majority of employment. Continued security issues have dampened consumer confidence, while donor-led investments also decelerated. The country's dependence on donor assistance leaves it highly vulnerable to the planned exit of international security forces in 2014.

Growth in Bangladesh softened slightly to 6% in the fiscal year 2013 from 6.2% in the previous year. The decline was mainly driven by slower growth in agriculture and the services sectors. The economy also suffered from political unrest related to parliamentary elections. Growth of the industrial sector picked up slightly to reach 9%. The economy has seen growth of more than 6% in the past few years due to expanding garment exports and strong household spending fuelled by steady workers' remittances. Annual private investment, however, recently contracted for the first time in at least a decade due to political tension and the increasing adverse effects on the economy arising from the country's inadequate infrastructure and energy shortages.

The economy of Bhutan depends on exports of hydropower to India. These exports helped the country enjoy high economic growth of 6.9% in the fiscal year 2013. Investment in large-scale hydropower projects propelled construction activities, although tight domestic financial liquidity constrained bank lending. Tourist arrivals continued to support private consumption. The country's macroeconomic conditions are closely linked to India in terms of export earnings, official grants, a pegged exchange rate and inflation.

The Indian economy expanded by 4.7% in the fiscal year 2013, up from 4.5% in the previous year. This rate is, however, far below the 9.5% pace registered in pre-crisis years. A fragile global economy has weighed on growth in recent years, but delays in tackling structural impediments, such as rising inequality, high inflation, infrastructure shortages and public spending effectiveness, have also been important factors. The economy experienced market volatility and heavy losses in the value of the Indian rupee during the period May-August 2013, as a large amount of capital was withdrawn from the country on speculation of a change in the United States monetary policy stance. Tight monetary policy to contain inflationary expectations and capital flight also had an impact on domestic demand.

Consumer confidence deteriorated, with car sales in 2013 declining for the first time in a decade. Fixed investment also slowed, in line with sluggish demand and higher interest rates. Subdued output growth pushed up the measured unemployment rate by one percentage point to 4.7%. Structural challenges have constrained the country's capacity to weather capital market volatility as was seen in mid-2013.

Structural impediments like rising inequality and infrastructure shortages held back economic growth

The economy of the Islamic Republic of Iran contracted for the second year in a row in the fiscal year 2013, though at 1.7%, the rate was much lower than in 2012. International sanctions severely limited oil production and exports, which accounted for nearly three fourths of GDP, as well as goods imports and access to international financial markets. Lower global oil prices and sluggish household spending amid high inflation and jobless rates also contributed to the economic decline. Prices spiked after the Government lowered significantly the official exchange rate in July 2013.

Maldives enjoyed more rapid growth, of 3.7%, in 2013, as compared with 1.3% in 2012. The tourism sector, which accounts for one third of GDP, recovered from a mild contraction recorded in 2012. Tourist arrivals rose by almost 20%, with a notable expansion in visitors from China. The fisheries sector expanded for the first time in seven years, while manufacturing and construction activities were less robust.

In Nepal, economic growth in the fiscal year 2013 fell to 3.6% from 4.5% in the previous year. Political uncertainty resulted in weak budget implementation. Agricultural activities, which account for one third of the economy, also slowed due to a poor monsoon harvest and limited access to fertilizers. Domestic production continued to be constrained by electricity shortages, while tourism and retail trade expanded. Workers' remittances play a major role in sustaining household spending and growth of the economy. The country's foreign exchange earnings rely on these remittances, while limited production capacity has made the country highly dependent on imported goods.

Economic growth in Pakistan was largely stable at 3.7% in the fiscal year 2013. Growing security concerns and energy shortages continued to hamper the business environment. Agricultural output growth decelerated in 2013 due to poor weather conditions, while industrial production picked up on capacity enhancement and investment in alternate energy, especially by large-scale manufacturing operations. On the demand side, an impetus to growth came from private and public consumption, whereas overall investment remained sluggish. The investment-to-GDP ratio fell to 14.2% of GDP in 2013 from 14.9% of GDP in the previous year.

Growth of the Sri Lankan economy accelerated to 7.3% in 2013. Similar to most of its neighbouring countries, output growth was mainly driven by household consumption and supported by remittance inflows, a supportive monetary policy and steady tourism revenue. The hotels and restaurants sector advanced favourably, while the construction industry benefited from reconstruction activities in areas that suffered extensive damage during the internal conflict that ended in 2009 and urban housing demand. Reducing large fiscal and external current account deficits and improving the business environment are among the Government's policy priorities.

In Turkey, GDP growth rebounded to 4% in 2013 from 2.2% in 2012. This is still well below the 6.7% pace that was registered in the pre-crisis years. The upturn in 2013 was domestic demand-led, especially through private consumption growth. Capital market disruptions were notable in mid-2013 and early 2014, largely triggered by the tapering of quantitative easing in the United States. This was partly a reflection of weak macroeconomic fundamentals, such as a sizeable external current account deficit due to strong imports of oil and intermediate goods. Weak European economies, major trading partners of Turkey, also adversely affected the growth performance of the country.

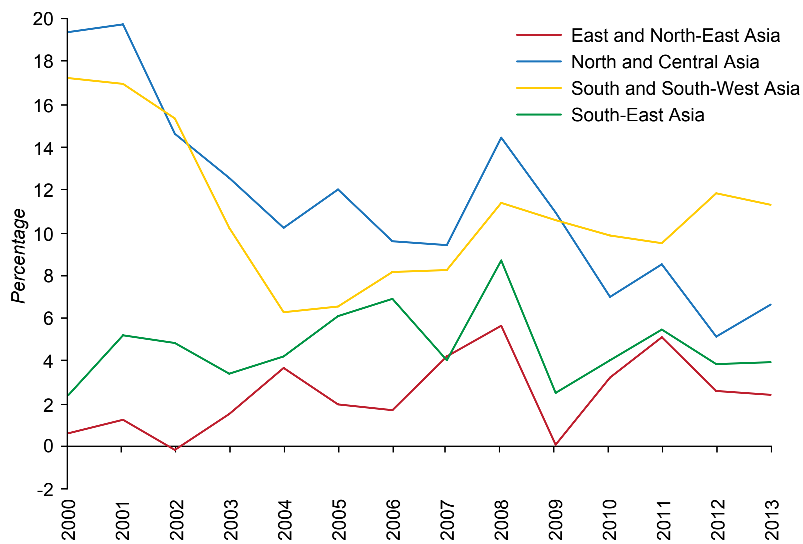
South and South-West Asia has gradually transformed into services-based economies. For the subregion as a whole, the services sectors accounted for 57.9% of total output in 2012, or 3.4 percentage points higher than a decade ago. The rise of the services sectors coincided with a comparable decline in agriculture and stagnant industrial activities. Data for 2012 show that the share of services in GDP varied from two fifths in Bhutan to four fifths in Maldives. The services-oriented structural transformation witnessed by the subregion, however, failed to create enough jobs to enable people to move from agriculture to more productive jobs in services. The employment elasticity of growth in the subregion has come down with the ascent of the services sector. Therefore, agriculture continues to support more than 50% of workers. The subregion needs to focus on developing manufacturing and other industries that have higher employment-creating potential to create more jobs for the subregion's youthful population and to accelerate the process of poverty alleviation.[10]

Inflation softened but still elevated

Inflationary pressures in South and South-West Asia remained strong relative to other subregions in recent years (see figure 2.12). For most of the economies in the subregion, persistently high inflation was driven by supply-side constraints, such as energy shortages, that limit domestic production. Rising costs of raw agricultural materials and labour also contributed to high inflation.

In India, the inflation rate was still high at 9.5% in 2013. In addition to supply constraints, the weakening of its currency, which led to higher import prices for energy, coupled with cuts in fuel price subsidies contributed to higher price levels. Price pressures in India kept inflation in Bhutan and Nepal at high levels as the currencies of these two countries are pegged to the Indian rupee and their economies are heavily reliant on imports from India. In contrast, inflation in Pakistan moderated to 7.4% in 2013, although the impact of the depreciating currency was felt in the later months of the year. The domestic currency has appreciated in recent months, which should help contain inflation in the

Figure 2.12. Inflation in selected Asia-Pacific subregions, 2000-2013



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Note: The data for East and North-East Asia excludes Japan.

current fiscal year. Bangladesh, Sri Lanka and Turkey also experienced moderating inflation of 6.9-7.7%. In the Islamic Republic of Iran, inflation surged to 35.2%, as international sanctions limited the supply of goods, while a much weaker official exchange rate resulted in higher import prices.

High food inflation disproportionally hurts the poor

Food inflation has typically outpaced overall inflation in the subregion. Cereal items have traditionally driven food inflation, but the contribution of meat and dairy products, fruits and vegetables has risen in recent years, as household incomes increased. High food inflation hit the poor harder, as they spend proportionally more on food purchases, especially cereals and vegetables. Food items account for nearly 60% of the Bangladesh consumer price index and close to half of the indices of India and Nepal. The dominance of traditional agriculture and reliance on imported cereals in Bangladesh makes domestic food prices highly vulnerable to weather conditions and global price developments. In Sri Lanka, about one third of cereals consumed domestically need to be imported. To contain food inflation, substantial wastage of agricultural produce, particularly perishables, such as fruits and vegetables, need to be minimized by improving the supply chain logistics and setting up cold storage and processing facilities. Moreover, it is essential to enhance productivity in the agriculture sector by ensuring that farmers, particularly small-holder farmers, benefit from modern technologies.

High inflation in the subregion limits room for countercyclical monetary policy. This not only reduces the subregion's ability to weather external shocks, but it also results in high interest rates, which discourage fixed investment, especially by small enterprises. Rather than tightening monetary policy, which would dampen economic growth and employment, cost-push inflation in the subregion could be dealt with through such measures as lower import tariffs, strict price checks, cutting food wastage and targeted food subsidies. Market competition should also be strengthened. There could also be enhanced public provisioning of basic services to help the poor, however, this would be difficult to carry out due to limited fiscal space.

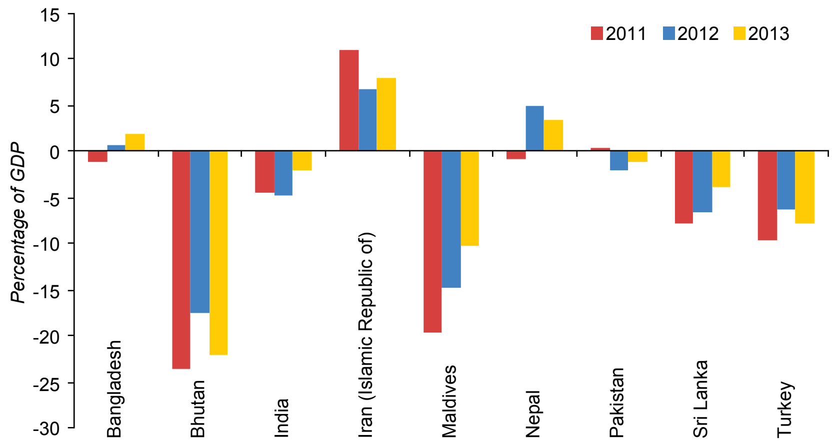
External current accounts improved on export rebound

Merchandise exports generally rebounded in 2013. Shipments from Bangladesh, India, Pakistan and Sri Lanka increased after contracting between 2% and 7% in 2012. The pickup was mainly fuelled by strengthening import demand from developed economies, which accounted for at least half of the total exports from most of the economies in the subregion. The weaker Indian rupee also spurred exports, lowering the current account deficit to 2% of GDP in 2013 (see figure 2.13). In contrast, exports from Nepal and Turkey declined following sluggish economic activity in India and Europe, respectively. International sanctions negatively affected oil exports from the Islamic Republic of Iran.

Trade deficits narrowed due to stronger exports but they remained sizeable. The subregion in general continued to rely on imported food and energy. Export items are typically low value-added and concentrated in textiles and garments in Bangladesh, Nepal, Pakistan and Sri Lanka. Goods exports account for less than one fifth of GDP in most economies, highlighting the need to enhance productive capacity. Meanwhile, governments have recently sought to address trade deficits. Bangladesh raised import tariffs, while India, Pakistan and Sri Lanka introduced measures to curb gold imports.

Current account deficits narrowed in several of the economies in the subregion in 2013 as workers' remittances and tourism revenue increased and exports rebounded. Among countries that receive sizeable remittances, inflows have been growing in Bangladesh, Nepal, Pakistan and Sri Lanka in recent years, in line with a higher number of overseas workers. Although remittances have supported household spending and contributed to

Figure 2.13. External current account balance in selected South and South-West Asian economies, 2011-2013



Sources: ESCAP, based on national sources; and International Monetary Fund, World Economic Outlook Database, April 2014.

Note: Fiscal-year data for Bangladesh, Bhutan, India, the Islamic Republic of Iran, Nepal and Pakistan.

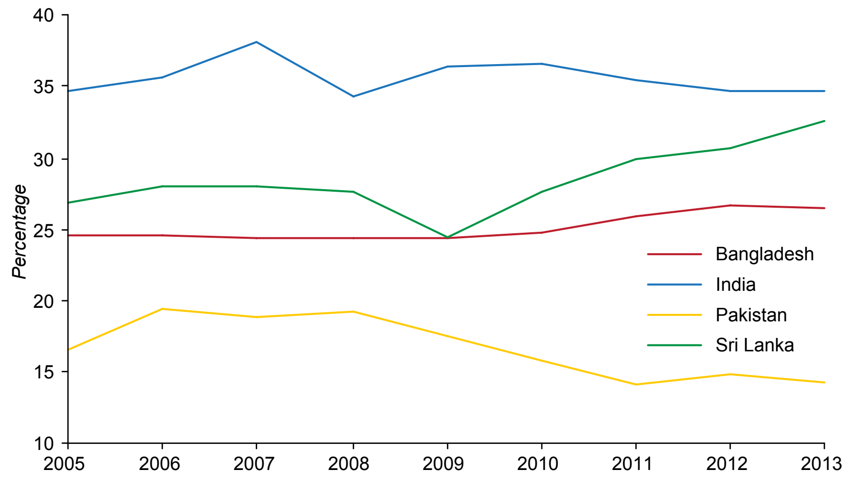
current account surpluses in Bangladesh and Nepal, they also point to inadequate job opportunities at home. Most migrant workers are also employed in low-skilled sectors. Meanwhile, the number of tourists to India, Maldives, Sri Lanka and Turkey rose steadily, although the current account deficit in Maldives remained at about 10% of GDP due to the country's heavy reliance on imported goods.

Signals pointing to a possible tapering of monetary stimulus in the United States in mid-2013 led to disruptions in some capital markets and currencies (see chapter 1 for details). Between May and August 2013, the Indian rupee depreciated by almost 15%, while share prices in Sri Lanka and Turkey lost about 10% and 25%, respectively. Capital market volatility also increased in Turkey in early 2014. In response to the volatile conditions, countries introduced capital flow management tools. For instance, India lowered the limit on overseas investment. More heavily affected economies were those with large fiscal and current account deficits financed by external short-term capital flows. This highlights the need for a deeper structural transformation to drive the subregion's dynamic competitive advantage.

External account vulnerability is high for some economies. Foreign exchange reserves held by Pakistan plummeted in 2013. The level at the end of the year was equivalent to only two months of imports, although this has improved in recent months. Financial support from the IMF was secured after the Government made commitments to tackle the fiscal deficit. However, reducing the fiscal shortfall should not be at the cost of development and social expenditures, but rather through revenue-raising measures, reforms of state-owned enterprises and rationalizing current spending.

Current account deficits in several of the economies partly reflect inadequate domestic savings. Pakistan has a low investment level, at around 14% of GDP, as compared with Bangladesh, India, Nepal and Sri Lanka, which all have the investment-to-GDP ratios of about 25% or higher (see figure 2.14). Domestic savings in the subregion are, however, often too low to finance large investment needs. The savings-investment gaps reached about one fifth of GDP in Bhutan and Maldives and were also notable in Sri Lanka and Turkey. These countries experienced large current account deficits in recent years. Low domestic savings in the subregion are partly underpinned by a lack of public savings, as reflected in persistent fiscal deficits. Enhancing private and public savings would help sustain the subregion's investment level and reduce its external account vulnerability.

Figure 2.14. Investment-to-GDP ratio in selected South and South-West Asian economies, 2005-2013



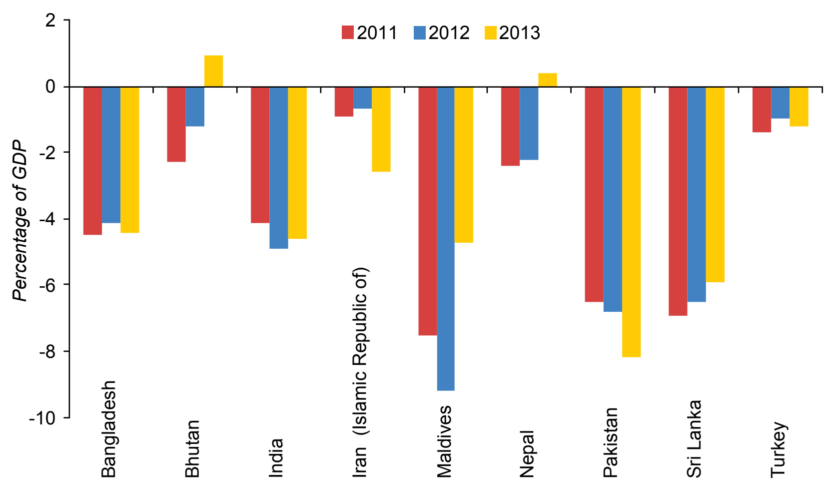
Source: ESCAP, based on International Monetary Fund, World Economic Outlook Database, April 2014.

Policy responses and structural reforms: accommodative macroeconomic policies

Macroeconomic policies in 2013 were largely accommodative in South and South-West Asia, as growth levels remained below the pre-crisis pace amid the fragile global economic recovery. Moreover, structural reforms were introduced in some economies.

Fiscal policy remained supportive to economic growth in 2013, but concerns regarding high budget deficits have risen. Except in Bhutan and Nepal, the economies in the subregion posted fiscal deficits in the fiscal year 2013, ranging from 1.2% of GDP in Turkey to 8.2% of GDP in Pakistan (see figure 2.15). The deficits in Bangladesh and Pakistan have widened over the past years, partly due to contingent liabilities associated with public-private partnership projects, especially in the energy sector. India, Maldives and Sri Lanka experienced lower budget deficits. More broadly, fiscal deficits in South and South-West Asia are higher and more persistent

Figure 2.15. Budget balance in selected South and South-West Asian economies, 2011-2013



Source: ESCAP, based on national sources.

than in other subregions. They are driven primarily by a large informal economy, a small tax base, loss making state-owned enterprises and inefficient tax collection. Attempts to address budget deficits must therefore tackle these root causes instead of by cutting essential development and social expenditures to meet short-term exigencies.

Fiscal policy space is often limited in these countries. Expenditures on maintaining internal security and weakly targeted subsidies are considerable, while those on interest payments are as high as 30% of total spending in some of the economies. The public debt level is close to 80% of GDP in Bangladesh and Sri Lanka and more than 50% in Bhutan, India and Pakistan. Sizeable public external debt in Sri Lanka makes the country subject to greater exchange rate risk. Limited fiscal space has not only reduced available funds for development expenditure, but in economies, such as Pakistan, a large proportion of current expenditure is financed through borrowing. In Afghanistan and Bhutan, fiscal positions are also highly dependent on external funding and grants.

Monetary policy was generally accommodative amid some softening of inflation and fragile external demand. In 2013, policy interest rate cuts totalling 50 and 100 basis points were made in Bangladesh and Sri Lanka, respectively. In India, the policy rate was cut steadily from January 2013 until September when the monetary policy changed course in response to heightened capital market volatility. A similar turnaround was observed in Turkey in early 2014 to stem currency depreciation and capital flight, and in Pakistan, in late 2013, as inflation edged up. The cash reserve ratio was lowered in India, Nepal and Sri Lanka. Broad money supply growth was comparable to the past years. Loose monetary policy enabled strong bank credit growth in Bangladesh, although the country's non-performing loan ratio was high at close to 10%. Meanwhile, monetary policy effectiveness is limited in several of the economies, such as Afghanistan due to an underdeveloped financial system, Bhutan and Nepal as a result of pegged exchange rates with India, and the Islamic Republic of Iran due to a large informal market for foreign exchange.

Turning to the structural reform agenda, in the twelfth national development plan (2012-2017) of India, it is emphasized that the country needs to reverse the recent economic slowdown, while ensuring that growth was more inclusive and sustainable. Tackling macroeconomic imbalances, particularly high fiscal and current account deficits, is also cited as an immediate policy challenge.[11] Some of the country's recent reform initiatives include: relaxing caps on foreign investment in such sectors as retail and telecommunications; allowing foreigners to invest in pension funds; setting up an investment committee to speed up the implementation of large infrastructure projects; passing a food security act that provides subsidized food grains to two thirds of the population; and introducing clearer guidelines on the land acquisition process. Regarding financial reforms, there are proposals to create a new category of banks that would focus on lending to small businesses and low-income households, and to introduce a structured monetary policy framework to increase central bank independence. The formation of a new Government after parliamentary elections in April-May 2014 should provide impetus to economic reforms.

India's national development plan aims to ensure more inclusive and sustainable development

In Bangladesh, one key initiative is an amendment in the labour law to strengthen worker rights by allowing more trade unions and requiring a provision for group insurance for work-related accidents. Another key development is the introduction of an online tax registration system, which facilitates tax payments. Meanwhile, more recent initiatives have focused on supporting the garment sector amid political disruptions. They included lower income tax for garment exporters and reduced lending rates on input procurement.

Outlook for 2014 and policy challenges

The outlook for the subregion in 2014 is positive. As discussed in chapter 1 in detail, the Indian economy is expected to stage a modest recovery and grow by 5.5% in the fiscal year 2014. This recovery is to be supported by an improved performance in the industrial and services sectors. Higher growth in the developed countries will likely enhance external demand, which would be further supported by the recent depreciation of the Indian rupee. However, to secure growth, more emphasis must be placed on removing structural impediments, building business confidence and creating fiscal space to support investment. The removal of infrastructure deficiencies, especially with regards to power and transport, is needed to promote growth. The growth prospects of the country also depend on the pace of a structural reform agenda carried out by the new Government.

Growth in Pakistan is projected to pick up to 4.1% in the fiscal year 2014. In recent months, there have been some notable positive changes in the economy, including improved growth of large-scale manufacturing industries, expansion in private sector credit, accumulation of foreign exchange reserves and appreciation of the Pakistani rupee against the United States dollar. Despite these positive developments, the economy still faces many challenges and structural reforms are needed to address them. The investment-to-GDP ratio is one of the lowest in the subregion. Tackling the problem of severe energy shortages is key to promoting investment and growth on sustainable basis. There is also a need to reduce the country's trade deficit by improving production efficiency and export competitiveness and lowering its reliance on imported oil in meeting domestic energy needs. Also, the budget deficit, which continues to be large, needs to be reduced significantly in the coming years.

The economy of Bangladesh is projected to grow at a steady rate of 6.1% in the fiscal year 2014. The agricultural sector is expected to perform better due to improved weather conditions and last year's low base. However, slower expansion of exports and falling workers' remittances may hold back growth. Massive investments in infrastructure are needed to raise growth to higher levels.

Sri Lanka is projected to maintain high growth momentum, with its economy expected to expand at a higher rate of 7.6% in 2014. The high growth rate is expected to be supported by an increase in investment, particularly in infrastructure by the Government, a favourable macroeconomic environment and the continued recovery in the global economy. Greater involvement of the private sector in economic activities will further enhance the growth prospects of the country. Further fiscal consolidation and improving tax revenues, however, remain major challenges.

Relatively fast economic growth has translated into only a modest poverty reduction

Strong hydropower exports should sustain high output growth of 7.1% in Bhutan. Steady remittance inflows and tourism income would particularly benefit Maldives and Nepal, both of which are expected to grow by 4.5%. On the condition that the withdrawal of international security forces from Afghanistan is smooth, the economy is projected to maintain steady growth of 3.2% in 2014.

The economy of the Islamic Republic of Iran is likely to expand by 1.5% in 2014 after contracting in the past two years. This improved performance is contingent upon eased sanctions on oil exports. In Turkey, growth is expected to be stable at 4% in 2014, as economies in the European Union start to recover. However, further escalation in tensions between the Russian Federation and Ukraine can undermine growth in Europe, as well as in Turkey. Domestic politics and uncertainty can also weigh on growth.

The South and South-West Asia subregion has enjoyed relatively rapid economic growth, but this has translated into only a modest reduction of poverty. The proportion of the population living in poverty (based on $1.25 a day) decreased steadily from more than a half in the early 1990s to around 29% in 2010. However, the subregion is still home to close to 40% of the world's poor, up from 27% two decades ago.

Income inequality deepened in Bangladesh, India and Sri Lanka. Gender disparities are also a matter of concern in most economies with significant costs to potential GDP growth (see box 2.4).

Limited fiscal space has constrained the ability of Governments in most countries in the subregion to deliver public spending that focuses on more inclusive development. As discussed in chapter 3, increased

Box 2.4. Empowering women, enabling development

Gender inequalities that result in the dichotomization of women into the private domain and men into the public domain, and the consequent lower rates of female participation in economic activities outside of the home, are a documented obstacle to reducing poverty and an impediment to socioeconomic development that is inclusive, equitable and sustainable.

In South and South-West Asia, gender inequality is evident in female and male labour force participation rates. The labour force participation rates for women in the countries of South and South-West Asia are between 18 and 52 percentage points lower than the labour force participation rates of men. For example, in Bangladesh, the labour force participation rates for women and men are 36% and 82%, respectively. In Turkey, 29% of women of working age are in the labour force, compared with 70% of men.[a]

Beyond quantitative measures of participation, discrimination and inequality are evident across almost every dimension of women's wage employment and entrepreneurship: gender pay gaps, where the earnings of women are less than those of men; occupational segregation; and the insecurity of vulnerable employment, including work that comes without social protection, takes place in hazardous work environments and involves casual work contracts.[b]

Cognizant of the challenges that women encounter to fully and freely participate in economic activities, and of the immense social and financial value that their participation yields, Governments are undertaking initiatives to promote women's economic participation, such as embracing policy reform, education and training, service provision, and measures in support of women's decent work and entrepreneurship.

For example, in Bangladesh Vision 2021,[c] the Government of Bangladesh has committed to increasing the labour force participation of women to 40% by the year 2021. Complementing the Bangladesh Vision 2021, the Government also adopted specific measures to increase women's labour force participation, employment and enterprise development in its sixth five-year national development plan, including realizing equal pay for equal work, providing childcare services and promoting women's access to credit facilities.

In India, positive policy actions include the National Microfinance Support Programme and the prominent National Rural Employment Guarantee Scheme. Regarding the latter initiative, in seeking to address poverty among women and men in rural India, in the Scheme the following was mandated: one third of beneficiaries must be women; equal wages for women and men; and the provision of childcare for children under the age of six years who accompany their mothers to work.

For the last two years in Maldives, the Ministry of Economic Development has led the "Employment and Enterprise Development for Women and Youth" initiative. Policy actions, such as those that target awareness raising, leadership training and allocation of resources, can address key determinants of gender inequality and yield concrete benefits for individual women and men, their families, their communities and their countries.

a International Labour Organization (2013).
b International Labour Organization (2010).
c A political manifesto introduced in 2008 that stands as a political vision for the country for the year 2021. For more details see http://www.drrgateway.net/sites/default/files/Bangladesh%20Vision_2021_English.pdf.

domestic tax revenues would be the key to improve fiscal space. Tax revenue on income and profits is low, at less than 20% of total tax revenue, in several countries. Only 1 in 10 working-age persons in 2010 was a wage and salaried worker, who are the main source of income tax revenue. Such a low share is driven mainly by such factors as poor tax administration, various tax exemptions, limited employment opportunities and a very high share of informal and vulnerable employment in which up to 80% of people employed in the subregion are unpaid family workers and own-account workers. Therefore, the countries need to enhance their tax collection efforts by broadening the tax base, improving tax progressivity and strengthening tax administration. This is needed not only to expand their fiscal space to close their development gaps, but also to address rising inequality.

Closing infrastructure gaps is central to energizing industrialization and job-creation. Many countries in the subregion suffer from severe energy shortages. According to a recent World Bank study, almost 70% of firms surveyed in Pakistan cited electricity shortages as the most binding business obstacle. Such firms estimated that sale values would have been at least 10% higher without power outages. A recent estimate suggests that the subregion needs to invest up to $2.5 trillion over the next ten years to close its infrastructure gaps.[12] Due to limited fiscal space, PPPs on infrastructure projects have the potential to play an important role. However, this arrangement has thus far failed to fully take off and when it had been set up, ironically further strains were placed on fiscal balances due to contingent liabilities. Infrastructure investment with private participation in the subregion amounted to about $7.2 billion per year during the period 2000-2011, compared with $15.8 billion in Latin America and the Caribbean. However, in promoting PPPs, policymakers should consider carefully appropriate risk-sharing and guaranteeing demand or revenue, as well as ensure equity and access for remote areas and disadvantaged groups.

SOUTH-EAST ASIA

Diverse growth performance

Average economic growth of the economies in South-East Asia slowed to 4.9% in 2013 from 5.5% in 2012 (see table 2.5). Exports and domestic

Table 2.5. Rates of economic growth and inflation in South-East Asian economies, 2012-2014

(Percentage)

	Real GDP growth			Inflation[a]		
	2012	2013	2014[b]	2012	2013	2014[b]
South-East Asia[c]	**5.5**	**4.9**	**4.6**	**3.9**	**3.9**	**4.0**
Brunei Darussalam	0.9	-1.8	1.2	0.5	0.4	0.5
Cambodia	7.3	7.6	7.2	2.9	2.9	3.4
Indonesia	6.2	5.8	5.4	4.3	6.4	5.5
Lao People's Democratic Republic	8.3	8.2	7.5	4.3	6.4	6.0
Malaysia	5.6	4.7	5.0	1.7	2.1	3.0
Myanmar	7.3	7.5	7.8	2.9	5.8	6.6
Philippines	6.8	7.2	6.7	3.2	2.9	4.3
Singapore	1.9	3.9	3.5	4.6	2.4	2.5
Thailand	6.5	2.9	2.2	3.0	2.2	2.4
Timor-Leste	8.3	8.1	8.0	10.9	10.6	9.5
Viet Nam	5.2	5.4	5.7	9.1	6.6	6.2

Sources: ESCAP, based on national sources; and CEIC Data. Data available from www.ceicdata.com (accessed 15 June 2014).

a Changes in the consumer price index.
b Forecasts (as of 15 June 2014).
c GDP figures at market prices in United States dollars in 2010 (at 2005 prices) are used as weights to calculate the subregional aggregate.

Notes: Data for Myanmar is reported on a fiscal year basis, 2013 refers to fiscal year spanning 1 April 2013 to 31 March 2014; and Timor-Leste GDP is reported as non-oil GDP.

demand lost momentum in Indonesia, Malaysia and Thailand. Bucking the trend was economic growth in the Philippines, which grew at a more rapid rate. The economies of Cambodia, the Lao People's Democratic Republic and Myanmar continued to expand at rate that exceeds 7%, despite significant human capital and infrastructure challenges.

In Brunei Darussalam, GDP contracted by 1.8% in 2013 after growing by 0.9% in 2012. Oil output declined markedly in the second half of the year. Public investment and non-energy activities held up more favourably. Expanded petrochemical and refinery capacities are expected to support growth in the coming years, but diversification into sectors, such as banking and tourism, remains a priority.

The economy of Cambodia accelerated slightly to 7.6% in 2013. Garment exports continued to drive growth. The minimum wage in the garment industry, which employs about 600,000 workers, was raised; yet, working conditions still need to be improved. Beyond garments, steady agricultural growth has been supported by public investment in rice milling and storage facilities. Credit growth continued to expand rapidly, and the country's banking sector received the highest FDI among the country's service industries. However, the proportion of credit channelled to long-term investments needs to be increased at the expense of credit for consumption and real estate.

Economic growth in Indonesia slowed amid monetary policy tightening

Output growth in Indonesia slowed to 5.8% in 2013 from 6.2% in 2012, as the monetary policy was tightened to curb inflation and put a cap on the current account deficit. Growth in fixed investment eased on the back of higher interest rates and the depreciation of the Indonesian rupiah, while public investment in infrastructure rose to about 3% of GDP, the highest level since the 1997 Asian financial crisis. Export earnings remained subdued on softer global commodity prices, but a decrease in imports resulted in higher net exports for the year. Private consumption held up more strongly, supported by tax reductions, cash transfers and higher minimum wages. The impact of slowing output growth was felt in the labour market, as the official unemployment rate edged up to 6.25% in August 2013 from 6.14% in the previous year. Financial markets experienced increased volatility in mid-2013, triggered by fears over the withdrawal of monetary policy support in the United States.

The economy of the Lao People's Democratic Republic sustained high growth of 8.2% in 2013. Hydropower and mining activities continued to drive growth, but garments and other manufacturing activities have emerged as important sources of output and employment growth. The services sector, particularly telecommunications, also expanded rapidly. Accession to the World Trade Organization in 2013 and the planned railway linking the capital city to major cities in southern China could open up new opportunities. Developing human resources and institutional capacity would help the country benefit fully from these developments.

Growth in Malaysia slowed from 5.6% in 2012 to 4.7% in 2013. Demand for the country's exports waned in the first half of the year and investment growth softened albeit from a high base, as public outlays dropped sharply. Growth was primarily driven by private consumption, which rose by 7.6% amid low inflation, robust employment expansion and the introduction of minimum wages in 2013. However, a rapid increase in consumption in recent years has been accompanied by rising household debt levels, which has become a concern. On the supply side, growth in the export-oriented manufacturing sector and in some services sectors, such as finance, was sluggish, but communications, real estate and business services expanded rapidly.

Economic growth in Myanmar accelerated slightly to 7.5% in 2013, driven by natural gas exports and higher investment in the energy sector. Improved business confidence following recent reforms has attracted foreign investment in telecommunications, infrastructure and garments, among others. This was reflected in increased capital imports, new business registrations and rapid credit growth in the private sector. Nevertheless, significant challenges remain. Medium-term priorities include expanding access to electricity in rural areas and developing the banking sector, as the economy remains largely cash-based. Telecommunication facilities are also limited, with mobile phone penetration estimated at only 11%, the fourth-lowest rate in the world.

The economy of the Philippines expanded by a robust 7.2% in 2013, well above its historical trend. Notably, the country posted a strong economic performance despite being struck by Typhoon Haiyan in November 2013, which caused extensive damage and more than 6,000 confirmed deaths. Private consumption buoyed the economic expansion, supported by steady overseas workers' remittances. Investment also increased notably, particularly in construction, although overall the investment-to-GDP ratio remains relatively low, at about 20% of GDP. Net exports hampered growth as imports rose while exports suffered from weak demand for semiconductors and other electronic components, which account for about 40% of total exports. Despite a booming economy, the country's official unemployment rate was high, at 7.5%, in 2013.

The economy of Singapore rebounded from sluggish growth of 1.9% in 2012 to 3.9% in 2013. External-oriented sectors, such as manufacturing, wholesale trade and transportation, bounced back in the second half of 2013. Other sectors, such as construction and business services, also registered improvements, although the tight labour market weighed on some labour-intensive sectors. In the country's 2014 budget, the need to invest in labour-saving technologies and worker training is emphasized. Additional support for students from low-income families and elderly groups was also introduced to reduce income inequality.

The economy of Thailand slowed notably to 2.9% in 2013 from a high base of 6.5% in 2012. Exports stalled as key items, such as electronics products, auto vehicles and rice, performed poorly. Weak merchandise exports were, however, partially offset by strong tourist arrivals. Domestic demand also weakened as the effects of fiscal stimulus faded and the post-flood reconstruction was completed. Rising household debts, arrears in government subsidy payments to rice farmers and political uncertainty, which began in November 2013, have put a damper on consumer confidence. Political tensions have also delayed major public investment projects in water management and infrastructure and raised uncertainty over planned public spending. Taken together, the economy expanded by a mere 0.6% in the fourth quarter on a year-on-year basis.

Rising household debt and political uncertainty put a damper on consumer confidence in Thailand

Non-oil economic growth in Timor-Leste softened marginally to 8.1% in 2013. Given moderating oil production during the year, overall GDP growth was rather weak. The economy is driven largely by government spending, backed by the Petroleum Fund, and energy-related sectors, such as construction. Domestic production is confined to subsistence farming and coffee, resulting in high reliance on imported goods. A major challenge for the country is to effectively use oil revenues to foster social development and diversify the economic structure.

Economic growth in Viet Nam picked up slightly, to 5.4%, in 2013. The economy recovered gradually from the effects of a high-inflation episode and banking sector problems. Both consumption and investment grew at a steady pace. On the supply side, services continued to grow rapidly, while manufacturing picked up in the second half of the year. Nonetheless, there was a 12% increase in the reported number of firms that ceased operations in 2013, as compared with 2012. Reform of state-owned enterprises, which account for about 40% of GDP, would help enhance the quality of investment.

In the least developed countries in the subregion — Cambodia, the Lao People's Democratic Republic and Myanmar, industry's share of GDP more than doubled over the past two decades. However, this increase has been concentrated in a few sectors, such as garments and mining. Agriculture still accounts for up to a third of total output in these economies. The pattern of structural change in other economies in the subregion has been more mixed, with industry's share rising in Indonesia but falling in the Philippines, where the services sector accounts for nearly 60% of GDP, making it the most services-driven economy in the subregion after Singapore. Overall, there has been a notable income convergence within South-East Asian economies. However, as highlighted in the *Survey* 2013,[13] convergence has been arguably slower in education, health and other measures of human development. The least developed countries also significantly lag behind in terms of integration into global supply chains, which, in turn, limits their ability to diversify their economies and engage in higher value-added activities.

Intraregional investment and cooperation are important to narrow this gap. There is much potential to foster this, given the wide cross-country differences in levels of economic development and national savings, which ranged from 13% of GDP in Cambodia to 45% of GDP in Singapore in 2013. In the context of ASEAN, it is important that all countries can benefit from increased integration as envisioned in the ASEAN Economic Community plan. This would require increased intraregional FDI inflows and technical assistance to the lower-income countries.

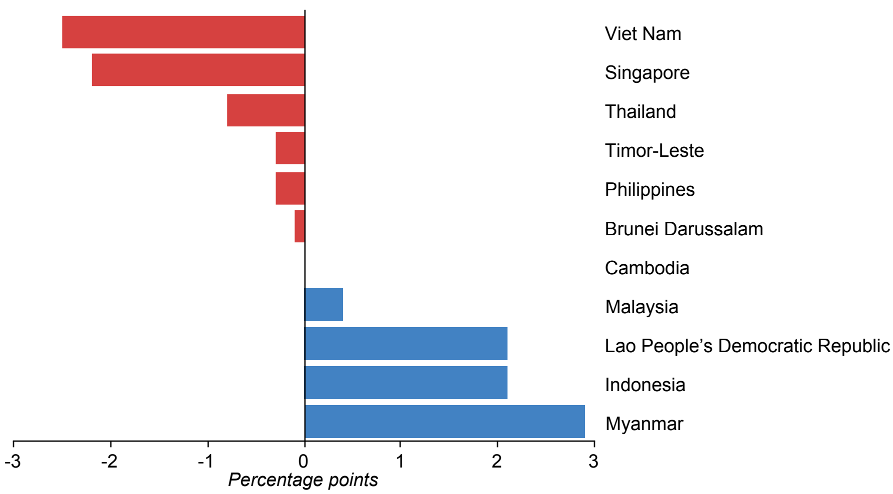
Stable inflationary pressure

Inflation was stable, at 3.9%, in the subregion as a whole in 2013. Several of the economies experienced lower inflation (see figure 2.16). Indonesia was not one of them. It faced steep price increases as subsidy rationalization pushed up prices of gasoline and diesel by 44% and 22%, respectively. Price pressures were further boosted by a weaker currency, resulting partly from capital outflows from the country. Inflation also increased rapidly in the Lao People's Democratic Republic and Myanmar, owing to high credit growth and new investments.

In Viet Nam, inflation moderated to 6.6% in 2013 following a series of fiscal and monetary tightening measures. Inflation was high, at 10.6%, in Timor-Leste due to supply-side bottlenecks and strong demand fuelled by public spending.

Elsewhere, price increases were modest despite policy changes and external factors that had the potential to raise price pressures. Inflation in Cambodia remained relatively low at 2.9% despite a minimum wage hike in the garment industry, and in Thailand, it stood at 2.2%, even though the minimum wage rates were

Figure 2.16. Inflation in South-East Asian economies, changes in 2013 relative to 2012



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

raised nationwide. In Malaysia, inflation remained low, at 2.1%, despite price subsidy cuts on sugar and fuel. Inflation was also largely stable in the Philippines, at 2.9%, although food prices surged in December 2013 in the wake of Typhoon Haiyan. Inflation in Singapore eased to 2.4%, but housing prices and transport costs remained at relatively high levels.

External current accounts: exports picked up towards year-end

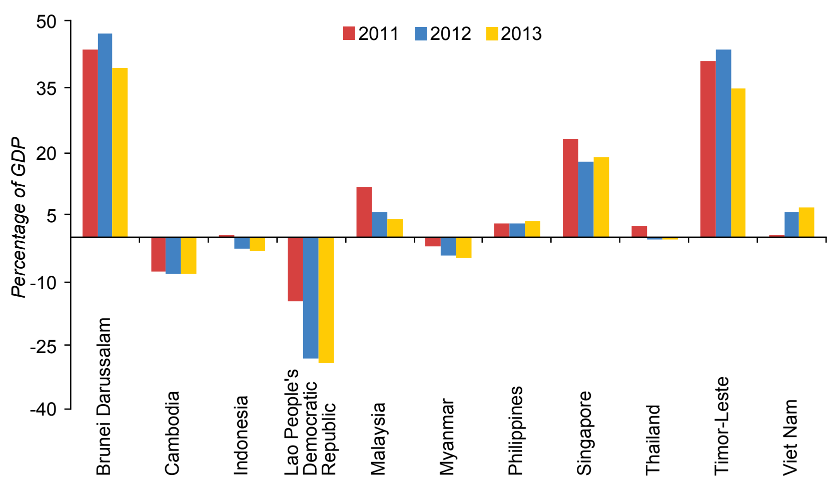
A stronger recovery in developed markets towards the end of 2013 helped revive shipments in key exporting economies in the subregion, such as Malaysia and Singapore. Export growth in Thailand, on the other hand, was flat for the whole year, as key items, such as electronics and auto vehicles, performed poorly. Softer demand for, and prices of, primary commodities weighed on exports from Indonesia. Weak demand in developed economies held back exports in most South-East Asian economies in the early part of 2013.

Overall, import growth in the subregion was subdued, in line with softer domestic demand in most of the economies. Imports of intermediate goods slowed in countries whose export products were based on the assembly of imported parts and components. Imports of capital goods were more robust due to ongoing large public infrastructure projects in several of the countries. The economies of Malaysia, the Philippines, Singapore and Viet Nam recorded current account surpluses, while Thailand and Indonesia posted small deficits (see figure 2.17).

For 2013, portfolio capital inflows into the subregion continued strongly, although the prospects of a tapering of quantitative easing in the United States triggered a sharp reversal in midyear. These outflows resulted in weaker exchange rates in several of the subregion's economies. For the full year, the Indonesian currency depreciated by about 21% against the United States dollar and the currencies of Malaysia, the Philippines and Thailand depreciated 7-8%. Despite financial market turbulence in the middle of the year, Indonesia posted a $9.8 billion net portfolio investment inflow for the year. The Philippines also recorded a sizeable net portfolio investment inflow in 2013.

FDI inflows were generally robust in 2013. In the first half of the year, the inflows increased by 3-14% in Indonesia, Malaysia, the Philippines and Viet Nam. Foreign investments in the garment and banking sectors in Cambodia and in the natural resources sector in Myanmar were steady. In contrast, investment inflows dropped by about 8%

Figure 2.17. External current account balance in South-East Asian economies, 2011-2013



Sources: ESCAP, based on national sources; and International Monetary Fund, International Financial Statistics database. Available from http://elibrary-data.imf.org/ (accessed 15 June 2014).

in Singapore and by 53.5% in Thailand. Meanwhile, the Philippines and Viet Nam, two countries that receive sizeable workers' remittances, reported increases in remittance incomes of 5-7% in 2013.

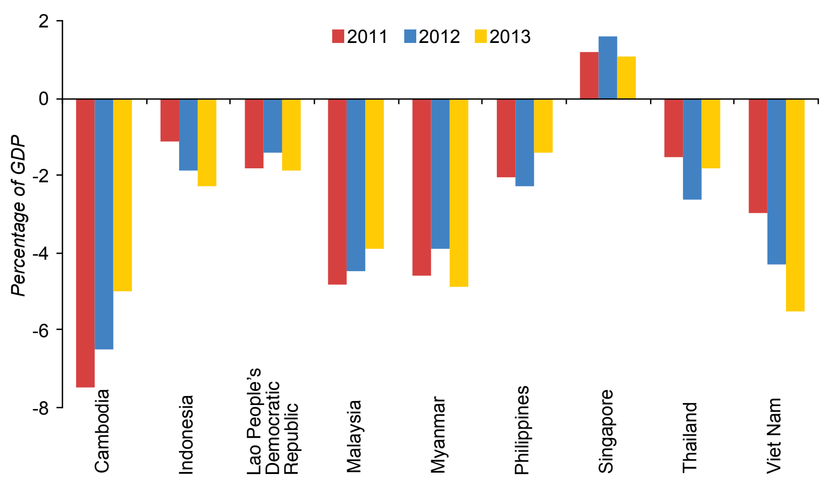
FDI, particularly vertical FDI, has played an important role in the development of the subregion's extensive production networks. Investment in this area was initiated by the Japanese in the late 1980s, strengthened by the ASEAN Free Trade Agreement in 1993, and further expanded through trade with China. As countries prepare for the ASEAN Economic Community, it is important that the quality and quantity of FDI inflows to the lower-income economies improve. While FDI already accounts for a substantial portion of GDP in Cambodia, Myanmar and Viet Nam, it is often limited to only a few sectors. Even Indonesia, which has seen a rapid increase in inflows in recent years, could attract more FDI, considering the size of its economy; at $18.4 billion in 2013, FDI accounted for only 2.1% of GDP, compared to up to 6% of GDP in Viet Nam. Meanwhile, the Philippines could benefit substantially from FDI to boost its total investment, but this would require policy measures, such as easing foreign ownership restrictions and improving the business environment. However, this should not include lowering labour and environmental standards or generous fiscal consessions. Finally, given that services account for a third of ASEAN exports, expansion of intraregional FDI in services would boost export competitiveness and improve productivity in the domestic services sector, which remains generally low.

Policy responses and structural reforms: multi-faceted reform agenda moves forward

Monetary policy remained largely accommodative in the subregion in 2013. Malaysia has kept its policy interest rate at 3% since mid-2011, and in the Philippines, the policy interest rate has been held steady at 3.5% since late 2012. Thailand cut the rate three times in the period covering 2013 and early 2014 to 2%, amid falling market confidence and sluggish economic growth. Indonesia, on the other hand, raised its policy interest rate by 175 basis points between June and November 2013 to cope with rising inflation and to stem capital outflows. In addition to interest rates, countries used other monetary policy tools to manage liquidity and reign in asset bubbles. For instance, Indonesia lowered the minimum holding period for central bank bills from six months to one month in order to increase their liquidity and tighten the loan-to-value limits on mortgages for second and third residential properties.

Fiscal consolidation was witnessed in some countries in the subregion in 2013 (see figure 2.18). Indonesia,

Figure 2.18. Budget balance in selected South-East Asian economies, 2011-2013



Sources: ESCAP, based on national sources; and CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Malaysia and the Philippines rationalized energy price subsidies and/or raised electricity tariffs to restore medium-term fiscal sustainability. Poorly targeted energy subsidies have taken up a sizeable amount of the national budget in the past in Indonesia and Malaysia, with little impact on poverty reduction. Indonesia decided in mid-2013 to cut fuel subsidies to curb fiscal deficit, however, despite this, up to 13% of government revenues had to be spent on fuel subsidies in 2013. Malaysia also marginally reduced its fuel subsidies in September 2013, after spending some 2.5% of GDP on fuel subsidies in 2012. Both countries offered assistance to low-income households through compensatory cash transfers and increased welfare payments. Indonesia hiked fuel prices by a third on average and provided cash transfers to mitigate the impact on poor households. While the fiscal savings from subsidy cuts have been lower than expected due to a weaker currency, subsidy rationalization should help provide greater fiscal resources for social spending, such as on an universal health-care, which is to be introduced in 2014.

On the revenue side, Malaysia announced the introduction of a 6% tax on goods and services in an effort to widen the tax base; it will come into effect in April 2015. This measure could help lower the public debt, which increased to nearly 55% of GDP in 2013 from 40% of GDP prior to the global financial turmoil. However, any tax reform should take into account and address the possible impact on low-income households. A revenue-boosting effort may also be warranted in Indonesia, as non-oil tax revenue has been stagnant, at around 10% of GDP, in the past years despite rapid economic growth. In the Philippines, tax administration reforms raised the share of government revenue in GDP to 15.2% in 2013. In Thailand, however, government revenue deteriorated on the back of lower corporate tax rates and tax relief.

Countries in South-East Asia are introducing policy reforms on multiple fronts, including in reducing energy subsidies and boosting public expenditures on infrastructure, education, health and social protection. At the same time, monetary and financial authorities are using various macroprudential measures to address such issues as financial instability. In the Philippines, the central bank redefined real estate activities to lessen exposure of banks to the sector. In Indonesia, a more stringent rule on down payments was introduced to slow credit for the purchase of housing and automobiles. Similarly, in Malaysia, asset price build-ups in certain sectors have been dealt with by using macroprudential measures rather than by increasing the policy rate, which could unnecessarily dampen overall domestic demand and hurt investment in productivity-enhancing projects.

Governments and central banks in the subregion are also working to expand access to financial services to low-income households and micro, small and medium-sized enterprises. For instance, the Philippines Development Plan 2011-2016 envisions a "development-oriented and inclusive financial system" with "effective interface of bank and non-bank products, delivery channels, technology and innovation to reach the financially excluded".[14] In line with this, the central bank is expanding its financial literacy training programmes and consulting financial sector stakeholders to draft a national strategy for financial inclusion.

Timely implementation of public infrastructure projects remains a challenge

Infrastructure development is a medium-term policy priority in several countries, but timely implementation of public sector projects remains a challenge. In Thailand, further delays in implementing major public investment projects in water management and public transport would undermine national competitiveness. In the Philippines, the Government may need to consider relaxing its fiscal-deficit cap of 2% of GDP in order to finance the reconstruction of Typhoon Haiyan-hit areas and to close infrastructure gaps in general. The Philippines have launched several projects under PPPs since 2012, while Indonesia has passed a land-acquisition bill to speed up the process for acquiring land for new infrastructure projects. In Malaysia, the Government's Economic

Transformation Programme is helping to generate a pipeline of infrastructure investment projects.

Social protection schemes have increased in the Philippines and Viet Nam in recent years. In the Philippines, the share of the population covered by the government-owned health insurer increased from 62% in 2010 to 81% in 2013. Viet Nam introduced an unemployment insurance scheme in 2009, and decided in 2012 to extend social security to half of the labour force by 2020. With the aim to achieve universal health coverage, Viet Nam introduced government-subsidized health insurance premiums for vulnerable groups, with coverage being extended to two thirds of the population in 2013.

Outlook for 2014 and policy challenges

Economic growth in South-East Asian economies as a group is set to moderate further in 2014 relative to 2013. Growth projections for Indonesia, Malaysia, the Philippines and Thailand are discussed in detail in chapter 1. Briefly, Indonesia is projected to grow more slowly, at 5.4%, amid subdued commodity exports and tight monetary policy. The impact of a sudden acceleration in tapering of eased monetary policy in the United States can also be stronger than anticipated, especially if structural issues, such as current account deficits financed by short-term external borrowings, persist. In the Philippines, growth could ease to 6.7%, although strong remittance inflows would continue to sustain private consumption. In Malaysia, growth is projected to increase slightly to 5% on stronger exports and investment. Thailand is expected to experience another year of low growth, although political uncertainty has eased somewhat in recent months. Projected growth at 2.2% assumes a rebound in the second half of the year.

The economy of Singapore, which is highly dependent on exports of goods and services, should benefit from the expected global economic recovery. Growth is however projected at a slightly lower rate of 3.5% in 2014 mainly due to domestic challenges. Tight labour market conditions will weigh on growth. Rising labour costs without corresponding gains in productivity is a cause of concern. The Government is actively pursuing policies to raise productivity through incentive policies, but the realization of gains will take time. Meanwhile, growth is projected to improve to 5.7% in Viet Nam amid improving credit conditions. Continuation of monetary policy caution and renewed focus on structural reforms, particularly the restructuring of state-owned enterprises and the banking sector, should support projected growth. Private investment is also expected to pick up.

Growth prospects for 2014 in the least developed countries are mixed. Output growth in Cambodia is expected to ease to 7.2%. Exports and investment should remain strong, but political and labour disputes are a concern. Similarly, growth in the Lao People's Democratic Republic could slow to 7.5% from a high base, with hydropower, construction and services activities as the main drivers. Growth of the non-oil sectors in Timor-Leste is expected to decelerate marginally to 8%, as public expenditure growth moderates amid efforts to ease demand-side pressures and enhance the quality of expenditures. In contrast, economic growth in Myanmar is likely to accelerate further to 7.8%, supported by increases in gas production, trade and agricultural output. Expansion of electricity supply could lead to higher growth than what is currently projected. However, the ongoing ethnic conflict could hold back Myanmar's progress.

One of the policy priorities is to tackle widespread informal employment

Key downside risks to these outlooks are increased financial volatility and subsequent monetary tightening that would be due to unexpected changes in the direction of monetary policy in the United States, a weaker-than-expected growth performance in China, and any sharp rise in international food and fuel prices led by supply shocks.

One of the medium-term priorities is to expand productive employment opportunities. Official unemployment rates remain relatively high in Indonesia and the Philippines despite strong economic growth records. Another pressing concern is widespread informal employment, which tends to have limited job security and lower labour productivity. Countries are addressing these challenges through various policy tools, such as raising minimum wages in Thailand, ensuring financial support to small enterprises in Indonesia and strengthening vocational training in Viet Nam. Singapore also runs a worker training programme that targets low-wage workers. Improving industrial safety and working conditions is also critical, especially in the least developed countries of the subregion.

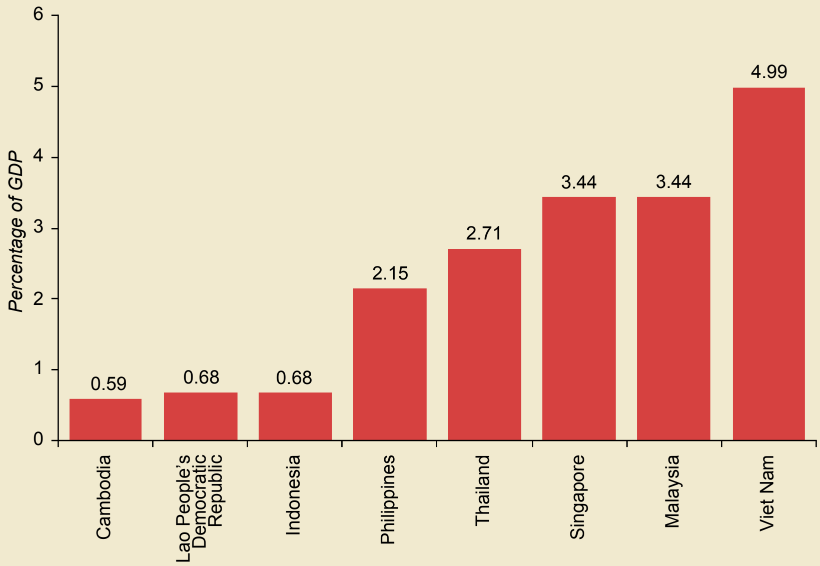
Rising and/or high inequality is also a concern. Therefore, fostering equitable economic growth is another important policy challenge. In Malaysia, the urban-to-rural income ratio edged up to 1.9 in 2012. In the Philippines, poverty incidence remained high, at 20%, in 2012. Higher level of inequality has weakened the positive impact of economic growth on poverty reduction. As recommended in the *Survey* 2013, investing in education, health services and social protection is generally affordable and helps enhance the social development gains from economic growth. In box 2.5, the need to strengthen social protection in South-East Asia is highlighted.

Box 2.5. ASEAN Declaration on Strengthening Social Protection

Access to social protection is deeply rooted in the Universal Declaration of Human Rights (1948) which upholds the rights of everyone to social security and to a standard of living adequate for the health and well-being of themselves and their families. This human right declaration, however, remains unrealized for 35% of the population in the ASEAN region, namely those living on less than $2 a day, according to the ESCAP database. Having no security against unemployment, sickness, disability, economic shocks and natural disasters exacerbates vulnerabilities faced by the poor.

Despite significant wealth generated, conflicting political priorities and insufficient spending on effective social protection programmes mean that poverty rates remain high and inequalities are increasing. Public spending on social protection varies widely among ASEAN countries (see figure A).[a] Malaysia, Singapore and Viet Nam each spent more than 3% of their GDP on social protection in 2010 while, in Cambodia, Indonesia and the Lao People's Democratic Republic, this figure was only 1%.[b]

Figure A. Social protection expenditure as a share of GDP in selected South-East Asian economies, latest available data



Source: Asian Development Bank, staff estimate, using data from country sources. Downloaded from Asian Development Bank's Social Protection Index Database (SPI).

Box 2.5. *(continued)*

Extension of social protection can take place along two dimensions — horizontal and vertical. The horizontal dimension (breadth) refers to the number of persons covered by existing schemes. The vertical dimension (depth) refers to the levels of benefits in existing schemes. The reported variation in social expenditure among ASEAN member countries conceals information on the choices of breadth and depth of social protection schemes and, as a result, the impact on the lives of potential and actual beneficiaries.

The 2008 ASEAN Charter recognizes social protection as a key foundation for inclusive and sustainable development.[c] To realize this commitment, ASEAN member countries adopted the Declaration on Strengthening Social Protection in October 2013 at the 23rd ASEAN Summit. Based on the Social Protection Floor framework, the Declaration sets common principles among countries, as they prepare for the ASEAN Economic Community, which takes effect in 2015. It recognizes social protection as a cross-cutting issue that requires participatory involvement of Governments, service providers, civil society and the private sector. Social protection is seen as an investment in people that should be supported by adequate resources.[d]

Among its strategies to improve social protection, the Declaration advocates the expansion of social insurance to the informal sector and the strengthening of social assistance programmes for persons with disabilities, elderly, children and other vulnerable groups. Furthermore, it calls for collective progress towards universal health coverage. Overall, the Declaration manifests ASEAN aspirations of pushing beyond economic integration, toward the rights-based imperatives of broader social and political integration.

[a] The calculation on social protection expenditures follows the definition of the Asian Development Bank Social Protection Index, as explained in ADB (2013b).
[b] Expenditures for the provision of free public health care were not included in the calculation of the Social Protection Index and are thus not included as part of social protection expenditures. The indicator "Social protection expenditure as a percentage of GDP" only includes health expenditures that are implemented as forms of social insurance, or targeted as special assistance to particular vulnerable groups (social assistance).
[c] Association of Southeast Asian Nations, The ASEAN Charter. Jakarta: ASEAN Secretariat, 2008. Available from www.asean.org/archive/publications/ASEAN-Charter.pdf.
[d] ASEAN Declaration on Strengthening Social Protection, adopted in Bandar Seri Begawan, Brunei Darussalam, 9 October 2013. Available from www.asean.org/images/archive/23rdASEANSummit/5.%20asean%20declaration%20on%20social%20protection_final.pdf.

CONCLUSION

The present chapter provides a survey of macroeconomic developments during 2013 in the countries of Asia and the Pacific. In addition to economic growth, standard macroeconomic indicators, such as fiscal balance, external current account balance and inflation, are used. Generally, widening fiscal and external current account deficits and a rise in inflation are interpreted as a deterioration of an economy.

While they are useful indicators, their aggregate levels are not always informative about a country's macroeconomic health. For example, the IMF-World Bank Development Committee noted "the fiscal deficit is a useful indicator for purposes of stabilization and for controlling the growth of government liabilities, but it offers little indication of longer term effects on government assets or on economic growth".[15] Since the external current account deficit generally mirrors fiscal deficits, the aggregate levels of external current account deficits, too, do not indicate a lot to guide policies.

The above, however, does not mean that policymakers should ignore developments in those indicators. The spirit of the discussion here is to draw attention to the fact that the devil is in the details. The aggregate levels are just warning bells.

Policymakers need to examine whether the rise in fiscal deficits or public debt is due to falling revenue or rising expenditure. If it is due to falling revenue, then more efforts would be needed to raise the revenue base and collection efficiency — the subject matter of next chapter. When a budget deficit is due to rising spending, countries should see whether it is used for such activities as building better schools and hospitals. If so, there should be less concern as long-term debt would become sustainable when productivity increases. Likewise, policymakers need to examine the structure of the external current account. Policy responses would differ depending on whether the widening current account deficit is due to imports of capital goods or luxury consumer goods, or it is driven by falling exports.

Policymakers also need to determine whether fluctuations in fiscal deficits are due to a short-term business cycle or long-term structural reasons. Fiscal deficits normally go up during an economic downturn due to both built-in automatic stabilizers (falling revenue and higher social security payments) and discretionary countercyclical spending. These kinds of deficits repair themselves over the cycle. On the other hand, rising fiscal deficits owing to structural reasons, such as inefficient tax administration or escalating public sector wage bills, would require fiscal reforms.

Finally, some level of inflation is unavoidable. It could be even necessary to encourage resources to shift towards desirable activities. Research shows that moderate inflation does not necessarily harm economic growth.[16] In contrast, high interest rates needed to control inflation may constrain access to credit, especially to SMEs, and hence dampen job creation. Moderate inflation lowers real wages, which can be helpful for job growth. Moderate inflation also reduces the real value of corporate and private debt, thus boosting domestic demand.[17] Policymakers should also understand the causes of inflation. Is it demand or supply-driven? Is its source primarily domestic or external? Policies to deal with inflation will differ based on answers to these questions.

Therefore, extreme caution is needed in interpreting aggregate macroeconomic indicators. Policymakers must not react to every movement in them. Policy design requires careful analysis of details at the disaggregate levels.

Endnotes

1 See Lin (2011).

2 In China, a value-added tax is levied on the difference between a commodity's price before taxes and its production cost while a business tax is levied on a business' gross revenue – for services revenue and does not provide credit for input tax. So the tax system overburdens the services industry compared to the manufacturing industry.

3 See China's 12th Five-Year Plan (2011).

4 See World Bank (2013b) and Isakova, Plekhanov and Zettelmeyer (2012).

5 See China Health and Retirement Longitudinal Study (2013).

6 See AusAID (2012).

7 See ADB (2013a).

8 For example, global car companies, such as General Motors and Toyota Motors, plan to cease vehicle productions in Australia by 2017. It would leave not only workers in the auto sector unemployed, but also affect those employed in downstream sectors, such as business services.

9 See IMF (2014).

10 See ESCAP-SSWA (2012).

11 See India, Planning Commission (2013).

12 See Andrés, Biller and Dappe (2013).

13 See ESCAP (2013b).

14 See Philippines, National Economic and Development Authority (2011).

15 See IMF-World Bank Development Committee (2006) and also IMF (2012c).

16 See Bruno and Easterly (1998).

17 See Akerlof and Shiller (2009).