



THE STATE OF INCLUSIVE AND SUSTAINABLE DEVELOPMENT IN UNCERTAIN TIMES



 We countries in Asia should strive to balance economic growth, social development and environmental protection. 

Xi Jinping,
President of the People's Republic of China

Development in Asia and the Pacific is under pressure with the region increasingly buffeted by the travails of the developed world. Growth in the developed world has continued to slow as the euro zone fell into a double-dip growth contraction and growth in the United States remained in anaemic territory. The generalized slowdown across the region in 2012 points to structural issues, such as rising inequality, and energy and infrastructure shortages, due to past policy mistakes and inadequate policy responses. The solution to invigorating the domestic drivers of growth in the region lies in making the development process more inclusive and sustainable.

As a result of reduced demand in the developed world, the Asia-Pacific region experienced a broad-based slowdown in 2012. The persistent climate of economic policy uncertainty in the euro zone and the United States is estimated by ESCAP to have reduced GDP in the Asia-Pacific region by 3% below what it would have been otherwise, with a total loss in GDP of \$870 billion. A number of large economies in Asia and the Pacific, most notably those of China and India, which proved resilient in the early part of the Great Recession of 2008-2009, subsequently have slowed markedly, reducing the support they had previously provided to Asia-Pacific economies through the channel of intraregional demand.

ESCAP analysis indicates that lower growth compared to recent years could become a “new normal” for many regional economies if present economic trends were to continue. The output loss could be significant for the region as a whole at almost \$1.3 trillion from the start of the crisis until 2017. Policies to create or strengthen alternative sources of growth should be viewed as a priority in order to prevent the onset of the “new normal” of lower growth.

The impact of the generalized slowdown on inclusive and sustainable development in the region stands to be substantial

The impact of the generalized slowdown since 2011 on inclusive and sustainable development in the region stands to be substantial with job and income growth expected to decline. Job growth is already seen to be on the wane, with 10 out of 13 countries in a recent regional sample exhibiting a year-on-year decrease in job growth compared to 2011. Of critical concern is the impact the slowdown in income growth will have on poverty and inequality. ESCAP analysis indicates that the population-weighted mean Gini coefficient for the entire region has already increased from 29.9% in the 1990s to 36.8% in the latest available year. Furthermore, inequality has a critical impact on the

achievement of social goals. The social development index developed by ESCAP shows an average potential loss of over 20% due to inequality.

The slowdown in 2012 of the two powerhouses of the region, China and India, has been the key new concern for the smaller economies of Asia and the Pacific. The slower growth in the major regional economies has reduced demand for imports from the smaller exporting economies in the region. However, a more positive development in the medium-term is likely to arise from the ongoing effort to rebalance the Chinese economy towards being more consumption-led, in line with the government's efforts to reduce hardcore poverty, income inequality and regional disparities. This rebalancing may produce a net positive impact on other countries in the region by creating new sources of demand in the Chinese economy. ESCAP analysis indicates that the total benefit in exports for the region would be nearly \$13 billion during the period 2013-2015.

Economies in the region confronted by the challenges of slowing demand in the developed world will have to consider implementing supportive measures at the domestic and regional levels to maintain their development progress. In addition, governments will have to take action to ensure specifically that the jobs and incomes of the poorest and most vulnerable sections of society are protected during this difficult period.

The generalized slowdown across the region has been compounded by long-term structural issues, such as rising inequality and energy and infrastructure shortages, which can be partly attributed to past policy neglects and inadequate policy responses. In other words, the underlying causes of the difficulties being faced go beyond the impacts emanating from the developed world. The slowdown, which is affecting even economies of the region that have large domestic markets, highlights the shortcomings in the development strategies pursued over the past few decades.

The structural solution to invigorating the domestic drivers of growth for the economies in the region lies in making the development process more inclusive and sustainable. Countries are increasingly giving prominence to social protection measures. In this regard, the introduction of minimum wage requirements is another policy gaining increased resonance in the region. ESCAP analysis indicates that a minimum wage policy, if designed carefully along with supportive adjustment measures, boosts workers' income and improves long-term job prospects without adversely affecting businesses. For example, recent minimum wage hikes in Thailand are projected to increase employment growth by up to 0.6 of a percentage point by 2015, while real GDP growth is expected to increase by 0.7 of a percentage point above the level foreseen if no minimum wage increases were implemented.

Many economies in the region are well-placed to undertake well-targeted fiscal and monetary policies directed to productive and social sectors of the economy

Fortunately, many economies in the region are well-placed to undertake the measures required through the use of well-targeted fiscal and monetary policies directed to productive and social sectors of the economy with high-employment intensity. In addition to contributing to sustained economic growth, such coordinated and well-designed policies can also support efforts to mitigate climate change while advancing developmental aspirations and ensuring affordable food security.

There is also a high degree of complementarity among the regional economies in terms of natural and human resources. Additionally, the region as a whole has a large volume of financial reserves. Thus, enhanced regional cooperation offers an avenue for escaping from adverse external developments as well as for addressing long-term development deficits. Countries must avoid a race to the bottom by competing among themselves with tax concessions or lowering environmental and labour rights protection

to lure foreign investment. Ultimately, no one wins from these kind of beggar-thy-neighbour policies; instead, these policies are harmful for all.

HEIGHTENED VULNERABILITIES AND POLICY CHALLENGES

Uncertain global environment requires vigilance

The key concern for the global economy remains the spillovers from the difficulties in the euro zone, with the euro zone slipping back into a double-dip recession in 2012 (see figure 1.1). Despite a raft of policy measures over the past year supported by the European Union and the International Monetary Fund (IMF) to enhance the confidence of the financial markets, instability continues, as evidenced by periodic increases in spreads at debt auctions to unsustainable levels.¹

Underlying the response of the financial markets is a fundamental uncertainty about the use of austerity as the primary response to reduce debt ratios. One concern is whether the level and duration of austerity being attempted will be politically and socially feasible. In recent months, there have been widespread protests by the populace in austerity-ridden economies with such upheavals only likely to grow as spending cuts and job losses continue. The jobless rate in Spain in the last three months of 2012 rose to 26%, or 5.97 million people, the highest level since the mid-1970s, due to the country's prolonged recession and deep spending cuts. Youth unemployment surged to 55%. The unemployment rate in Greece also increased in the final quarter of 2012 to more than 26.8%, the highest level in the European Union, with youth unemployment edging towards 60%. Portugal registered the third highest unemployment level in the European Union at 16.7% by the third quarter of 2012, a record for that economy.

More fundamentally, it remains highly unlikely that the current austerity policies will achieve the purpose of bringing down debt to GDP ratios to proposed

Figure 1.1. Real quarterly GDP growth of major developed economies, year-on-year, 2007-2012



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 30 March 2013).

levels. This is because austerity is leading to sharper contractions in economic growth than expected by those designing such policies, causing both a slowdown in the reduction of debt as government revenues decrease, as well as leading to increases in the required reduction of debt to meet debt-to-GDP ratio targets given that GDP itself is contracting.² In fact, the IMF has recently noted that there was a serious miscalculation of the depth of the resulting negative impact of austerity policies on growth when it first recommended fiscal consolidation during the early phase of recovery (IMF, 2012c).

If the contractionary impact of austerity measures continues, eventually the countries in debt crisis will default or will have to unilaterally change their terms of debt repayment. In that case, these countries may not continue to be accepted as members of the euro zone. If such a worst-case scenario of a disorderly debt default or countries exiting the euro zone were to play out, the impact on the global economy as well as on Asia and the Pacific may be severe. The first consequence of such an unexpected event would be significant instability in the financial markets as systemically important banks would be affected by an unexpected “credit event”.³ Furthermore, confidence in the euro, a major world currency used as a store of value

and medium of exchange, would be affected. Most immediately, the region may see an exit of capital in a “flight to safety” as occurred in 2008 following the collapse in the subprime market and the demise of Lehman Brothers.⁴ In the real sector, if such a “credit event” is accompanied by a country exiting the euro zone, the consequence could be a sharp contraction in growth for the affected country as economic activity would be constrained during the complications arising from a change of currency and non-repayment of debt. In addition to these impacts, the contagion impact in terms of perceptions of other countries engaging in such an exercise in the future would lead to further decreases in economic activity in the euro zone. The resulting contraction of economic activity in the euro zone could have a substantial adverse impact on Asia and the Pacific through the trade and finance channels.

The situation in the United States seems slightly better in comparison to the travails of the euro zone and has provided some support to the global economy. The economy has experienced volatile but positive growth in recent quarters (see figure 1.1), although the initial estimate of fourth quarter GDP growth was in slightly negative territory due to uncertainty tied to the outcome of the “fiscal cliff” negotiations. There

are signs that the housing market, a key driver of the recession in the economy, may have bottomed out as evidenced by a range of noisy but broadly positive data readings over recent months. Consumer confidence also appears to be recovering, a key requirement given the consumption-dependent nature of the economy. Unemployment, as a consequence of this steady increase in economic activity, has been on a downward trend. Given the importance of the United States as an export market globally, and specifically for Asia and the Pacific, the positive growth in the United States economy may provide some support to growth in the region. Nevertheless, growth rates and demand in the United States remain far below their levels before the crisis and therefore do not assist growth in the region to the same degree as they did prior to 2008.

The negotiations on resolving the fiscal programme of the United States in coming years, through numerous interrelated legislative deadlines such as the “fiscal cliff”, the budget sequester, the continuation of government funding and the raising of the debt ceiling, have created additional difficulties for Asia-Pacific economies. The problems stem from not only the actual impacts of these decisions on spending and growth in the United States but also from the uncertainty created by a series of partial measures to deal with the issues which have served to delay final resolution. The lack of clarity regarding the economy’s medium-term fiscal policy position is tied to legislative deadlock, resulting in a series of short-term pacts and extended uncertainty on global financial markets in response to concerns about the health of the United States economy. This uncertainty has affected the region through periodic episodes of short-term capital outflows from Asia-Pacific markets. Any possible composition of the eventual outcome of the negotiations to resolve the fiscal programme of the United States will result in a reduction in demand in the United States as taxes are increased and government spending is curtailed. Given that spending cuts may be undertaken along a ten-year horizon, some measures could be backloaded to occur once the economic recovery is more solid. Nevertheless, it is likely that growth in the United

States will be put under further pressure by reduced demand that will result from the pact. It can be argued that the United States is currently engaged in a moderate form of austerity, a reversal from its previous expansionary policy stance.

The persistent climate of economic policy uncertainty in both the euro zone and the United States has markedly affected regional output levels

The persistent climate of economic policy uncertainty in both the euro zone and the United States is estimated by ESCAP to have reduced GDP in the Asia-Pacific region by 3% below what it would have been otherwise. This equates to total loss in GDP of \$870 billion. However, the analysis shows that governments in the region could fortify their economies against the impact of such economic uncertainty by implementing pro-active policies. This could on average, moderate the negative effects on GDP for countries by around 75%. With regard to employment, pro-active policies could save large number of jobs, up to 2.6 million workers just in the case of China (see box 1.1).

The outlook for the economy of Japan remains subdued. Given the importance of exports for the Japanese economy, the global slowdown has substantially affected its growth prospects. While the economy initially benefited from an uptick in growth in 2012 due to the resumption of economic activity following the Great East Japan Earthquake, growth has now retreated towards the moderate levels seen over past years (see figure 1.1). Exports had particularly suffered as the yen appreciated strongly up until the third quarter of 2012 due to the repatriation of funds by the domestic financial sector. The enactment of a large new round of fiscal stimulus in early 2013 of \$116 billion combined with a policy of monetary easing with an inflation target of 2% and a depreciation in the exchange rate offers the possibility of some additional increment to domestic demand and exports in coming months. However, the impact of the country’s current slowdown on Asia and the Pacific is limited as the

Box 1.1. How has policy uncertainty in the euro zone and United States affected Asia and the Pacific?

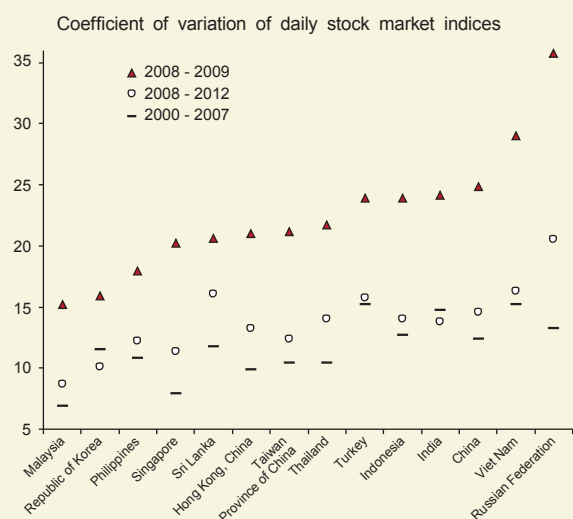
In the past few years, the world economy has been characterized not only by lower growth but also by increased economic uncertainty. Near-term economic prospects have become more unpredictable, with sharp upward and downward revisions in growth projections. Policy uncertainty in developed economies is the main factor behind this environment. Examples of issues that are triggering this unclear environment include divided negotiations on the fiscal cliff and debt ceiling in the United States, a possible breakup in the euro zone, and the timing and size of monetary injections by various monetary authorities.

Uncertainty in advanced economies threatens global economic stability. Consumers delay their spending on durable goods and housing due to heightened job insecurity. Businesses are reluctant to expand operations given less predictable demand. Financial institutions also tighten lending standards as perceived default risks escalate. In addition, massive inflows and sudden reversals of foreign capital, particularly in the form of short-term portfolio investments, add volatility to domestic financial markets. The stalled growth in the United States in late 2012, underpinned by widespread concerns over the outcome of the fiscal cliff negotiations, emphasized the significance of economic uncertainty.^a

Economic uncertainty appears to have risen in Asia and the Pacific in recent years. The volatility^b of daily stock market indices, a high-frequency variable that is very sensitive to changes in market sentiments, surged in 2008-2009 relative to the pre-crisis period (see figure A). This finding also remains generally true when measured over the longer period of 2008-2012, a period in which episodes of macroeconomic upswings and downswings occurred. Similarly in the real sectors, export-oriented economies, such as Malaysia, Republic of Korea, Thailand and Hong Kong, China registered more pronounced changes in inventories as a share of GDP during the crisis years of 2008-2009. Rapid destocking and restocking of inventories often indicate large mismatches between anticipated and actual shipment orders. Overall, fluctuations in the trade and domestic components of GDP have pushed up volatility in output growth in most regional economies (see figure B).

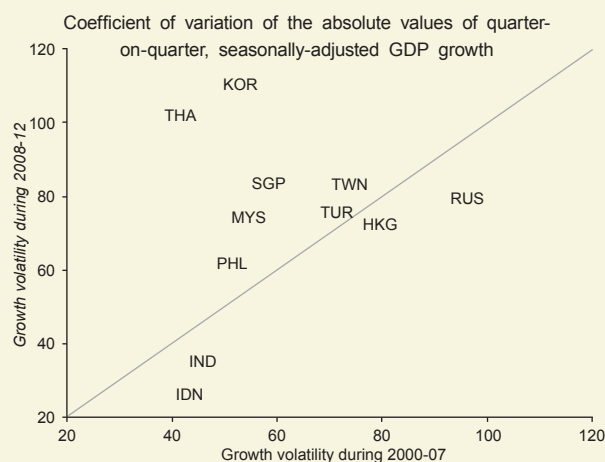
Based on a counterfactual analysis, ESCAP finds that if advanced economies were exposed to lower policy uncertainty between 2008 and 2012 than actually observed, the annual output levels of Asia-Pacific economies would have been 3% higher on average (see panel A in figure C). Here, it is assumed that a less volatile macroeconomic environment benefits growth performance through

Figure A. Movements in regional stock markets have become more volatile



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 15 March 2013).

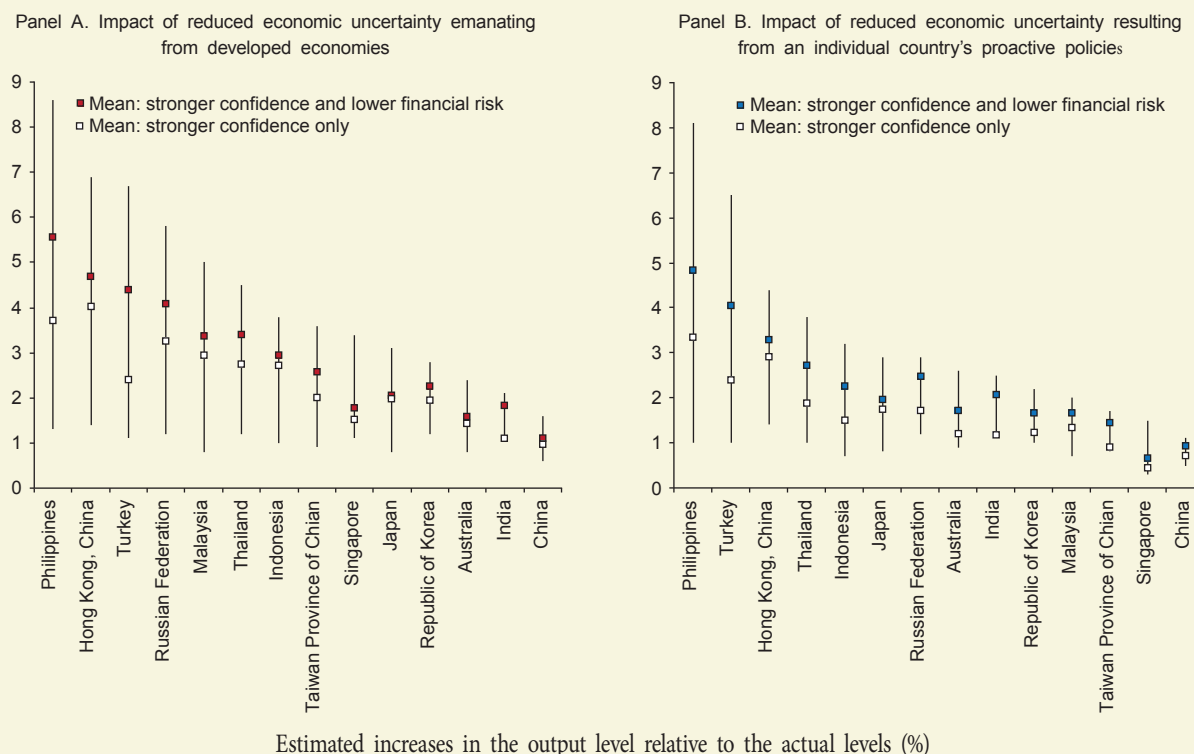
Figure B. Output growth volatility also rose or remained high in many Asia-Pacific economies



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 15 March 2013).

Box 1.1. (continued)

Figure C. Policy uncertainty markedly affected regional output levels over 2008-2012 but country proactive policies could moderate the impacts



Source: ESCAP, based on the Oxford Global Economic Model.

Note: The vertical lines show the ranges of the impact in any given year between 2008 and 2012.

at least two channels: stronger market confidence and lower bond market distress.^c In the Philippines, Turkey, and Hong Kong, China, the estimated impact in any given year during the period 2008-2012 could be up to 7-9% of total output. These estimates are sizeable, considering that the assumed magnitude of improvement in market confidence and bond market distress is relatively modest. Meanwhile, the analysis also shows that the impact is slightly more modest if increased economic certainty helps to support market confidence, but does not reduce perceived risks in the financial sector (represented by unfilled markers in panel A).

ESCAP analysis, however, indicates that proactive fiscal and supportive financial policies could on average offset 75% of the impacts of policy uncertainty stemming from the developed world. The proactive government policies include: automatic stabilizers that sustain household consumption amid shocks, such as unemployment benefits for workers and agricultural price support and insurance for small farms^d; active macroeconomic policies to restore confidence, such as targeted cash transfers and bank deposit insurances; building and maintaining ample fiscal space; and structural and medium-term policies, such as a shift towards countercyclical fiscal policies and deepening domestic financial markets.^e

The second scenario assumes country-level policy responses which result in stronger market optimism^f and lower financial risks for the particular Asia-Pacific economies that implement such policies. Panel B in figure C shows the positive impact on GDP for each country through the application of proactive fiscal and financial policies. The magnitude of the output loss arising from policy uncertainty in the advanced economies can be moderated by an average of 75%. This reduction in the adverse impact of policy uncertainty can offer significant relief to citizens in terms of preserving jobs. In China, for example, proactive

Box 1.1. (continued)

policies could reduce the impact on unemployment by around 2.6 million workers in a single year. This employment effect in the Russian Federation could be as high as 800,000 workers

- ^a Destocking subtracted nearly 1.6 percentage points from United States output growth in the final quarter of 2012. This arguably was the result of firms making adjustments in preparation for weaker domestic demand if scheduled tax rate increases and spending cuts were to materialize.
- ^b Here, volatility is measured by the coefficient of variation, i.e. standard deviation divided by its mean.
- ^c More specifically, the scenario assumes that (i) consumer and business confidence in all economies in the model simultaneously fell by only two-thirds of the actual declines, and (ii) the gap between the interest rates on government and corporate bonds and a safe-haven interest rate was 200 basis points narrower than the actual margins. In the model, changes in market sentiments directly affect consumption expenditures, fixed investment and the stock market index. Given these assumptions and specifications, the size of the country-level impact depends, among others, on the contribution to GDP by domestic demand components as well as the linkages between the real sector and the stock and bond markets.
- ^d According to the ILO, the proportion of unemployed persons who benefit from unemployment assistance in Asia is less than 20%. This compares to around 40% in Latin America and the Caribbean and as high as 80% in developed countries.
- ^e See chapter 3 for more details on how to strengthen countries' economic resilience.
- ^f The second scenario assumes improvements in market confidence and bond market distress of similar magnitudes as the first scenario. The difference is that here the changes are applied to each Asia-Pacific economy individually rather than to all economies in the model simultaneously as in the first scenario.

economy increasingly relies on exporting to other countries in the region, most particularly China, rather than the reverse. The prospects for Japan, therefore, in common with other economies in the region will be dependent in significant measure on the ability of the large emerging economic powerhouses in Asia and the Pacific to sustain their growth.

Weak economic environment heightens labour market vulnerabilities

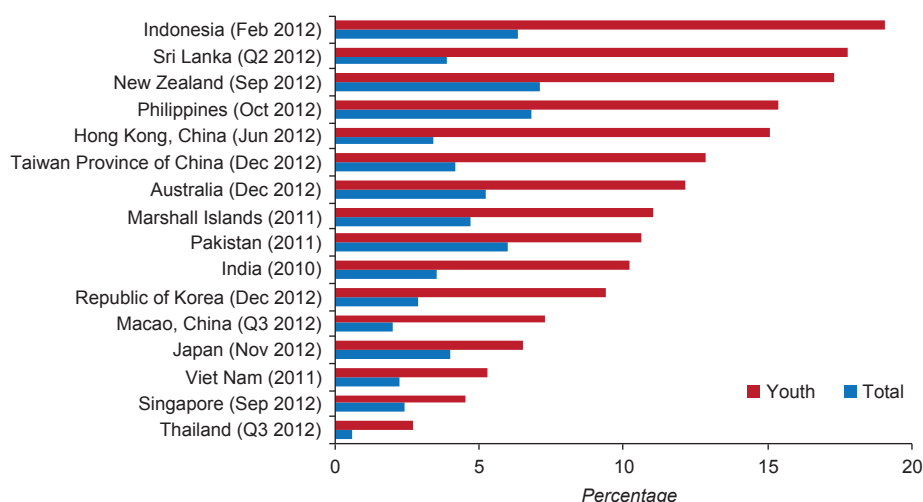
The weak global economic climate continues to put downward pressure on Asia-Pacific labour markets in terms of employment creation and the quality of jobs. In a sample of 13 economies with year-end 2012 employment data, 10 economies witnessed a year-on-year job growth decrease compared with 2011. Notably, employment growth in Indonesia decelerated by 333,000 jobs in August 2012 as compared with August 2011.⁵ The Philippines saw a sizeable contraction in employment of 882,000 jobs from October 2011 to October 2012. Job growth also moderated in the more industrialized economies of Japan, the Republic of Korea, Singapore, New Zealand, Hong Kong, China and Taiwan Province of China.

Although overall unemployment remained typically low in most Asia-Pacific economies (often below 5%), young people continue to face considerable

disadvantages in terms of securing decent employment (see figure 1.2). Despite some recent progress, more than one in six young people in the labour force remain unemployed in Indonesia, Sri Lanka, the Philippines, New Zealand and Hong Kong, China. Across the region, economically active youth on average are three to five times more likely to be unemployed than their adult counterparts. Among the Pacific island countries, young people in Samoa and Vanuatu make up almost 60% and 50% of the total unemployed population, respectively.⁶ In the Marshall Islands the youth unemployment rate is almost three times the adult unemployment rate.⁷ In terms of gender differences, unemployment is more prevalent among young women than young men in the South-East Asia and the Pacific and South Asia subregions; this trend is reversed in the East Asia subregion where the youth unemployment rate for males is higher than for females (ILO, 2011c)⁸. Given the uncertain global economic environment, youth unemployment is forecast to edge slightly upwards in 2013, to 13.4% in South-East Asia and the Pacific, 10% in South Asia and 9.8% in East Asia (ILO, 2013).

Unemployment, however, is only one dimension of the jobs predicament facing youth as the number of young people working in poor quality and low-paid jobs is much greater than the number of unemployed young people. In developing Asia, poverty rates

Figure 1.2. Total and youth unemployment rates in selected Asia-Pacific economies, latest available data



Sources: National statistical offices; International Labour Organization, *Key Indicators of the Labour Market*, 7th ed. (Geneva, 2011).

Notes: Youth aged 15-24, except Hong Kong, China (aged 15-19); Macau, China (aged 16-24); Pakistan (aged 15-19); Singapore (residents aged 15-29) and Viet Nam (aged 20-24).

are commonly higher among working youth than working adults (ILO, 2011c). Moreover, the youth employment challenge highlights another important feature in particular for some of the region's emerging and industrialized economies. This is the increasing importance of absorbing young jobseekers into the labour market as populations age, labour forces shrink and new drivers of growth are needed. To this end, policymakers should focus on employment-centred macroeconomic policies that foster stronger aggregate demand and job creation as well as improved access to finance and credit. Other key measures to consider are developing education and training systems to ensure skills are more relevant, investing in active labour market policies, fostering youth entrepreneurship and ensuring rights for young people (ILO, 2012i).

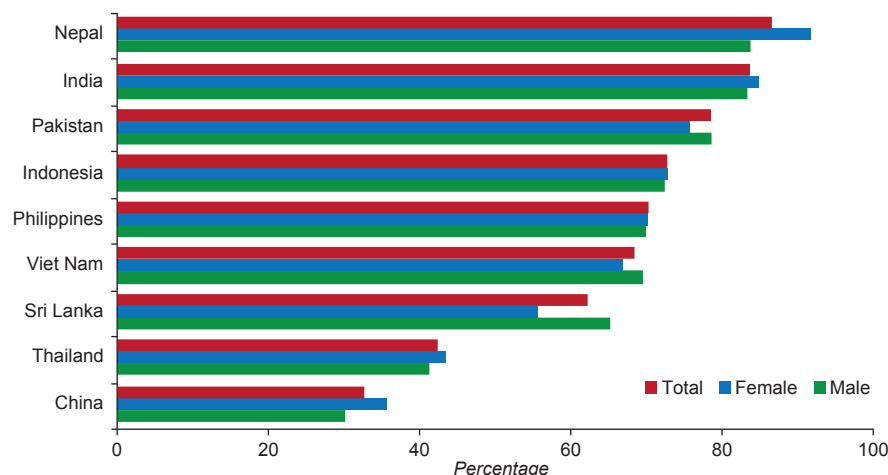
In addition, the prolonged global economic recession is hampering prospects for improving working conditions and raising the quality of employment throughout Asia and the Pacific. Nearly three in five (or nearly 1.1 billion) of the region's workforce remain trapped in low quality, vulnerable jobs as own-account or contributing family workers (ILO, 2013). Vulnerable employment rates are notably higher in the South Asia subregion at 76.9%, accounting for 491 million workers. Moreover, vulnerable employment is more

pervasive among women than men, underlining the comparative disadvantages that women in Asia and the Pacific face in accessing more secure and better jobs as wage earners.

Vulnerable jobs typically entail working in informal conditions with limited legal protection and access to basic rights at work. In this regard, job-related informality is pervasive throughout developing Asia-Pacific economies (see figure 1.3). Outside the agricultural sector in India, Nepal and Pakistan, around 80% of all workers are engaged in informal employment. In Indonesia, the Philippines and Viet Nam, the comparable shares are approximately 70%. Vulnerable and informal workers face tremendous difficulties in their ability to cope with external shocks (whether economic, social or environmental), given their low earnings and the precarious and irregular nature of their job arrangements. In turn, widespread informality and poor job quality pose significant concerns for policymakers seeking to reverse recent regional trends in high and rising inequality and rebalance their economies towards stronger domestic markets.

Addressing the crisis of poor quality jobs pervasive in Asia and the Pacific requires a multi-pronged approach which must include boosting labour

Figure 1.3. Informal employment as a share of non-agricultural employment in selected developing Asia-Pacific economies, latest available data



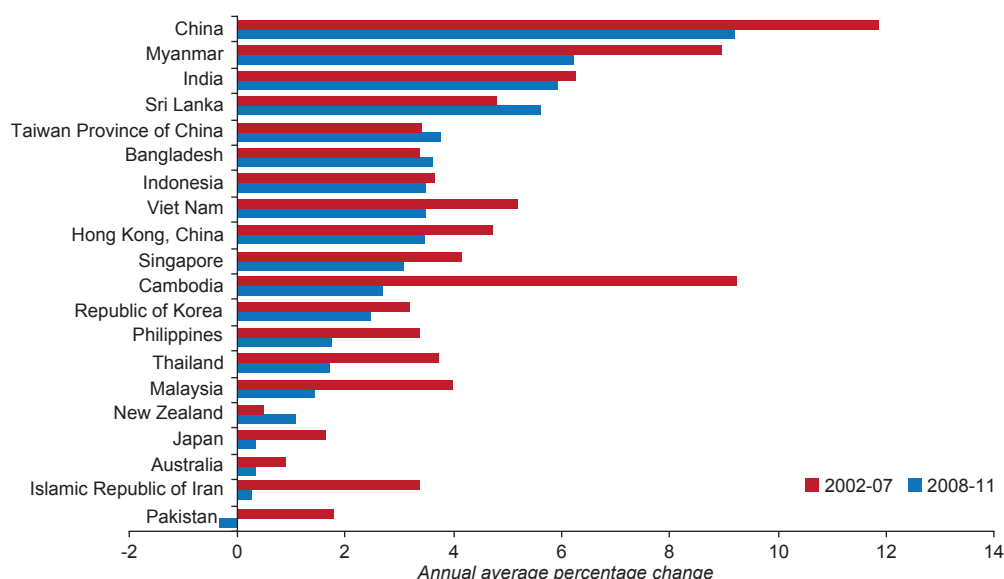
Sources: International Labour Organization, *Statistical Update on Employment in the Informal Economy* (Geneva, June 2012) and national statistical offices.

Notes: Indonesia includes only Banten and Yogyakarta; Sri Lanka excludes the Northern Province; China covers six urban areas.

productivity. The global recession of 2008-2009 has moderated productivity increases considerably in comparison to the pre-crisis trend in a majority of Asia-Pacific economies (see figure 1.4). For example, in Cambodia, annual average productivity growth slowed by a striking 6.5 percentage points from 9.2% during 2002-2007 to 2.7% during 2008-2011. During the same periods, substantial deceleration

also took place in the Islamic Republic of Iran (3.2 percentage points), China and Myanmar (2.7 percentage points), Malaysia (2.5 percentage points) and Pakistan (2.2 percentage points). This slowdown is even more worrying given that labour productivity levels in developed economies globally continue to outpace developing Asia-Pacific economies by a wide margin – ranging from five times the level in

Figure 1.4. Labour productivity: GDP per person employed in selected Asia-Pacific economies



Source: International Labour Organization: *Key Indicators of the Labour Market*, 7th ed. (Geneva, 2011).

East Asia to seven times the level in South-East Asia and the Pacific and nine times the level in South Asia.⁹ Stronger policy emphasis on skills and human resources development, greater investments that boost productivity in the rural and small and medium-sized enterprises (SMEs) sectors and facilitating greater movement of workers into industry and services, among other measures, would be instrumental.

There is growing recognition throughout the region that fostering inclusive and balanced growth requires stronger labour market institutions

In addition to improving job quality, there is growing recognition throughout the region that fostering inclusive and balanced growth requires stronger labour market institutions. This includes wage systems that can help ensure that wages grow consistently with productivity increases. Higher wages and household incomes would facilitate the growth of domestic markets and reduce the region's reliance on low-wage manufacturing exports to drive growth. To this end, minimum wage policies and related wage reforms have taken greater prominence, including, among other economies, Hong Kong China, Malaysia, the Philippines and Viet Nam (ILO, 2012a).

ESCAP analysis indicates that a minimum wage policy boosts workers' income and improves long-term job prospects without adversely affecting businesses provided it is carefully designed along with supportive adjustment measures. For example, it is estimated that recent minimum wage hikes in Thailand would increase employment growth by up to 0.6 of a percentage point by 2015, while real GDP growth would also increase by 0.7 of a percentage point above the level without the minimum wage increase (see box 1.2).

Food and fuel price pressures despite slowing headline inflation

Headline inflation is down across many economies in the region as demand-side pressures decline in

tandem with slowing economic growth (see figure 1.5). Price increases have also moderated in response to monetary policies which were progressively tightened across the region until early 2012 (see figure 1.6) when the balance of concerns between economic growth and rising prices was tilted more towards the latter at a time of relatively robust growth. Since early 2012, however, the reverse increasingly became the case and some governments, such as India, the Philippines, the Republic of Korea and Thailand have loosened monetary policies as one of their policy measures to support domestic economic activity to counteract the repercussions from slowing external sectors.

While headline inflation is down across the region, there remains considerable divergence in its level across countries. For countries with relatively high inflation, rising prices are often not due to increased demand or overheating but to supply shocks or rising production costs because of shortages of critical infrastructure. In some cases, rising prices are due to upward adjustment of administered prices or the removal of subsidies. One of the key shortfalls currently for many such economies is the enormous infrastructure gaps that exist between the requirements and actual investment. The availability of energy is the most immediate need for supporting economic activity.

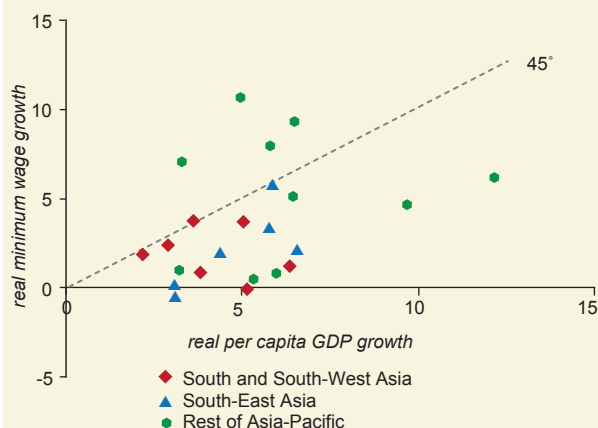
An additional complication in the management of price pressures is the high and volatile prices of food and fuel across many economies in the region. It can be seen that movements in consumer price inflation in many economies of the region substantially track movements of global food and fuel prices (see figure 1.5). Global oil prices since the nadir of the global recession in 2009 have increased dramatically in a volatile manner. Driven by geopolitical instability-related supply concerns in the Middle East, prices remain at over \$100 a barrel for Brent crude. Of even greater concern is the evolution of food prices in recent months, with the FAO food price index of key commodities increasing to near record levels on the back of weather-related shortages in key producer economies.

Box 1.2. Recent minimum wage policies boosting inclusive growth

Wage growth in Asia and the Pacific has generally remained weak over the past five years despite relatively robust economic performance (ILO, 2012f).^a Likewise, minimum wages^b have fallen into neglect in some countries and they are often insufficient to meet workers' basic daily necessities, including health care. With adjustments in minimum wages lagging behind rising GDP per capita, economic growth has not translated into higher wages, especially in relatively richer countries in South-East Asia and South and South-West Asia (see figure A). Apart from these general observations, the level of minimum wage rates can be seen to vary considerably across countries, driven by differences in domestic economic environments and prevailing labour market institutions. Many countries in the region, including Bangladesh, Bhutan, India, Kyrgyzstan, Myanmar, Sri Lanka, Tajikistan and Uzbekistan, have minimum wage rates set well below \$100 per month (see figure B).

Recently, governments in the region have used minimum wages as a policy tool to protect vulnerable workers and to stimulate domestic demand. The implementation of minimum wages is also increasingly considered as an important component of industrial policy for promoting industrial restructuring towards higher value-added activities and diversification to maintain international competitiveness. Since the beginning of 2012, minimum wages have been raised or have been introduced for the

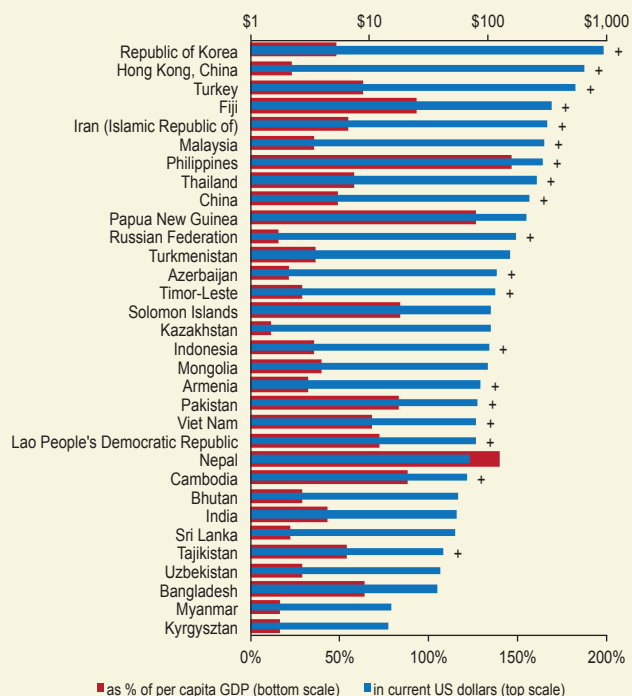
Figure A. Minimum wage growth and per capita growth in developing Asia-Pacific, 2002-2011



Sources: ESCAP, based on various national sources and data from International Labour Organization, Global Wage Database and United Nations Statistics Division.

Notes: The horizontal axis shows compound annual growth of real GDP per capita over 2002-2011 for selected developing Asia-Pacific economies. The vertical axis presents real minimum wage growth compounded over the same period.

Figure B. Monthly minimum wage rates in selected developing Asia-Pacific economies



Sources: ESCAP, based on various national sources and data from International Labour Organization, Global Wage Database and United Nations Statistics Division.

Notes: Figures shown are monthly minimum wage rates in place as of 1 January 2013 both in current United States dollars (top scale) and as % of per capita GDP (bottom scale). In countries where multiple minimum wage rates are set at the sectoral level, the rate for manufacturing or unskilled workers is applied. In cases where a national statutory minimum wage is not mandated, the minimum wage in place in the capital or major city is used. The (+) signs indicate that the minimum wage rates have been raised since the beginning of 2012.

Box 1.2. (continued)

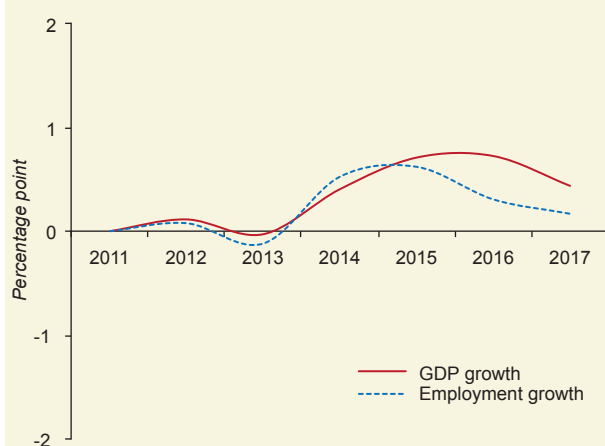
first time in more than 20 economies across the region. Malaysia was the most recent economy to establish a comprehensive national minimum wage in January 2013, set at 900 Malaysian ringgit (RM) (\$290) a month for Peninsular Malaysia and RM800 for Sabah and Sarawak. Likewise, the new daily minimum wage of 300 Thai baht (THB) (\$10) per day set in Thailand came into effect across the country in January 2013. This large increase of 40% or more, depending on the province, came after more than a decade during which minimum wages hardly kept up with inflation, and fell far short of productivity growth.

A common criticism of minimum wage adjustments is that they raise labour costs, resulting in layoffs of workers – especially SMEs. This may be a valid consideration if minimum wages were increased abruptly without appropriate measures for adjustment in labour-intensive sectors. However, fears that minimum wages *per se* lead to employment losses appear to lack empirical verification. Instead, a recent World Bank study on Indonesia found that minimum wage increases succeeded in boosting wages in the manufacturing sector, but had not led to employment losses for manufacturing workers and had only had a minuscule impact on non-manufacturing workers.⁶ This is in line with findings from developed economies that all point at the negligible negative employment effects of minimum wages.

Moreover, minimum wages have many benefits apart from boosting workers' income. Increased incomes for workers boost consumption demand, while increased labour costs trigger new economic activities with higher value-added content. Minimum wages thus improve the competitiveness of an economy by raising skill levels in preparation for increased international labour competition. Such wage policies also contribute to reduction of income inequality by redistributing income towards low wage workers. This, in turn, improves workers' morale and reduces the risk of industrial unrest, which ultimately increases productivity and reduces worker turnover.

The multi-year simulation exercise of ESCAP, based on the actual data for Thailand, models the impact of minimum wage increases on employment and real GDP growth for the period 2012–2017. In Thailand, the previous province-level minimum wages have been successively replaced by a single minimum wage of THB300 per day for the entire nation in 2012 and 2013 – corresponding to nominal increases of 40% or more, depending on the province. According to the Government official figures,

Figure C. Estimated impact of minimum wage hikes in Thailand



Source: ESCAP, based on the Oxford Economic Global Model.

Notes: Figures shown are estimated impacts of minimum wage hikes in Thailand in terms of percentage point change of real GDP and employment growth over 2012–2017. Baseline cases are ESCAP projections when minimum wages did not rise in 2012 or 2013.

the labour supply grew by 1.4% in 2012, 0.5% faster than growth of the working-age population. Arguably, higher wages attract more people to enter the labour force, especially drawing workers from the informal economy, and helping to overcome the labour shortage in the country. Assuming that 5 million workers were paid less than THB300 per day before the wage increase,^d the scenario analysis indicates that employment growth would accelerate by up to 0.6 of percentage point by 2015, while real GDP growth would increase by 0.7 of percentage point above the level without the minimum wage increase (see figure C). More importantly, the initial adjustment costs, the reason for which minimum wage laws are often criticised, are likely to be insignificant. The net negative impacts on employment and GDP growth are estimated at just under 0.1 of percentage point in 2013, implying that an increase in labour costs resulting from minimum wage increases would be offset by, or, in most cases, dominated by positive employment impacts due to a boost in domestic consumer demand.

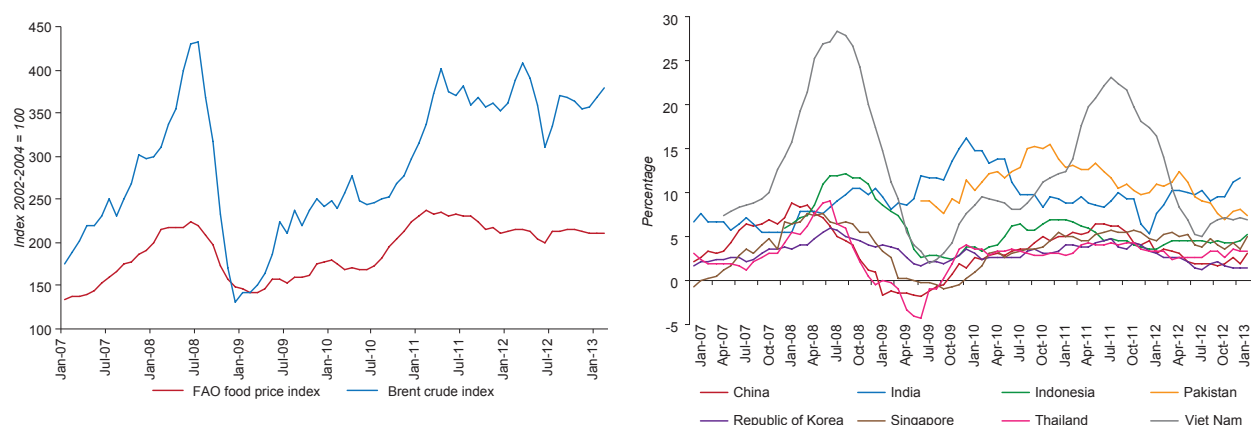
Box 1.2. (continued)

The results of this macroeconomic simulation illustrate that recent minimum wage hikes in Thailand are unlikely to trigger significant unemployment. In fact, unemployment has fallen marginally in Thailand since the new minimum wage was first introduced in six provinces in April 2012, ahead of nation-wide implementation in 2013. Additionally, any price effect of the new minimum wage is likely to be short-lived and relatively small in size. It should be understood that minimum wage policies need to be designed to minimize any potential adverse impact. For instance, in China, minimum wage laws are regularly reviewed and revised at least once every two years to ensure that changes are not too drastic and do not have a significant short-term impact on overall economic growth. In Thailand, upon the announcement of the minimum wage hike in 2012, the government introduced several policy support measures to smoothen the adjustment phase for businesses, such as providing tax allowances and reducing employers' social security contributions.

A minimum wage policy, if carefully designed and implemented with supportive adjustment policies by governments, increases incomes for workers, boosts consumption demand and helps narrow the earning gap. Moreover, it forces firms to improve production efficiency and hence contributes to economy-wide productivity growth. While some fear that higher minimum wages could have some short-term negative impacts on employment, inflation or GDP growth, these impacts have been found to be negligible in most cases – and need to be weighed against the long-term economic benefits and their positive social impacts. Nevertheless, it is important for countries that which have introduced minimum wage legislation to undertake active labour market programmes in tandem with business support measures, especially for SMEs, to tide over short-term adjustment difficulties.

- a Real wages grew regionally, on annual average by 5.2% in the years 2008-2011 compared to the regional average annual GDP growth of 6.8% over the same period. If China is excluded from this calculation, real average wages contracted by 0.3% per annum.
- b Minimum wage is defined by the International Labour Organization (ILO) as “the lowest level of remuneration permitted which in each country has the force of law and which is enforceable under threat of panel of other appropriate sanctions. Minimum wages fixed by collective agreements made binding by public authorities are included in this definition.” (ILO, 1992). Also, the number of minimum wage rates set within the same country is also quite different. Some countries have only one national minimum wage rate, whereas others have multiple minimum wage rates by districts, occupations, age, and qualification. India, for instance, has more than 1,200 different rates.
- c See for details Del Carpio, Nguyen and Wang (2012).
- d This assumption is in line with the number estimated by the National Economic and Social Development Board, a Thai government agency.

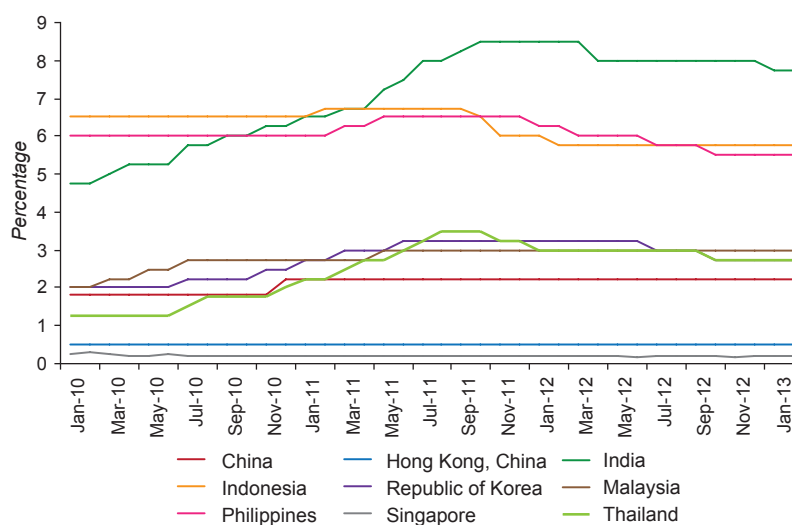
Figure 1.5. Oil price, FAO food price index and consumer price inflation (year-on-year) in selected developing Asia-Pacific economies, 2007-February 2013



Sources: ESCAP, based on data from Food and Agriculture Organization of the United Nations. Available from www.fao.org/es/esc/prices/PricesServlet.jsp?lang=en; and www.fao.org/worldfoodsituation/wfs-home/foodpricesindex/en/; United States Energy Information Administration. Available from tonto.eia.doe.gov/dnav/pet/pet_pri_spt_s1_d.htm; and CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 30 March 2013).

Note: LHS panel: y-axis refers to monthly values of FAO food price index and crude index; RHS panel: y-axis refers to the year-on-year monthly values of CPI of the selected economies.

Figure 1.6. Policy rates in selected developing Asia-Pacific economies, 2010-February 2013



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 30 March 2013).

Notes: The policy rates for each country include rediscount rate for China; discount window base rate for Hong Kong, China; Reserve Bank of India repo rate for India; Bank of Indonesia month end reference rate for Indonesia; Bank of Korea base rate for the Republic of Korea; overnight policy rate for Malaysia; repurchase rate for the Philippines; overnight repo rate for Singapore and the 1-day bilateral repurchase rate for Thailand.

Food and fuel price rises have been exaggerated by the increasing financialization of commodity markets

As highlighted in the ESCAP 2009 *Economic and Social Survey of Asia and the Pacific* (ESCAP, 2009a), food and fuel price rises due to concerns about supply-related shortages have been exaggerated by the increasing financialization of commodity markets. Commodity assets managed by financial investors have increased over the past decade from less than \$10 billion to \$404 billion in June 2012. Loose monetary policies of the developed world, most notably quantitative easing (QE) in the United States, along with the unwillingness of governments to regulate participants in commodity markets, have continued to draw excess funds to the commodities markets due to the markets' comparatively high expected returns. The presence of financial investors, betting on an increase in fundamental prices due to supply shortages, serves to exaggerate price increases.

The commencement in 2012 of a new round of QE, referred to as QE3, is expected to contribute to

the pressure as investors are driven into all global asset classes. In the long-term, with a perception that food and fuel prices are on an increasing trend due to growing global wealth and finite supply, such commodities present a compelling investment story. Furthermore, the participation of financial investors is driven by herd behaviour which suffers from periods of mass entry and withdrawal from such markets. The resulting volatility in food prices hurts commodity producers as the accuracy of medium-term decisions regarding production based on prices is jeopardized.

Without regulations that are aimed at managing the participation of financial investors, price rises will continue to be exaggerated. Implementation of legislation agreed under the Dodd-Frank Act in the United States to limit the holdings of financial investors in commodity markets which was set to begin in October 2012, continues to be delayed. As of December 2012, financial regulators have issued only 48% of final rules mandated by the Dodd-Frank Act of 2010, and have missed deadlines for implementing 89% of the Act's provisions (Government Accountability Office, 2013).

The other element of policy-induced distortion to the commodity markets has been the growing impact of biofuel mandates. With mandates in place in the United States and the European Union on the amount of fuel to come from biofuels, substantial amounts of the developed world's crop production is being redirected towards fuel. In the United States, high and progressively increasing mandates for the minimum amount of total fuel to come from biofuels are already in place. It is estimated that around 40% of corn production in the United States is now devoted to biofuel (Graziano da Silva, 2012), up from negligible levels in 2000. With drought affecting corn production combined with no relaxation in mandated biofuel levels, the proportion of corn being redirected is likely to increase even further in the short-term.

In the case of the European Union, the mandate for 10% of fuel to come from biofuels by 2020 has led to countries already self-imposing mandates at varying levels in an effort to meet the requirement by that date. Since the amount of food crops available to produce biofuels in the European Union is limited, the mandates have an immediate knock-on effect on food production in other regions, such as the developing world. Coupled with the existing impact of mandates, the high price of oil has increased concerns that governments will be under pressure to increase the role of mandates to reduce the growing impact of fossil fuel dependence on pump prices.

In a number of developing economies in the region, high food prices partly stem from domestic structural factors such as low productivity or lack of extension services due to cuts in public spending, which affect the supply of food crops. Government policies often attempt to ensure food security by insulating the domestic food market from global forces through export control measures. Nevertheless, global prices still have some effect on such economies through avenues such as the need for procurement prices to track global prices to some degree to discourage smuggling abroad of food crops.

Tight monetary policy is not the appropriate primary response to inflation due to supply bottlenecks, administrative price adjustments or food price rises, as it dampens general domestic economic activity without addressing the structural factors underlying the price rises. The more appropriate response to dealing with economies with such supply constraints is to create a supportive environment for investment through accommodative interest rate policies in general, supplemented by directed credit to areas of critical need, including agriculture and rural infrastructure. Public procurement and distribution of food can also play a significant role in addressing food price inflation.

Macroeconomic instability heightening through short term capital inflows

Macroeconomic stability of economies in the region is being imperiled by the fresh wave of global short-term capital coming to its shores spurred by expansionary monetary policies in the developed economies. In September 2012, the United States Federal Reserve announced the resumption of an aggressive asset purchasing programme to the value of \$40 billion per month in mortgage-backed securities, with the intention of lowering long-term interest rates, spurring economic activity and creating jobs. This original value was further boosted in December 2012, adding an additional \$45 billion a month in purchases of Treasury bills. Unlike previous quantitative easing measures, this new programme of \$85 billion in monthly asset purchases is open-ended and set to continue until there is a significant improvement in labour market conditions. The European Central Bank, the Bank of Japan and many other advanced economies' central banks have also undertaken variants of QE and other forms of unconventional monetary policy. Furthermore, in early 2013, Japan outlined plans to start a monthly purchase plan of \$145 billion in assets from the start of 2014 to boost growth and combat deflation.

Expansionary monetary policies in the developed world are once again leading to difficulties for macroeconomic management in the region

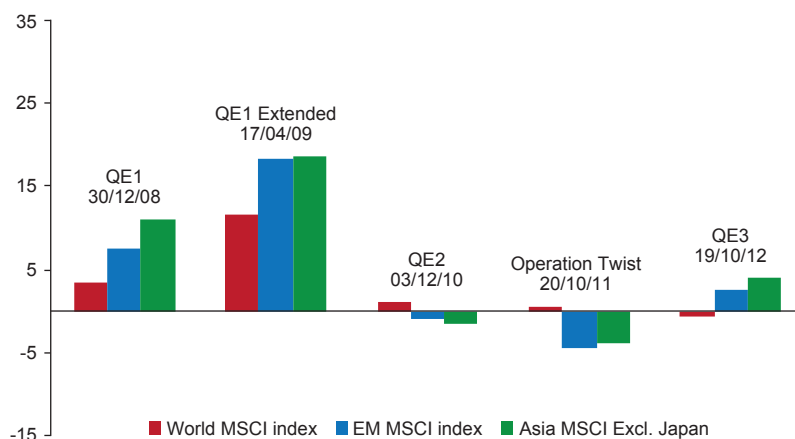
Expansionary monetary policies in the developed world are once again leading to difficulties for macroeconomic management in the region. This is due to the logical decisions of financial investors to reallocate their funds from the depressed bond markets in the developed world to currency and asset markets in the region. Current and probable medium-term investment returns in this region are far more attractive in terms of both interest rate differentials and medium-term economic growth prospects. The comparative attraction of this region remains largely unchanged since the previous two rounds of QE earlier in the Great Recession of 2008-2009. The impact on capital flows to Asia-Pacific economies during the two earlier rounds of QE was severe, and there is little reason to suspect that the outcome will be any different this time around.

The announcements and implementation of the renewed QE measures in advanced economies had immediate spillover effects on asset markets in the region (see figure 1.7). From the onset of QE3, the Philippines saw net capital inflows, mainly in the form of portfolio investment, nearly triple in

September and October 2012 from the same period a year earlier. Indonesia and the Republic of Korea also experienced a net inflow of about \$1.3 billion and \$1.4 billion, respectively, in September 2012, compared with a net outflow of \$540 million and \$2.4 billion the month before. Net foreign investment in bonds of the Republic of Korea rose to a 17-month high in December 2012, largely due to an optimistic economic outlook and speculation that the Korean won would continue to appreciate.

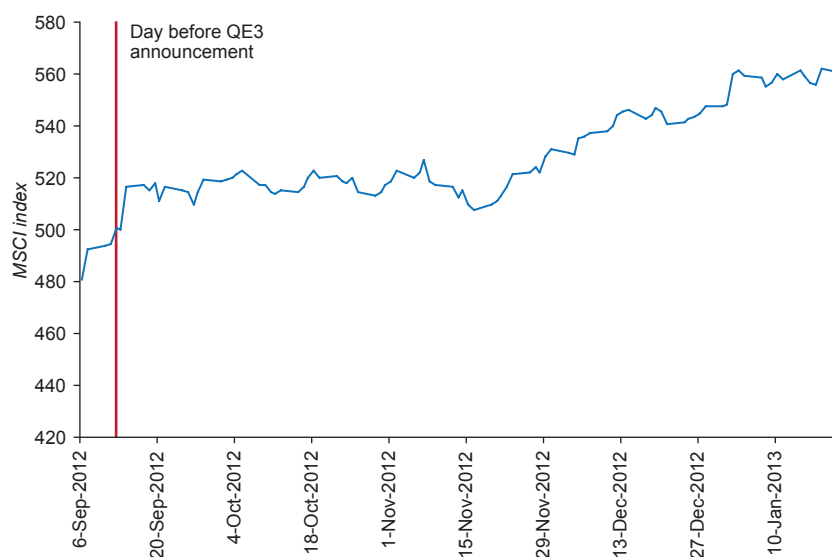
Equity markets in the region rallied, with the MSCI index gaining 2.36% one month after the announcement of QE3 in September 2012, and up to 9.18% three months after the announcement (see figure 1.8). The greatest rises were seen in the equity markets of the Republic of Korea and Hong Kong, China. The property sector is another area of interest for financial investors. For example, during the first month following the announcement of QE3, house prices in Hong Kong, China rose by 3%, while in the Republic of Korea and Singapore, they gained 1.195% and 1.125%, respectively. Governments have responded with a host of cooling measures in the property sectors. For example, in October 2012 and January 2013, the Monetary Authority of Singapore introduced a number of measures to contain a risk of property price bubbles. In October 2012, the government of Hong Kong, China raised the stamp duty on house purchases to stave off speculative investment flowing into the property markets.

Figure 1.7. Asset responses after quantitative easing implementation announcements, percentage change



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 15 January 2013).

Figure 1.8. Fluctuations in equities in developing Asian economies since QE3, MSCI Asia excl. Japan equities index



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 21 January 2013).

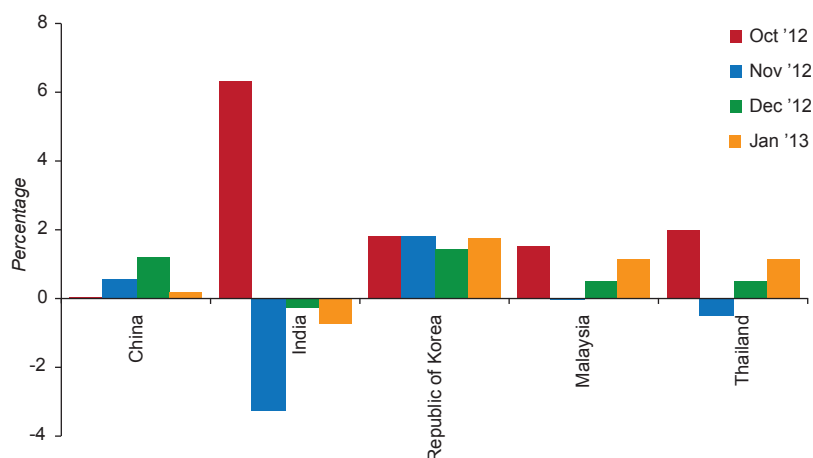
In the foreign exchange markets, on the back of massive capital inflows in September 2012, the Chinese yuan was pushed to its highest level since the official and market exchange rates were unified at the end of 1993. The progressive strengthening of the yuan against the dollar continued into the latter part of 2012 (see figure 1.9). Some regional currencies also experienced rapid short-term appreciation; the Thai baht gained about 0.57% against the United States dollar a day after the announcement of QE3 relative to the day before, while other regional currencies appreciated at a slower but more steady pace, such as the Korean won which was up 1.81% against the United States dollar a month after the QE3 announcement compared to its level the day before the announcement. The Korean won appears to have experienced the most consistent gains, appreciating more than 6% against the dollar relative to its pre-QE3 value by mid-January 2013, with emerging concerns that this could hurt the price-competitiveness of local exporters.

It should be noted that exchange rate movements are not a wholly accurate reflection of the extent of appreciation pressure, as governments have engaged in substantial foreign reserve accumulation (see figure 1.10) over recent years in order to dampen currency

rises. Countries are engaging in a competition to best manage their currency values relative to their competitors in order to protect the fortunes of their export industries, an attempt which is especially important at a time of reduced export demand. This exercise, however, is extremely costly as the resulting accumulation of foreign reserves imposes significant costs on governments. One is the direct cost of earning less interest income on the reserves compared to the interest cost of the accompanying domestic monetary sterilization, while the other is the opportunity cost of alternative uses of such funds for more productive investments. However, the increase in foreign exchange reserves witnessed in a number of countries, such as Bangladesh, is a more positive development as such economies are not as exposed to global financial flows, but instead have to maintain sufficient reserves to contend with real external sector shocks. The reserves of Bangladesh and Nepal increased to record levels recently, with those of Bangladesh climbing to more than \$13 billion by early 2013 while those of Nepal crossed \$5 billion in late 2012, largely on the back of remittance inflows.

The concern with the large amount of inflows into the region's asset markets is the macroeconomic

Figure 1.9. Fluctuations in selected developing Asia-Pacific currencies following announcement of QE3, monthly percentage change



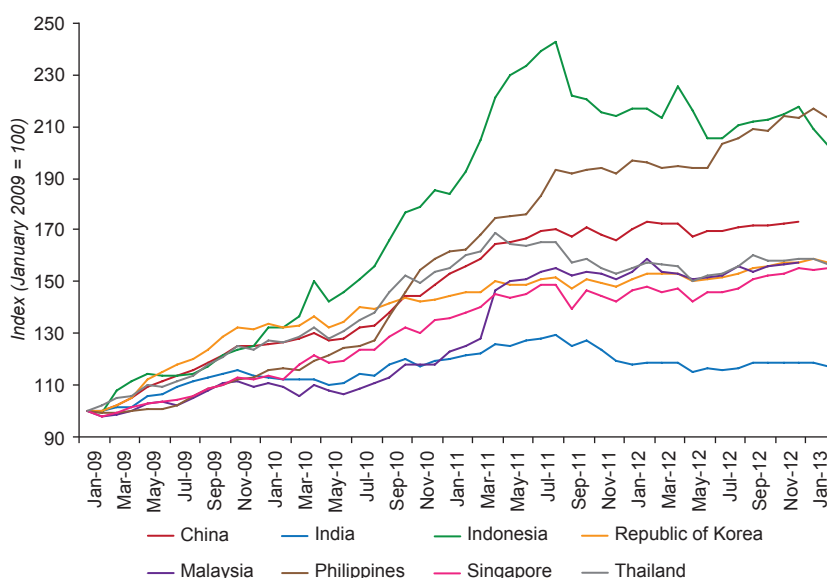
Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 15 January 2013).

vulnerability this creates if such flows were to reverse. As was seen during the 1997-98 Asian financial crisis, asset market prices could fall drastically and exchange rates could depreciate substantially, leading to the risk of a banking sector crisis as well as drastic loss of wealth of domestic citizens who invested in such assets. The traditional approach of governments in the region to deal with such an eventuality is to accumulate foreign exchange reserves. This method of protection, however, has been seen to be far from ideal. In recent

instances when currency support was required, at the time of the start of the crisis, the amount of reserves of countries proved insufficient and some governments such as the Government of Singapore and Government of the Republic of Korea were forced to request precautionary credit lines from the United States Federal Reserve as well as from other regional governments on a bilateral basis.

Calculations regarding the adequacy of reserves compared to the amount of capital outflow may

Figure 1.10. Foreign reserves in selected developing Asia-Pacific economies, 2009-February 2013



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com/> (accessed on 30 March 2013).

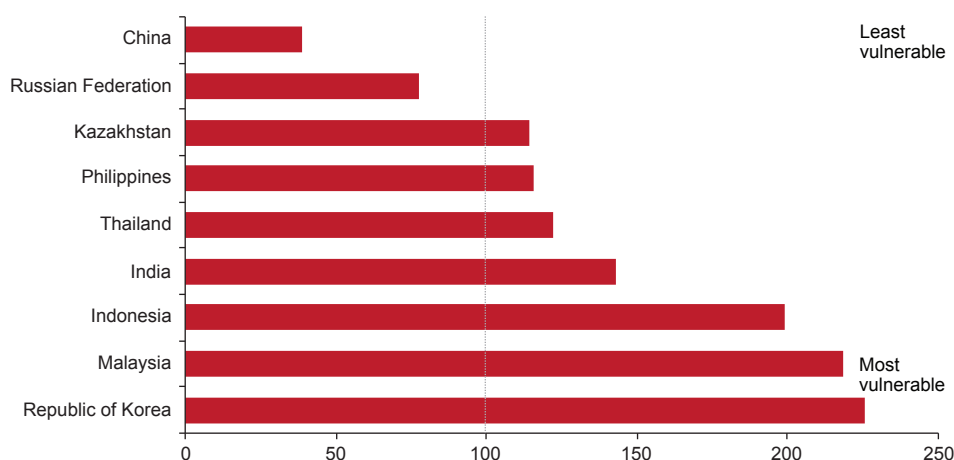
prove inaccurate, in part due to a lack of full accounting of the size of stock of foreign short-term capital which has built up in economies over recent years. The ESCAP vulnerability measure provides a measure of reserve adequacy taking into account a comprehensive estimate of the stock of such capital inflows. It indicates that a number of economies in the region remain significantly vulnerable to a renewed episode of short-term capital flight (see figure 1.11).

The other key concern pertaining to using foreign reserve accumulation as the primary approach to addressing pressure on economic management from the entry of short-term capital flows is that such an approach does not deal with the impact on asset markets of any sudden outflow. While exchange rate depreciation may be moderated by the use of reserves, equity or property markets could nevertheless decline sharply and substantially, therefore causing hardship for domestic investors and possibly initiating a banking crisis. This problem highlights the fact that foreign reserves accumulation is a second-best approach to dealing with such inflows as it does not tackle them at the source of entry and therefore does not address the various negative impacts within economies of such inflows.

An effective approach for managing disruptive short-term capital inflows is to limit the quantity and areas of the financial sector in which such flows may enter. Capital controls, as recommended by ESCAP for a number of years (ESCAP, 2010a), and other macroprudential measures have been gaining in popularity in recent years as policymakers are increasingly realizing that economies are living with a “new normal” of consistent pressure on their asset markets from foreign investors due to the global environment. To protect the independence of their macroeconomic policies, governments have been willing to give up the dubious benefits of dependence on easily reversible short-term capital flows in order to be able to dictate their own exchange rate policies and protect their citizens and banking sectors from excessive dependence on the whims of the global financial markets.

Uncertainties regarding the causes and effects of inflow surges, as well as the country, sector and time specific aspects defining capital inflows call for a careful strategy towards mitigating possible negative effects. This has been true of the Asia-Pacific region for decades, particularly as more than 60% of past inflow surges have ended suddenly.¹⁰ It is particularly relevant now in the region due to the unpredictable effects demonstrated by successive

Figure 1.11. Vulnerability yardstick as a percentage of foreign reserves in selected developing Asia-Pacific economies



Sources: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com> (accessed on 6 March 2013).

Note: Vulnerability yardstick is the sum of short-term external debt, latest quarterly imports based on four-quarter moving average and estimated international portfolio investment position. Based on latest available data.

rounds of QE. Therefore, countries may need to set capital flow management strategies based on a targeted approach or a combination of tools and incremental time-varying adaptation as elaborated in the ESCAP 2012 *Economic and Social Survey of Asia and the Pacific* (ESCAP, 2012b).

Preventing the recurrence of devastating boom-bust cycles and the contagion of economic crises require active financial and monetary cooperation at the regional level. The few existing mechanisms, for example, the Chiang Mai Initiative of ASEAN+3, the Asian Bond Market Initiative (ABMI), the ASEAN+3 credit guarantee facility and the Asian Clearing Union, all have partial membership coverage, remain small in scale and are largely still too underdeveloped to effectively act as stabilizers in times of crisis.

The region needs to further develop its financial architecture. This would require a mechanism to intermediate between the region's large savings and its unmet investment needs, especially for infrastructure development, in order to facilitate trade within the region, to strengthen regional crisis response and prevention facilities, and to build understanding and consensus on global multilateral cooperation. By enhancing regional cooperation,

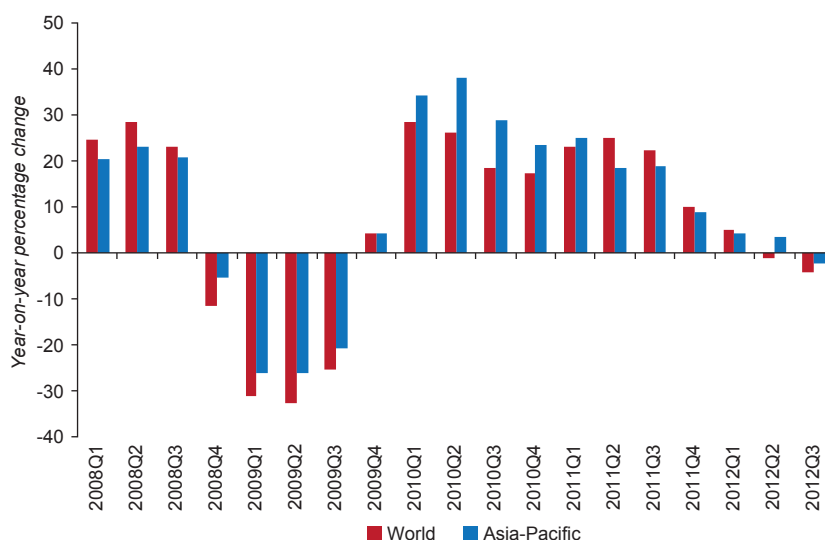
governments would be less compelled to build up large foreign exchange reserves to protect their economies against speculative attacks and liquidity crises, while at the same time this effort would establish the building blocks for global multilateral cooperation.

Trade performance under threat

After a strong recovery in 2010, exports from Asia and the Pacific are decelerating,¹¹ with export growth now below the pre-crisis level. The export growth of the developing Asia-Pacific region dropped from about 35% in 2010 to 13% in 2011, and was about 9% in 2011 excluding exports from China. After mid-2012, trade in the Asia-Pacific region started to contract. Exports from the Asia-Pacific region declined by 2% in the third quarter of last year (see figure 1.12).

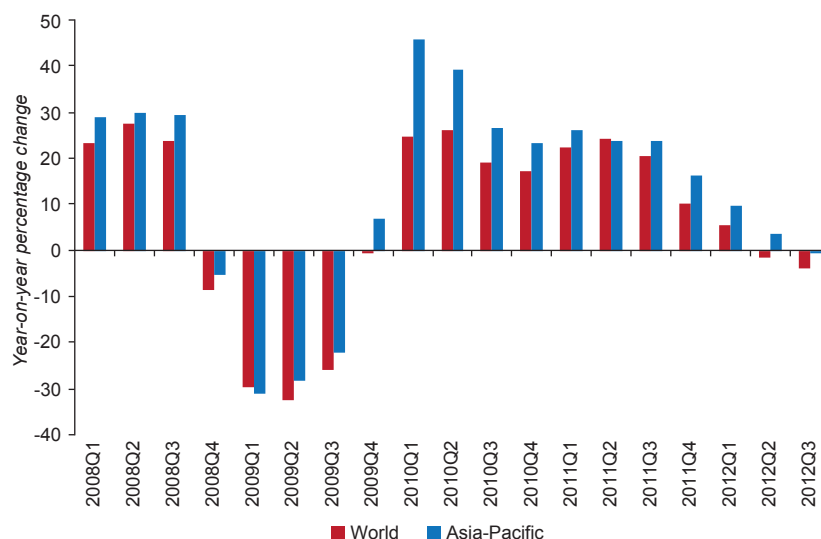
Data on imports from the region show a similar contraction, with growth dropping from 35% to 18% from 2010 to 2011, and to 14% in 2011 if imports from China are excluded. Import growth in the Asia-Pacific region declined throughout 2012 while the level of imports stagnated in the third quarter (see figure 1.13), reflecting the region's slowdown.

Figure 1.12. Recent developments in Asia-Pacific export growth



Source: ESCAP, based on World Trade Organization online short-term merchandise statistics (accessed in February 2013).

Figure 1.13. Recent developments in Asia-Pacific import growth



Source: ESCAP, based on World Trade Organization online short-term merchandise statistics (accessed in February 2013).

Major trading economies, such as Malaysia, the Republic of Korea, Thailand and Taiwan Province of China, have faced a significant slowdown in their exports, starting in the second half of 2011. The supply-chain disruptions due to flooding in Thailand at the end of 2011 affected trade in both the country and the region from the start of the disaster until well into the first quarter of 2012. Exports from Thailand recovered by February 2012 but have subsequently been fluctuating. Moreover, Indonesia, the Republic of Korea and Taiwan Province of China have been confronted with weakening demand from China and the rest of the world, which has resulted in declining growth of their exports from March 2012.

India was able to benefit from its unique trade pattern and record rapid export growth from the second half of 2011 until early 2012, when it then also experienced a steep decline in export growth. The country has been affected by its high specialization in exports of IT-related services combined with weak integration in regional production networks. Consequently, it is vulnerable to the economic uncertainty in the United States and the European Union. With both of these economic powers unable to restart their economic engines, the export performance of India in 2012 was no different from the rest of countries in the region.

The increasing demand for commodities and the strengthening of industrial capacity of emerging economies, especially in industries linked to the extraction of natural resources, have affected the region's composition of trade. A sector-based analysis reveals that while industrial products still comprise more than 80% of Asia-Pacific trade during 2002-2011, the share of petroleum products increased and agriculture maintained a relatively constant share. All three sectors were similarly hit by reduced demand for their exports, which lost dynamism and recorded growth of less than 10% in 2011. Imports of industrial and agriculture products also decelerated during 2011. On the other hand, energy-intensive activities in the region kept petroleum imports buoyant, with growth of almost 20% during the same period.

The growing consumption in emerging economies in the region has kept imports of consumer goods robust, with an increase of almost 20% recorded in 2011. On the other hand, weak economic conditions in developed markets and associated weakening of growth in the powerhouses of the region, caused imports intended for further production – including processing for exports – to decline much more. For example, imports of raw materials and intermediate goods fell from a 40% growth rate in 2010 to 16%

and 2%, respectively, in 2011. The growth rate in imports of capital goods almost disappeared, collapsing from 32% to a mere 5%, signalling weakening investment activities that, in turn, will have adverse effects on future production.

Slowdown in China affects the region

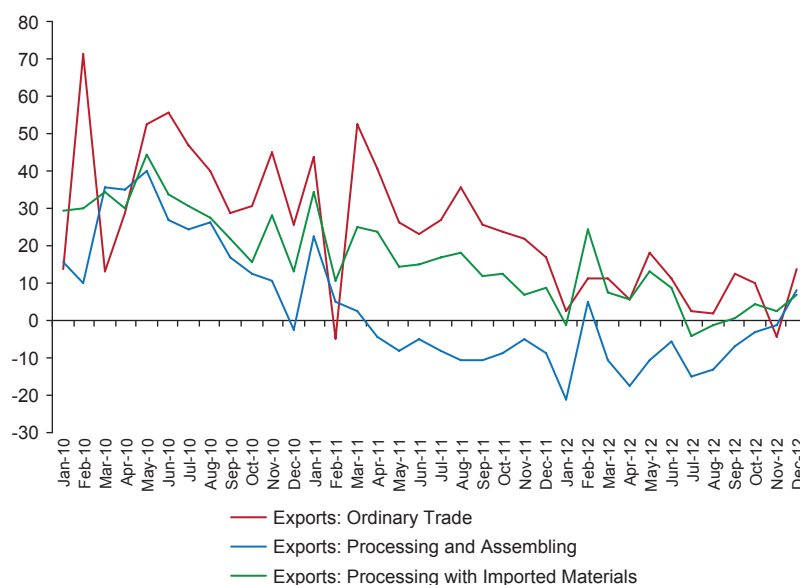
Trade in the region is facing significant new threats from the slowdown of the Chinese economy. China is currently the largest individual export market for the rest of the region. The country accounted for about 16% of exports by the rest of the Asia-Pacific region in 2011. The share for developing economies in the region was slightly lower, with 13.5% of their exports being shipped to China in 2011. About 50% of imports of intermediate goods to China are sourced from developing Asia-Pacific economies and Japan.

Recent data show that China is experiencing difficulties with maintaining its high export growth. After mid-2012, export growth of China decelerated significantly from 10.5% in the second quarter to 4.5% in the subsequent quarter. The growth was weaker on the import side, dropping from about

6.4% to 1.4% during the same period. Apart for the global trade collapse in 2008-2009, these growth rates are the lowest that China has faced in the past decade. This serves as a major factor in determining the intraregional trade outlook.

The decline in the export growth of China is putting a dent in exports from the other regional economies due to their role as suppliers of intermediate inputs for the processing of exports in China. The data provided by General Administration of Customs of China indicates that Chinese exports with high import content are struggling more than those with a high domestic value-added. Thus, export slowdown from China means contractions in the country's imports of raw materials and intermediate inputs from the rest of the world. Figure 1.14 shows that processing and assembling activities have experienced an export growth contraction since the second quarter of 2011. In these types of exports, import content is very high; China generally provides only assembling services while foreign suppliers provide raw materials, parts or components under a contractual arrangement for subsequent re-exportation of the processed products. Export growth from China recovered somewhat during the second half of 2012, but there remains

Figure 1.14. Monthly export growth in China by custom type,^a 2010-2012



Source: ESCAP, based on data from the General Administration of Customs of China, accessed from CEIC Data Company Limited. Available from <http://ceicdata.com> (accessed in February 2013).

^a Custom types are defined by the General Administration of Customs of China.

no indication that this recovery will be sustainable as the two major export markets of China (the United States and the European Union) are still facing subdued prospects.¹²

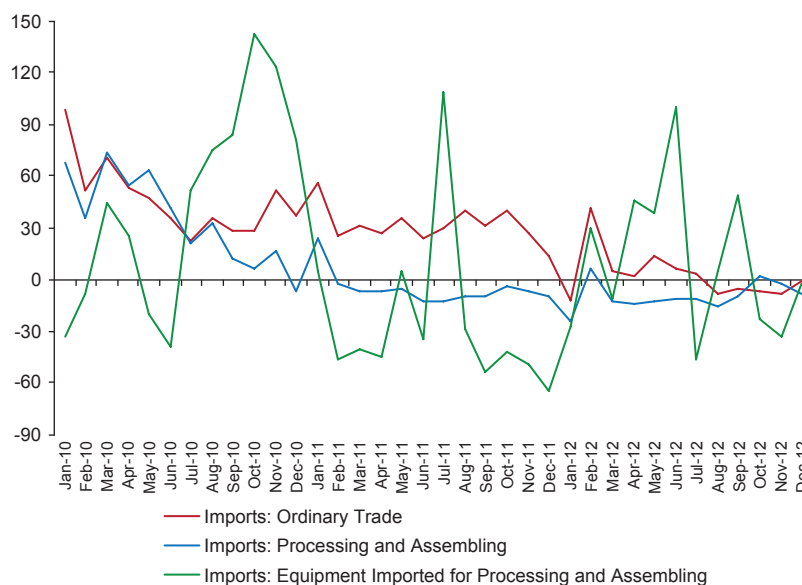
The import data reflect the chain reactions indicated on the export side. Imports from China that are for processing and assembling have been declining since early 2011 (see figure 1.15). Imports of equipment used for processing and assembling activities are fluctuating, and growth has mainly been negative. Ordinary imports, such as imports for domestic use, grew rapidly during 2010 and 2011 because of the Chinese economic boom and expansionary policies. However, a contraction of ordinary imports continued throughout 2012, from about 30% during 2011 to negative growth in the second half of 2012, indicating a significant slowdown in the domestic economy.

One option for sustaining the export performance of China would be to encourage product and market diversification. However, in the face of an economic slowdown in traditional destinations, other countries are also seeking increased market shares in non-traditional import markets mostly in emerging

economies. Amid global uncertainties, competition in emerging markets will be fierce. Therefore, policymakers need to identify policy mixes that would enable exporters to achieve greater efficiency and trade at lower costs. Cost-cutting through lower wages would be counterproductive as it would likely dampen domestic demand. Therefore, the best route for enhancing competitiveness is by improving productivity. In addition, broadening and strengthening regional economic integration is necessary as this will improve access to Asia-Pacific markets.

The evolving nature of demand in China is a critical factor for the direction of the region's economic relationships. There is some uncertainty tied to this issue. Policymakers in China have stated that their long-term aim is to improve the “quality of growth” by reducing the excessive dependence of the economy on exports and increasing the role of domestic demand; and within domestic demand, reducing the role of investment, both in infrastructure and recently in the housing sector, and instead boosting the disproportionately small role of consumption. The Government unveiled wide-reaching plans in February 2013 to empower

Figure 1.15. Monthly import growth of China by custom type,^a 2010-2012



Source: ESCAP, based on data from the General Administration of Customs of China, accessed from CEIC Data Company Limited. Available from <http://ceicdata.com> (accessed in February 2013).

^a Custom types are defined by the General Administration of Customs of China.

the poor and reduce inequality with the objective of lifting 80 million people from poverty by 2015. The plans include measures to increase the progressivity of the tax system by increasing the contributions of successful state-owned enterprises, and increase the various elements of tax contribution of the richer members of society. Furthermore, minimum wages in rural areas are to be increased significantly and the household registration system is to be reformed to allow urban residents from rural areas to be entitled to the social security and other entitlements of urban-registered citizens.

ESCAP analysis shows that the improvement of the inclusiveness of growth in China promised by the ongoing reform process, even if it were to result in lower headline GDP growth rates, could

have a significant positive impact on economies in the region. Despite a slowdown in headline GDP growth in China, largely as a result of a fall in investment, an increasingly consumption-driven Chinese economy would benefit regional exporters of consumer goods through increased penetration in the Chinese market. The total benefit in exports for the region would be almost \$13 billion during the period 2013-2015, with export growth for the region at up to 0.5 of a percentage point above the level without rebalancing (see box 1.3).

Foreign investment declined, especially in least developed countries

Due to macroeconomic fragility and policy uncertainty for investors amid the global slowdown, foreign

Box 1.3. The impact of a rebalancing China on Asia-Pacific economies

The twelfth five-year plan of the Government of China explicitly outlines a series of measures aimed at rebalancing the economy away from external dependence and towards a sustainable, domestically driven long-term growth path. Some initiatives that focus on boosting consumption, reducing reliance on exports, reforming financial markets and tackling various other structural impediments are already underway, with more planned to be implemented over the coming years. Due to the importance of Chinese imports to intraregional trade, this is likely to have an impact throughout the wider region. The five-year plan's aim to reduce the imbalance between consumption and investment may have particularly significant implications for exporters of capital goods as these exports have been largely fuelled by Chinese investment in recent years.

ESCAP conducted multi-year impact assessments for selected Asia-Pacific economies based on a scenario involving the rebalancing of the Chinese economy. Table A shows the likely impact of the rebalancing over the period 2013-2015. In the scenario, the rebalancing of the Chinese economy was compared to its projected long-term growth - the average pace of growth observed in the economy during the past ten years. The scenario assumes that the economy will expand by 8.6% annually during the period 2013-2015, a figure that is 1.7 percentage points less than the long-term trend but is consistent with the estimates reported by the Development Research Center of the State Council, a state agency of China (World Bank, 2012a). As a result of the rebalancing, fixed investment would grow 7.3 percentage points less and consumption would grow 2 percentage points more than what is projected based on the long-term trend. The impacts are reported both in terms of percentage point changes of real export growth and in terms of export benefits or losses. The ESCAP calculations assume that under the rebalancing scenario, the share of China in global consumption will continue to grow at the 1999-2011 average rate, while the share of global consumer goods imports will speed up to grow proportionately with consumption share throughout 2013-15.

ESCAP analysis shows that a rebalancing of the Chinese economy would have overall positive impacts on trade performance of the region's economies. Despite a growth slowdown, largely the result of a fall in investment, an increasingly consumption-driven economy would benefit exporters of consumer goods through increased penetration in the Chinese market. The total benefit in exports for the region would be nearly \$13 billion over the period 2013-2015, with export growth at up to 0.5 of a percentage point above the level without the rebalancing.

Box 1.3. (continued)

Table A. Estimated impact of a rebalancing of the Chinese economy on exports in selected Asia-Pacific economies, 2013-2015

	Impact on export growth (percentage points)	Benefit / loss over 2013- 2015 (million \$)
East and North-East Asia		
Hong Kong, China	-0.06	-829
Japan	0.15	3 619
Macao, China	0.12	3.1
Korea, Republic of	0.13	2 103
Mongolia	0.04	2.2
North and Central Asia		
Armenia	0.09	3.6
Georgia	0.03	1.3
Kazakhstan	0.10	274
Kyrgyzstan	0.02	1.3
Russian Federation	0.11	1 713
Pacific		
Australia	0.04	309
Fiji	0.07	1.7
New Zealand	0.49	558
Papua New Guinea	0.00	-0.01
South and South-West Asia		
Afghanistan	0.13	1.4
Bangladesh	0.00	-1.8
India	0.06	512
Iran, Islamic Rep. of	0.05	183
Nepal	0.06	1.6
Pakistan	0.05	36
Sri Lanka	0.03	7.7
Turkey	0.04	153
South-East Asia		
Cambodia	0.07	13.3
Indonesia	0.06	380
Malaysia	-0.01	-76
Philippines	0.16	226
Singapore	0.23	2 825
Thailand	0.04	269
Viet Nam	0.21	456
Total		12 745

Source: ESCAP, based on methodology in Sudip Ranjan Basu and others, "Euro zone debt crisis: scenario analysis and implications for developing Asia-Pacific", *Journal of the Asia Pacific Economy*, vol. 18, No. 1 (2013), pp. 1-25.

Notes: Figures shown are estimated impacts of a balancing of the Chinese economy both in terms of percentage point changes of real export growth average during the period 2013-2015 and in terms of benefits and losses during the same period. Although this table does not report estimated impacts for all economies in the Asia-Pacific region, the 29 economies listed above and China cover more than 95% of the region's total GDP.

Source: ESCAP, based on Steven Ayres and Yusuke Tateno (Bangkok, ESCAP, 2013), "The impact of a rebalancing China," ESCAP/Macroeconomic Policy and Development Division Working Paper. (forthcoming).

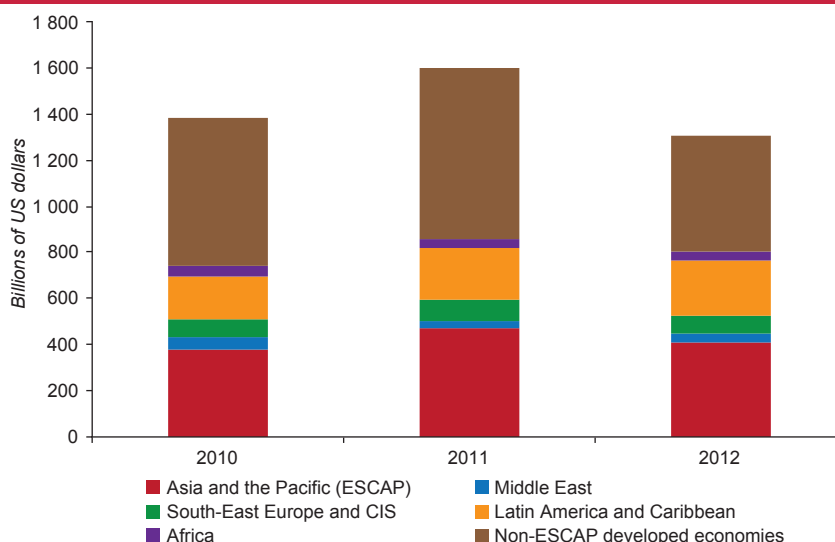
direct investment (FDI) in the region declined by 10% to \$399 billion in 2012 while globally these inflows fell by 18% to \$1.3 trillion (see figure 1.16), (UNCTAD, 2013). The global inflows are currently far short of the \$1.98 trillion pre-crisis peak in 2007. Notably, there is the risk that the lacklustre economic performance of the European Union and the United States as well as the slowdown in the regional powerhouses will further depress FDI flows in coming years.

Among the Asia-Pacific developing countries, five economies stand out in terms of attracting FDI inflows. Of these five “FDI giants”, China held the top position with 33% and the second position globally in 2012. Hong Kong, China accounted for a 20% share, followed closely by Singapore and the Russian Federation with shares of 15% and 12%, respectively. India attracted 7% of total FDI inflows to the Asia-Pacific region. The Asia-Pacific developed countries as a group accounted for 12% of total FDI inflows, but these inflows can be mostly attributed to Australia. In this regard, the role of least developed countries remains marginal with less than 1% of inflows going to these countries; this indicates the need for these countries to further improve their attractiveness as investment destinations.

Least developed countries have struggled to integrate into global and regional value chains, mainly due to poor infrastructure, high trading costs and low levels of human capital and technological development. In addition, least developed countries have faced competition from developing countries which also provide an abundance of low-cost labour, but often tend to be more productive (UNCTAD, 2011).

Following the emergence of regional and global value chains in the Asia-Pacific region amid rising levels of regional integration, particularly in the Association of Southeast Asian Nations (ASEAN), intraregional FDI flows have gained in importance. FDI flows among ASEAN countries have more than doubled in share between the periods 1998-2000 and 2008-2010. During the period 2008-2010, the ASEAN+6¹³ countries provided an average of more than 40% of the FDI flows to the subregion compared with an average of 15% during the period 1998-2000. This suggests that intra-ASEAN FDI flows have become an increasingly important source of financing in the subregion. One factor explaining the increase in intraregional investment is that as countries’ industries advance and move up the value chain, they start outsourcing and looking for investment opportunities in other countries.

Figure 1.16. FDI inflow by regions, 2010-2012



Source: ESCAP, based on UNCTAD, *Global Investment Trends Monitor*, No. 11 (accessed on 23 January 2013).

The main destination and source countries for intraregional greenfield FDI¹⁴ have changed little in recent years (see table 1.1). Looking back in three-year periods, in 2003-2005, 2006-2008 and 2009-2011, China was the main destination and Japan the main source of intraregional FDI flows. In terms of destinations, the second and third largest countries during 2003-2005, Australia and the Russian Federation, have given way to Viet Nam and India, which have kept their respective second and third positions since 2006. A similar reallocation has taken place among the main source economies. Coming in second and third during 2003-2005, Hong Kong, China, and the Russian Federation have been replaced by the Republic of Korea and China.

The concentration of intraregional FDI in a few countries in the region is an impediment for the region's least developed countries, which do not attract much global FDI. Therefore, greater efforts by various regional forums are needed to boost

intraregional FDI in poorer countries for the balanced and inclusive development of the region. The similarity of socioeconomic conditions among the developing countries in the Asia-Pacific region should encourage companies to look for opportunities in neighbouring countries. Companies that are used to a specific type of business environment should find it easy to trade and invest in countries where conditions are comparable, giving them an advantage over enterprises from developed countries. The smaller technology gap among companies from developing countries puts those firms in a good position to transfer and diffuse technology and knowledge among each other (ESCAP, 2011a).

However, resource-rich least developed countries, such as Afghanistan and Myanmar are attracting FDI in their extractive sectors. Such economies are confronted with the challenge of managing these flows in the most beneficial manner. FDI in extractive industries carries larger risks of corruption, opaque business practices, and undermining development

Table 1.1. Main destination economies for Asia-Pacific intraregional greenfield FDI flows, their main sources and share of total flows, 2009-2011

(Percentage)

Main destinations	Share of total flows	Main sources	Shares of total flows
China	27.6	Japan	24.9
		Taiwan Province of China	23.7
		Hong Kong, China	14.3
		Total	63
Viet Nam	11.5	Japan	43.3
		Republic of Korea	14.2
		Taiwan Province of China	10.6
		Total	68.1
India	10.6	Japan	34.2
		Republic of Korea	30.9
		China	10.7
		Total	75.9
Indonesia	8.3	Japan	28.1
		China	21.6
		India	16.7
		Total	66.4
Australia	5.4	Malaysia	59.8
		Japan	18.6
		China	7.0
Total	63.4	Total	85.4

Source: fDi Intelligence.

efforts in the destination country. Such prospective investors also often demand tax concessions and lower environmental protection. Extractive FDI has also been found to be disruptive for traditional societies. Furthermore, a rapid expansion in the resources sector can lead to the so-called “Dutch disease”,¹⁵ hampering the competitiveness of economies and hence economic diversification. Therefore, policymakers need to be aware of the risks from FDI in extractive sectors and should design appropriate regulatory measures. It is equally important for resource-endowed countries to improve their business climates and policy environments in order to attract a wider range of FDI in labour-intensive and internationally competitive sectors so as not to become overly reliant on a single sector or industry (ESCAP, 2011a).

Aid commitments to least developed countries not met

The challenging global outlook has had particularly important effects for the least developed countries of the region. A significant concern is the reduction in official development assistance (ODA) commitments of the developed world as a direct consequence of the global recession of 2008-2009. Net ODA flows from member countries of the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD) stood at \$133.5 billion in 2011, a decline in real terms of 3% compared with previous years, widening the delivery gap in meeting the internationally agreed aid target of 0.7% of GNI to \$167 billion (UNDESA, 2013). A total of 16 out of 23 member countries of DAC reduced their aid contributions in 2011, primarily due to the effects on their economies of the global recession of 2008-2009 (United Nations, 2012a). There is a distinct possibility that the proportion of ODA as a percentage of GNI of developed countries will decline further in coming years.

Declining ODA as a percentage of GNI is weakening the likelihood of donor countries reaching other internationally agreed targets. In 2010, this was

seen by the inability of DAC countries to meet the G20 Gleneagles target of 0.35% of their GNI. Furthermore, the 0.35% target had been regarded as only an interim measure and more achievable target on the road to meeting the target agreed at the United Nations of 0.7% of GNI.

There is growing evidence that ODA has not only declined in relative scale, but that its focus has shifted from budget support towards project support for many low-income developing economies (UNDESA, 2013). This has raised concerns about the effectiveness of ODA as funding is increasingly fragmented, increases the transaction costs of governments, fails to align with the development objectives of countries, and reduces the country ownership of programmes. The need for aid to be used to meet national development goals has led to growing calls for the reversal of the trend of ODA being increasingly shifted to project support (UNDESA, 2013).

The possible decline in the contribution of ODA in coming years is of particular concern for countries in their efforts to achieve the Millennium Development Goals

The possible decline in the contribution of ODA in coming years is of particular concern for countries in their efforts to achieve the Millennium Development Goals. There is the risk that fewer countries will be able to meet the Goals as agreed by 2015. The United Nations Millennium Development Goal Gap Task Force has called for governments to meet this challenge by pledging to honour their commitments to increase ODA despite budgetary pressures. As emphasized in the Task Force Report (United Nations, 2012a), such a commitment is in the donor countries' own best economic and political interests in an increasingly integrated world. Greater development in low-income countries leads to growing markets for trade and investment for developed economies, and creates reduced pressure for migration as living and working conditions improve in sending countries.

Remittances offering a complementary source of resilience

Remittances to Asia and the Pacific continued to increase considerably in 2012. As of 2011, countries in South Asia, South-East Asia and the Pacific receive almost half the estimated remittances in the world (ADB, 2012a). In 2012, the countries of East Asia, South Asia and the Pacific received a record \$219 billion in remittances in 2012 (World Bank, 2012b). India and China are the largest remittance-receiving countries in the region in absolute terms, followed by the Philippines (see figure 1.17). The level of dependence on remittances, measured as a percentage of GDP, continues to be significant in the region. Out of the top ten recipients of migrant remittances in terms of volume, five are located in Asia and the Pacific, namely India, China, the Philippines, Pakistan and Bangladesh.

Although still sparse, data availability on remittances is improving. China began to publish quarterly data on remittances for the first time in 2010. The latest data show a surge in remittances to the country for the first three quarters of 2011. Similarly, Thailand

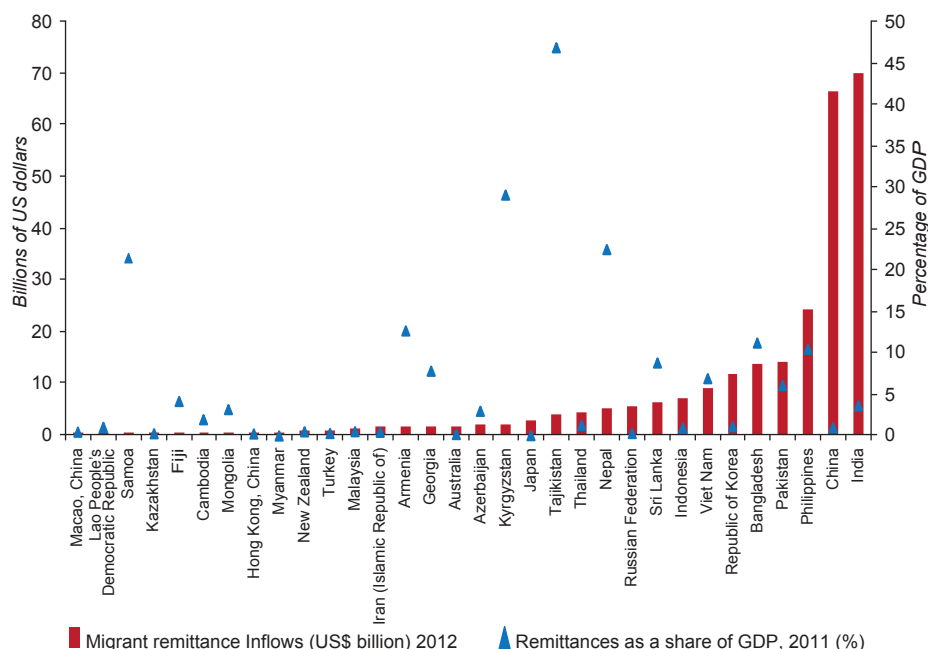
revised its historical data on remittance flows upwards, including that for 2011 by \$1.8 billion (World Bank, 2011).

Tajikistan tops the remittance dependency ranking in terms of percentage of migrant remittances as a share of GDP (47%) (see figure 1.17). Other countries in the region that are among the global top ten recipients of remittances as a share of GDP are Kyrgyzstan, Nepal and Samoa at 29%, 22% and 21%, respectively. Notably, all of the most remittance-dependent countries in the region are either landlocked developing countries or small island developing States.

Remittances are more resilient to the impact of economic crises compared to other types of private capital and provide protection from associated shocks

Not only are remittances more resilient to the impact of economic crises compared to other types of private capital, they also provide protection from associated shocks. Remittances are often counter-cyclical, rising

Figure 1.17. Remittance inflows in selected Asia-Pacific economies, values and shares of GDP



Source: World Bank. Migration and Remittance data. Available at <http://go.worldbank.org/A8EKPX2IA0> (accessed on 5 March 2013).

Note: LHS y-axis refers to migrant remittance inflows in billions of United States dollars in 2012, while RHS y-axis refers to remittances as percentage of GDP in 2011.

during economic downturns and natural disasters as migrants increase their transfers of funds in order to provide for their families' emergency needs. High levels of remittances may significantly complement, or exceed, the government's social spending as well as ODA. In the year ending in June 2012, Bangladeshis sent home \$13 billion, which constitutes more than all the government's social protection programmes put together (Bangladesh, 2012).

The share of remittances originating in the region itself is significant. In 2010, it accounted for about 34% of total remittances received by countries in the region. The World Bank estimates the figure to be between 26% and 43%, depending on the methodology used. This may explain, partly, why remittance flows were not affected by recessions in advanced countries and political developments in the Middle East. If this is the case, then a generalized slowdown in the region may adversely affect remittance flows.

Even while underestimating the real figures, official remittances are often higher than ODA in many developing economies in the region. For the top remittance-receiving countries, such as India, China and the Philippines, remittances surpassed ODA and FDI inflows. In the Greater Mekong subregion, remittances exceeded ODA and FDI inflows in terms of volume in Viet Nam (Jalilian, 2012).

While the growing comparative role of remittances as a source of funds is welcome, it is important to bear in mind that ODA continues to remain important for developing economies, especially least developed countries, due to the different impact on communities ODA has compared with to remittances. Remittances are valuable as they increase the capabilities of individuals and households, but they do not help in the manner that ODA does with regard to the provision of public goods, such as roads, water supply, education and health care. Therefore, the current curtailment in the magnitude of ODA as a result of the global recession of 2008-2009 in the developed world is of concern.

OUTLOOK FOR ASIA AND THE PACIFIC IN 2013

Moderate growth increase forecast in 2013

The near-term economic performance of the region is likely to pick up in 2013 but still be below its growth potential. Developing Asia-Pacific economies as a group is projected to expand by 6% in 2013, up slightly from 5.6% in 2012 (see table 1.2). Steady, although subpar, growth in the United States, and a rebound, though limited, in most major emerging economies, should help to increase global demand. Within the region, the effects of earlier policy easing and fiscal stimulus will also contribute to higher growth, but any improvement in prospects will be subdued. Leading indicators for industrial activity in major developing Asia-Pacific economies, such as consumer confidence in China, business sentiment in Europe and new orders in the United States, provide mixed signals. Moreover, the expected rebound in 2013 is still below the trend of 7.8% in 2010-2011 and 8.6% during the pre-crisis period of 2002-2007.

ESCAP analysis indicates that lower growth compared with recent years could become a "new normal" for many regional economies if present economic trends were to continue. The output loss could be significant for the region as a whole at almost \$1.3 trillion by end-2017. A "new normal" of lower growth may result in 27 out of 43 of economies sampled in the region. Policies to create or strengthen alternative sources of growth should be viewed as a priority in order to prevent the onset of the new normal of lower growth (see box 1.4).

Strong headwinds persist. Factors that have been keeping growth in the Asia-Pacific region at subpar levels were largely unchanged during recent quarters, highlighting lack of improvement in the overall environment. Sluggish world trade volume, partly underpinned by a slowdown in China and India, and subdued commodity prices will continue to hold back growth in export-oriented economies in 2013. Even in economies largely driven by domestic

Table 1.2. Selected economies of the ESCAP region: rates of economic growth and inflation, 2009-2013

(Percentage)

	Real GDP growth					Inflation ^a				
	2009	2010	2011	2012 ^b	2013 ^c	2009	2010	2011	2012 ^b	2013 ^c
East and North-East Asia^{d, e}	0.0	6.6	3.5	4.1	4.5	-0.7	1.2	2.3	1.3	2.0
East and North-East Asia (excluding Japan)^{d, e}	6.8	9.5	8.0	6.4	6.8	0.0	3.2	5.1	2.7	3.8
China	9.1	10.4	9.2	7.8	8.0	-0.7	3.3	5.4	2.7	4.0
Democratic People's Republic of Korea	-0.9	..	..	..	..	..	..	..	..	..
Hong Kong, China	-2.8	7.0	5.0	1.4	3.5	0.5	2.4	5.3	4.1	4.5
Japan	-6.3	3.9	-0.6	2.0	2.5	-1.4	-0.7	-0.3	0.0	0.4
Macao, China	1.3	26.4	20.0	9.0	13.5	1.2	2.8	5.8	6.1	5.7
Mongolia	-1.3	6.4	17.3	12.3	15.5	6.3	10.1	9.2	14.3	12.4
Republic of Korea	0.2	6.1	3.6	2.0	2.3	2.8	2.9	4.0	2.2	2.5
North and Central Asia^d	-5.3	4.6	4.8	3.9	4.0	10.8	7.1	8.7	5.4	6.4
Armenia	-14.2	2.6	4.7	7.2	5.5	3.4	8.2	7.8	2.6	3.5
Azerbaijan	9.3	5.0	0.1	2.2	1.5	1.5	5.7	8.1	1.8	2.1
Georgia	-3.8	6.4	7.0	7.0	6.0	1.7	7.1	8.5	-0.9	4.0
Kazakhstan	1.2	7.0	7.5	5.0	6.0	7.3	7.1	8.3	5.1	6.5
Kyrgyzstan	2.9	-1.4	5.7	-0.9	7.0	6.8	8.0	16.9	2.8	6.4
Russian Federation	-7.8	4.0	4.3	3.4	3.6	11.7	6.9	8.4	5.1	6.4
Tajikistan	3.4	6.5	7.4	7.5	6.5	6.5	6.5	12.5	5.8	9.1
Turkmenistan	6.1	9.2	14.7	11.1	8.0	10.0	12.0	12.0	8.5	10.0
Uzbekistan	8.1	8.5	8.3	8.1	7.0	14.1	9.4	12.8	13.2	10.0
Pacific^{d, e}	1.2	2.5	2.5	3.5	2.5	1.9	2.8	3.4	1.8	2.5
Pacific island developing economies^d	2.7	4.8	7.9	6.4	3.4	7.0	4.8	7.5	3.9	5.9
Cook Islands	-3.6	0.2	3.4	3.3	3.0	10.2	1.8	0.6	2.8	3.0
Fiji	-1.3	-0.2	1.9	2.5	2.7	6.8	5.4	7.7	3.5	3.0
Kiribati	-0.6	1.8	3.0	3.0	3.5	8.8	-2.8	7.7	-1.8	3.0
Marshall Islands	-1.3	5.2	5.0	1.9	2.3	0.5	1.6	9.5	5.7	4.5
Micronesia (Federated States of)	0.7	3.1	1.4	1.4	1.0	8.2	4.3	7.9	5.6	4.5
Nauru	0.0	0.0	4.0	4.9	8.0	21.2	-0.6	-3.5	-0.5	0.5
Palau	-4.6	0.3	5.8	4.0	3.0	4.6	1.2	2.1	6.0	5.5
Papua New Guinea	5.5	7.1	11.1	9.2	4.0	7.0	6.0	8.5	4.1	8.0
Samoa	-5.4	0.2	2.1	1.2	0.9	14.6	-0.2	2.9	2.1	1.4
Solomon Islands	-1.0	7.1	10.6	5.5	4.0	7.1	1.0	7.4	5.9	4.5
Tonga	3.2	3.3	2.9	0.8	0.5	1.4	3.6	6.2	1.2	2.7
Tuvalu	-1.7	-0.5	1.0	1.2	1.3	-0.1	-1.9	0.5	1.4	2.0
Vanuatu	3.5	2.2	4.3	2.0	3.2	4.3	2.8	0.8	1.4	2.5
Developed countries (Australia and New Zealand)^d	1.2	2.4	2.4	3.5	2.5	1.8	2.7	3.4	1.7	2.4
Australia	1.3	2.6	2.5	3.6	2.5	1.8	2.8	3.3	1.8	2.5
New Zealand	0.1	0.9	1.5	2.5	2.3	2.1	2.3	4.0	1.1	1.5
South and South-West Asia^{d, f}	4.0	7.7	6.4	4.1	5.1	11.0	10.0	9.4	11.1	8.5
Afghanistan	22.5	8.4	5.7	6.9	6.5	-8.3	7.7	11.8	9.0	6.0
Bangladesh	5.7	6.1	6.7	6.3	6.0	6.7	7.3	8.8	10.6	7.5
Bhutan	6.7	11.8	11.7	8.5	8.4	3.0	6.1	8.3	13.5	7.8
India	8.0	8.4	6.2	5.0	6.4	12.4	10.4	8.4	10.0	7.0
Iran (Islamic Republic of)	1.5	3.2	4.0	-0.9	0.8	10.8	12.4	21.5	25.2	21.8
Maldives	-3.6	7.1	7.0	3.4	4.3	4.0	4.7	11.3	10.9	8.3
Nepal	3.8	4.0	3.8	4.5	4.0	12.6	9.6	9.6	8.3	7.5
Pakistan	1.7	3.8	3.0	3.7	3.5	20.8	11.7	13.7	11.0	8.5
Sri Lanka	3.5	8.0	8.0	6.2	6.5	3.5	5.9	6.7	7.6	7.3
Turkey	-4.7	9.0	8.6	3.2	3.8	6.3	8.6	6.5	8.9	7.6
South-East Asia^d	1.0	8.3	4.5	5.3	5.4	2.3	3.9	5.5	3.8	4.1
Brunei Darussalam	-1.8	2.6	2.2	1.6	1.5	1.0	0.4	2.0	0.5	1.4
Cambodia	-2.0	6.0	7.1	7.3	7.0	-0.7	4.0	5.5	3.0	3.8
Indonesia	4.5	6.1	6.5	6.2	6.6	4.8	5.1	5.4	4.3	5.0
Lao People's Democratic Republic	7.6	7.9	8.3	8.3	8.1	0.0	6.0	7.6	4.3	6.8
Malaysia	-1.7	7.2	5.1	5.6	5.0	0.6	1.7	3.2	1.7	2.5
Myanmar	4.9	5.3	5.5	6.3	6.3	8.2	7.7	4.2	1.5	6.5
Philippines	1.1	7.6	3.7	6.6	6.2	3.2	3.8	4.8	3.1	4.1
Singapore	-0.8	14.8	5.2	1.3	3.0	0.6	2.8	5.2	4.6	3.5
Thailand	-2.2	7.8	0.1	6.4	5.3	-0.8	3.3	3.8	3.0	3.1
Timor-Leste	12.8	9.5	10.6	10.0	10.0	0.7	6.9	13.5	12.0	8.0
Viet Nam	5.3	6.8	5.9	5.0	5.5	7.1	8.9	18.7	9.3	8.0
Memorandum items:										
Developing ESCAP economies	4.6	8.6	7.0	5.6	6.0	3.6	5.1	6.4	5.0	5.1
Least developed countries	5.0	6.0	6.6	6.3	6.0	6.4	7.1	8.4	9.3	7.1
Landlocked developing countries	4.4	6.7	6.7	5.8	5.7	8.0	7.9	9.8	6.9	6.9
Small island developing States	2.4	5.3	7.9	6.2	3.8	6.3	4.9	8.2	5.0	6.3
Developed ESCAP economies	-5.5	3.7	-0.3	2.2	2.5	-1.0	-0.3	0.1	0.2	0.6
Total ESCAP	0.4	6.6	4.0	4.2	4.6	1.7	2.9	3.8	3.0	3.2

Sources: ESCAP, based on national sources; United Nations, Department of Economic and Social Affairs (2013). *World Economic Situation and Prospects 2013*, Sales No. E.13.II.C.2. Available from www.un.org/en/development/desa/policy/wesp/wesp_current/wesp2013.pdf; IMF, International Financial Statistics databases. Available from <http://elibrary-data.imf.org/>; ADB, *Key Indicators for Asia and the Pacific 2012* (Manila, 2012); CEIC Data Company Limited. Available from www.ceicdata.com; and web site of the Interstate Statistical Committee of the Commonwealth of Independent States, www.cisstat.com, March 2013.

^a Changes in the consumer price index.

^b Estimates.

^c Forecasts (as of 30 March 2013)

^d Calculations are based on GDP figures at market prices in United States dollars in 2011 (at 2000 prices) used as weights to calculate the regional and subregional growth rates.

^e Estimates for 2012 and forecasts for 2013 are available for selected economies.

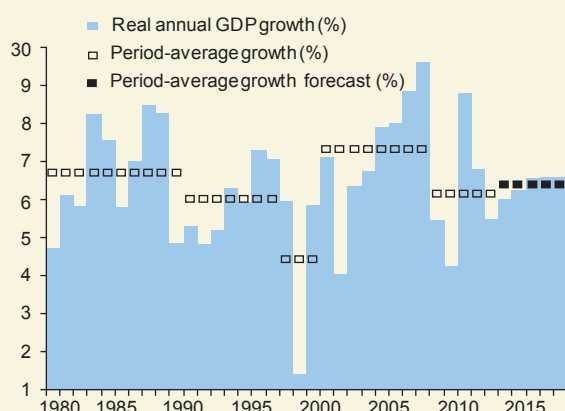
^f The estimates and forecasts for countries relate to fiscal years defined as follows: 2011 refers to fiscal year spanning 1 April 2011 to 31 March 2012 in India; 21 March 2011 to 20 March 2012 in Afghanistan and the Islamic Republic of Iran; 1 July 2010 to 30 June 2011 in Bangladesh, Bhutan and Pakistan; and 16 July 2010 to 15 July 2011 in Nepal.

Box 1.4. “New normal” of lower growth being witnessed in Asia-Pacific

Since the global financial turmoil began in 2008, the concept of a “new normal” of lower growth in developed economies has been put forward. The argument is that the reshaping of economies in the developed world will be a medium-term process. Governments are engaging in fiscal consolidation that reduces economic growth, while households and the business and financial sector are also spending less as they rebuild their balance sheets. As growth outcomes in the developed economies and the Asia-Pacific region remain closely linked, a “new normal” growth in the developed economies would also raise the possibility of an extended period of slower growth in the region. Five years since the start of the crisis, this box examines and finds that it is indeed the case that a “new normal” of lower growth is being witnessed in parts of Asia and the Pacific.

Overall, the Asia-Pacific region appears to be experiencing a “new normal” of moderately lower growth. Under assumptions of the continuation of present economic trends,^a projected and pre-crisis growth rates would differ by about one percentage point per year. In particular, growth in developing Asia-Pacific economies is estimated to decelerate from 7.3% per year during the pre-crisis period of 2000-2007 to 6.4% during the period 2013-17 (see figure A).^b

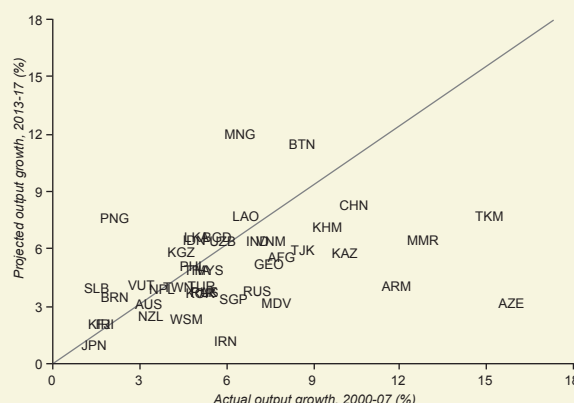
Figure A. Expected growth deceleration in developing Asia-Pacific is modest...



Sources: ESCAP, based on United Nations *World Economic Situation and Prospects*, IMF *World Economic Outlook*, and World Bank *Global Economic Prospects* and World Development Indicators.

Note: The period-average growth is for 1980-1989, 1990-1996, 1997-1998, 1999-2005, 2006-2007, 2008-2012 and 2013-2017.

Figure B. ...although a closer look suggests this could be much sharper in many economies



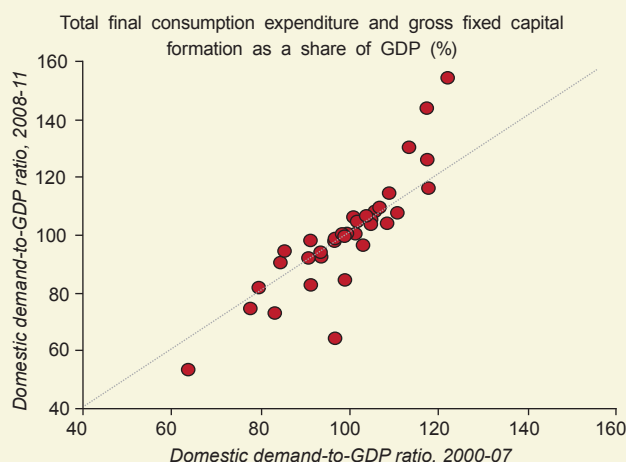
Sources: ESCAP, based on United Nations *World Economic Situation and Prospects*, IMF *World Economic Outlook*, and World Bank *Global Economic Prospects*.

Note: Refer to explanatory notes for country abbreviations.

Although medium-term growth prospects remain relatively robust in historical terms, this masks two important concerns.

- The crisis-related loss in output is sizeable. As compared to the pre-crisis pace of 7.3% per year, the output level by end-2017 would be more than 10% lower based on the scenario of actual growth during the period 2008-2012 and projected growth of 6.4% during the period 2013-2017. In value terms, the estimated loss amounts to almost \$1.3 trillion by end-2017.
- At a country level, several regional economies would suffer from substantially lower future growth than the region as a whole. Figure B plots the medium-term growth outlook against the pre-crisis trend. Most (27 out of 43) Asia-Pacific economies fall below the 45-degree line, which indicates a new normal of lower growth. In Armenia, Azerbaijan, the Islamic Republic of Iran and Samoa, future growth is projected at less than half of the pre-crisis pace, while Pakistan, the Republic of Korea, the Russian Federation and Singapore are also substantially affected.

Box 1.4. (continued)

Figure C. The role of domestic demand in Asia-Pacific has largely unchanged since the crisis

Source: ESCAP, based on World Bank World Development Indicators.

open economies. The progress at present appears gradual (see figure C). The share of total consumption and fixed investment in GDP in Asia and the Pacific has been mostly unchanged since the crisis began, or even lower in open economies, such as Azerbaijan, Brunei Darussalam, Turkmenistan and Taiwan Province of China. Implementation of policies to support domestic demand can be accelerated, including through enhancing the agricultural and services sectors, strengthening small businesses, providing stronger social safety nets to reduce precautionary savings, and upgrading public infrastructure.

- ^a The broad macroeconomic assumptions over the next years are that growth in developed economies gradually picks up but remains anaemic; the Chinese economy shifts towards a more sustainable growth as rebalancing moves forward; global commodity prices remain high and volatile relative to the past trends; and limited progress on reorienting sources of growth towards domestic demand in developing Asia-Pacific economies.
- ^b The emergence and magnitude of a "new normal" of lower growth is clearly sensitive to which "pre-crisis" period is used. Some analysts argue that the booming years of 2006-2007 were largely fuelled by imbalanced growth in developed economies, thus generally viewed as exceptional and unsustainable.

demand, which proved to be rather resilient in 2012, employment and earnings growth in 2013 are likely to remain constrained. Macroeconomic management in these outperforming economies and in economies with relatively free capital movements will also be complicated by the recent liquidity injections in developed economies. These liquidity injections have already intensified capital flows and domestic currency volatility in some economies of the region. In general, the potential effects of volatile short-term capital flows warrant close surveillance.

China and India are expected to rebound somewhat after a sharp slowdown in 2012. China is forecast to grow by 8% in 2013, slightly higher than 7.8%

As expected, economies associated with a new normal of lower growth exhibit greater trade exposure. In the 27 economies that likely face a "new normal" lower growth, goods and services trade accounted for nearly 1.1 times of GDP in the past decade, compared to below 90% of GDP in the other 16 economies. The former group of economies appears to rely more on high-income markets for their export earnings and less on commodity items (food, fuel and ores and metals). But whether stylized facts can be firmly established will require further investigation. After all, economic structure and policy directions of these economies vary noticeably. These problems ahead are not inevitable, with the region having the tools in its own hands to avoid the phenomenon of a "new normal" of lower growth. In addition to diversifying export markets, a widely discussed strategy to avoid the new normal is to boost domestic demand as a new or second source of growth. This is especially critical for more

in 2012, but 0.8 of percentage point lower than the 2012 forecast provided in the *Economic and Social Survey of Asia and the Pacific 2012* (ESCAP, 2012b) released in May. Growth in India in 2012 was notably lower than previously forecast, but the economy is projected to recover moderately to 6.4% in 2013. Improved, although still tepid, global trade should help to support growth in export-led economies in East and North-East Asia and South-East Asia. For example, growth in Hong Kong, China, the Republic of Korea and Singapore is projected at around 2.3-3.5% in 2013, up from 1.4-2% in 2012. Meanwhile, growth in North and Central Asia is likely to remain stable, benefiting from elevated global energy prices and sustained growth in the

Russian Federation. Renewed growth in India and healthy domestic demand should help to push up growth in South and South-West Asia. In contrast, developing Pacific island economies are likely to continue to face sluggish growth. As a group, Pacific island economies growth is projected to decelerate in 2013 due to a sharp, energy sector-led slowdown in Papua New Guinea which is by far the largest Pacific island economy. However, demand from Australia and New Zealand should remain reasonably strong.

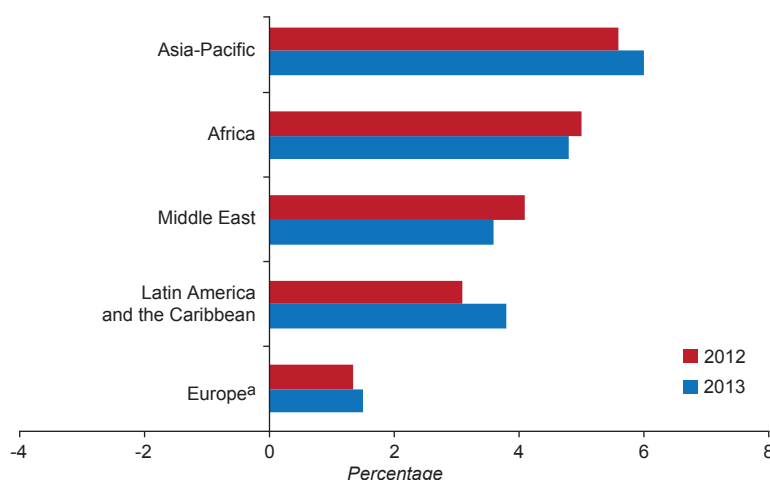
Despite the moderation in growth in the region as compared to previous robust rates, Asia and the Pacific still remains the most dynamic region globally and exerts increasing influence on other developing regions. The region is forecast to grow in 2013 at a rate far more rapid than not only the developed regions of the world, but also compared to other developing regions (see figure 1.18). The growing economic weight of the Asia-Pacific region has led to increasing interaction with other developing regions, most notably Africa and Latin America. However, in this regard, there remains significant unfulfilled potential. ESCAP analysis indicates that global South-South exports could increase by an additional \$194 billion during 2013-2014, if trade costs of low-performing developing countries could

converge by one-fifth towards the levels of high-performing developing countries through greater South-South cooperation in trade facilitation and logistics services and infrastructure development (see box 1.5).

Modest inflation forecast for 2013

The inflation forecast is generally modest in 2013, with prices projected to increase by 5.1% in the region (see table 1.2). Although inflation is not poised to rise sharply, it is important to note that prices are high, causing severe hardship to the poorest and most vulnerable sectors of society in many economies. Furthermore, while overall inflation may not rise for many economies, the key food and fuel sectors may face price pressure due to global supply concerns. The overall moderate outlook for inflation is due to growth remaining relatively weak, resulting in reduced domestic demand-pull factors and inflationary expectations. The inflation outlook is conducive for loosening monetary policy, but such an approach needs to be accompanied by active macroprudential policies and capital controls to prevent external-led pressures on asset prices. Moreover, monetary or credit expansion should be carefully designed to support SMEs, agricultural production and environmentally friendly industries.

Figure 1.18. Real GDP growth by regions of the world, 2012-2013



Sources: ESCAP, based on data from the United Nations regional commissions.

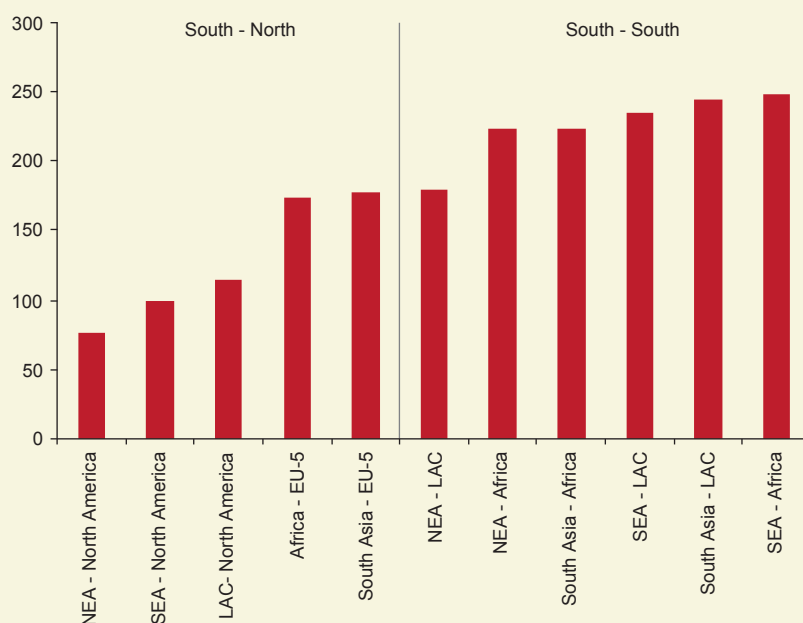
^a Member countries of the European Economic Commission.

Box 1.5. Lowering trade costs to spur South-South integration

As highlighted in the *Survey 2012*, South-South trade and investment has become increasingly important in the global economy. South-South exports grew by 19% annually in 2010-2010, compared to 12% for world exports. However, the latest ESCAP-World Bank Trade Cost data reveal that developing countries continue to suffer from significantly high trade costs (see figure A). For instance, it costs 2.5 times more for an economy of South-East Asia to trade with Africa than with North America.

By inferring trade costs from the observed pattern of production and trade across countries, the new ESCAP-World Bank Trade Cost data capture not only international transport costs and tariffs but also other potential cost components, such as differences in languages, currencies and import or export procedures. It is also comprehensive, covering 178 countries, including a wide range of developing countries, over the period 1995-2010.

Figure A. Average trade costs, 2007-2010, in percent ad valorem equivalent (international relative to domestic trade costs)



Source: ESCAP, based on ESCAP-World Bank Trade Cost database.

Note: NEA=Northeast Asia, SEA=Southeast Asia; LAC=Latin America and Caribbean.

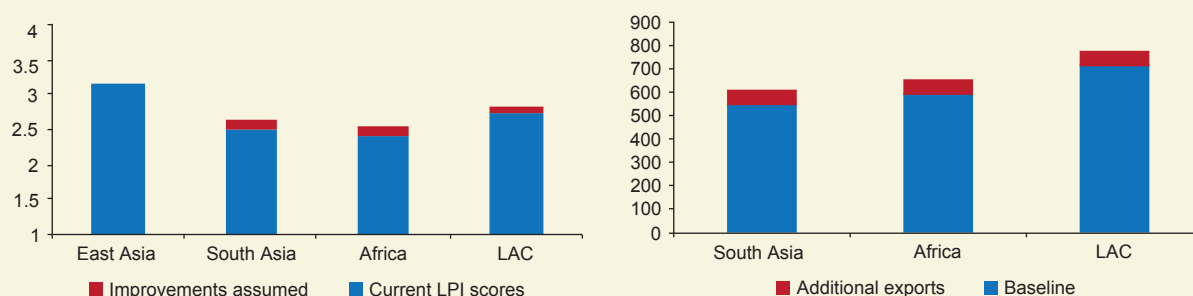
The trade cost data also reveal considerable disparity among developing countries, with areas such as East Asia exhibiting much lower levels of trade costs than, for example, Africa. A clear policy implication is that South-South cooperation could be improved to lower trade costs. In particular, cooperation in improving trade-related procedures, infrastructure and services could be enhanced in line with the recent trade literature which finds non-tariff trade costs to be significant determinants of trade flows.^a

In fact, South-South development cooperation, whose net disbursement was estimated at \$12.1 billion in 2006, has expanded rapidly, including in trade related areas.^b For instance, the development cooperation by China of \$1.9 billion in 2009 was nearly four times the 2000 level, with 45.7% of it going to Africa and 12.7% of it to Latin America and Caribbean. Of the 2,025 completed projects under grants or interest-free loans, 390 were in transport, power supply and telecommunications.^c Technical cooperation, export credits and special loans for SMEs are other important contributions related to trade.

Box 1.5. (continued)

Given the above, ESCAP analysis shows that if South Asia, Africa and Latin America and Caribbean, whose trade costs remain significantly high, could improve their trade logistics performance closer to the levels of their East Asian peers, their total exports could increase by an additional \$258 billion over 2013-2014, of which \$194 billion dollars would be in South-South exports (see figure B). The findings clearly indicate the potential of South-South cooperation to enhance the trade capacity of low-performing developing countries.

Figure B. Additional South-South exports in 2013-2014, in billions of dollars (right) associated with improvements in trade logistics, in Logistics Performance Index (LPI) scores (left)



Source: ESCAP.

This analysis is unique in that it applies recent estimations of export-cost elasticity in the context of narrowing the gap in trade costs among the world's major developing regions. In line with recent trade literature, the ESCAP analysis uses the Logistics Performance Index (1=low to 5=high) as a proxy for trade costs and assumes an export-cost elasticity of 0.5. Taking East Asia as a benchmark, the analysis assumes that South Asia, Africa and Latin America and Caribbean would each narrow the differences in LPI scores by one-fifth. Baseline export volumes are calculated using 2011 export volumes from the World Trade Organization (WTO) and 2012-2014 export growth projections from the United Nations Department of Economic and Social Affairs. The share of South-South exports in total exports of South Asia, Africa and Latin America and Caribbean are taken from the United Nations Conference on Trade and Development.

^a Hoekman and Nicita (2008) find a one point reduction in the Logistics Performance Index score (1=low to 5=high) to be associated with some 50% increases in both export and import volumes. Similarly, Arvis, Duval, Shepherd and Uktotham (2012) find a 10% improvement in the Liner Shipping Connectivity Index score (max. value in 2004=100) to be associated with a 3.8% decrease in trade costs.

^b ECOSOC (2008) estimated net disbursements of Southern development cooperation in 2006 at \$12.1 billion, with China, India and Brazil contributing between 0.04% and 0.11% of their GNI to ODA. Similarly, Zimmerman and Smith (2011) estimate that gross development flows from selected countries beyond the OECD/DAC stood at nearly \$11 billion in 2009, representing approximately 8% of global gross ODA.

^c China, Information Office of the State Council (2011).

Downside risks

Overall risks for the growth forecasts in 2013 remain tilted to the downside. A key downside risk is a sharper-than-expected economic slump in Europe. Although the region's direct financial exposure to banks in the euro zone is not sizeable, systemic risks could rise further under this scenario. Fiscal policy uncertainty in the United States, commodity price hikes due to heightened global financial liquidity and

continued geo-political risk in oil-producing areas, and possible food price hikes due to droughts in major food-producing countries pose additional risks. Within the region, the pace of growth deceleration in China and its implications for the direction of domestic policy, such as through rebalancing the economy's sources of growth and property market corrections, as well as a return of economic dynamism in India, are important. On the upside, there is room for macroeconomic policy responses to counteract the

strong and persistent headwinds in most economies. Better policy coordination in developed economies and well-directed policy stimulus in China and other export-oriented economies would reduce economic uncertainty, and potentially push growth in the Asia-Pacific region above the baseline. Enhanced regional cooperation in finance, trade, infrastructure investment, food and energy security and labour migration matters can also play a crucial role in ensuring sustained and inclusive development.

STRUCTURAL IMPEDIMENTS TO CONTINUED PROGRESS

The generalized slowdown across the region in 2012 raises the concern that, beyond the problems emanating from the developed world, there are shortcomings even within domestic economies in terms of the developmental strategies being pursued. Among others, these include unsustainable resource use rates, growing inequality, declines in public infrastructure investment, especially in agriculture, and low government revenues. These structural impediments exacerbate risk and vulnerability related to food, energy and commodity price increases, as well as to economic instability and slowdown. The need to focus on removing structural barriers to allow domestic demand to contribute more effectively to development is heightened further by the expectation that the export channel to the developed world will be less important for an extended period.

Growing inequality is threatening shared prosperity and constraining domestic markets

Sustained output growth has halved the mean poverty headcount (the proportion of people living on less than \$1.25 per day) in Asia and the Pacific from 52% to 19% between 1990 and 2010 (ESCAP, ADB and UNDP, 2013). However, declines in poverty in the region have been accompanied by greater levels of inequality (see figure 1.19), with the population-weighted mean Gini coefficient for the entire region increasing from 33.5% in the 1990s to 37.5% in the latest available year. Only 16 out

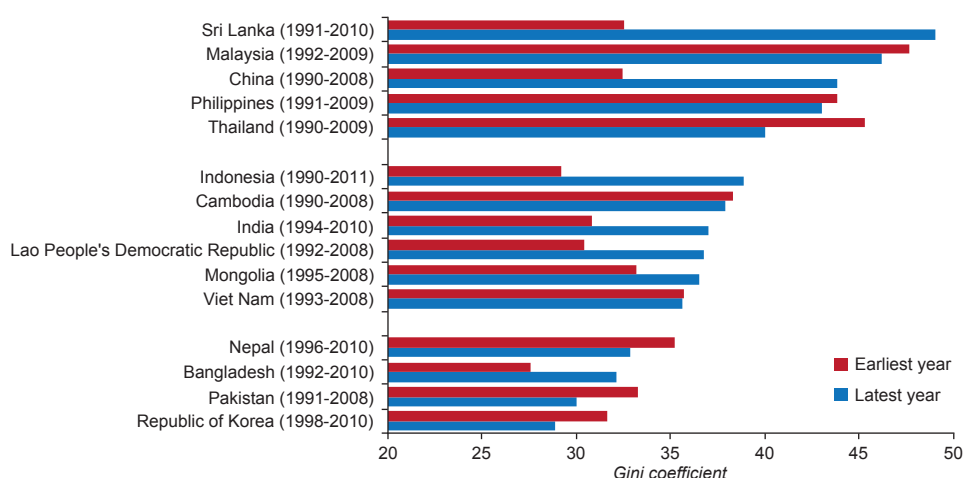
of 30 countries that enjoyed positive mean annual growth over the long run exhibited lower income inequality. Notably, inequality has increased in the East and North East Asia, North and Central Asia, and Southeast Asia subregions, with the increase varying across the subregions.

The above findings by ESCAP are in line with other recent studies, such as that of the Asian Development Bank (ADB) (ADB, 2012a), which finds that inequality widened in many countries of the region in the past two decades. According to the ADB study, inequality widened in 11 of the 28 economies with comparable data, including the three most populous countries, and in the drivers of the region's rapid growth—China, India, and Indonesia. From the early 1990s to the late 2000s, the Gini coefficient worsened from 32% to 44% in China, from 31% to 37% in India, and from 29% to 39% in Indonesia.

Inequality is important because of its negative impact on development outcomes, as seen by discounting levels of development achievement by a factor proportional to the extent of inequality (Sen, 1976) and (UNDP, 2011). For example, per capita GDP declines from \$2,208 to \$1,391 (in 2005 PPP) in India when adjusted for inequality (see figure 1.20-A). In the case of Malaysia, the decline is from \$12,526 to \$6,738. Inequality also reduces the poverty reduction impact of economic growth. Poverty declines at a faster rate for a given growth rate of GDP if inequality declines at the same time than when inequality does not change or rises.

Results from the updated ESCAP Social Development Index first presented in the *Survey 2012* (ESCAP, 2012b) clearly highlight the importance of reducing income and social inequalities for increasing equitable, inclusive and sustainable development in the region. The ESCAP Social Development Index combines the education and life expectancy components of the Human Development Index. Using data for 25 Asia-Pacific countries in 2011, each dimension's average value can be discounted according to the country's level of inequality in

Figure 1.19. Income inequality in selected developing Asia-Pacific economies, 1990s and latest available data



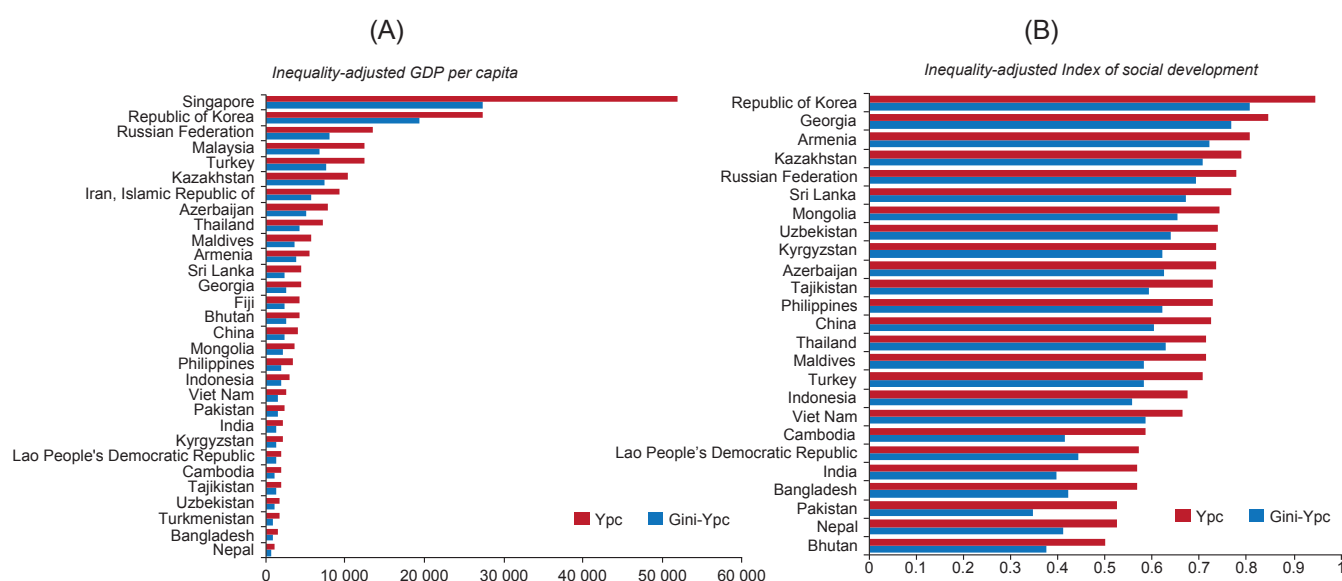
Sources: ESCAP, based on World Bank, PovcalNet data, supplemented by household survey data from India and publications of official statistical offices (Republic of Korea and Taiwan Province of China).

education and life expectancy (see figure 1.20-B). This indicates that the discount is particularly high in emerging economies, such as China, India, Indonesia and Turkey, where this inequality-adjusted social development index shows an average potential loss of more than 20%.

Inequality of opportunity was also found to be common across the region, particularly in physical

assets, such as capital and land, human capital, such as education and health, market access, such as labour and finance, and other public services, such as electricity, water and sanitation. In South-East Asia, for instance, there is a worrisome lack of access to education for income-poor families, with the incidence of education deprivation being 34 times worse in the Lao People's Democratic Republic for the poorest quintile than the richest

Figure 1.20. Inequality-adjusted GDP per capita and Index of Social Development, latest available data



Sources: ESCAP, based on data from UNDP (2011) *Human Development Report 2011*, World Bank (2012), PovcalNet data, United Nations Statistical Division.

quintile and seven times worse in Thailand (UNICEF, 2011b). In South Asia undernutrition among children decreased only slightly, from 64% in 1995 to 60% in 2009 for the poorest 20% of the population as opposed to a large decrease from 37% to 26% among the richest 20% during the same period (ADB, 2012b). Significant disparities in access to social services within countries are also stratified by area of residence and by gender.

Lack of progressivity in tax structure and insufficient public provisioning contributing to inequality

Inequality in the region has been exacerbated by the failure of fiscal policy to play its distributional role through making the tax structure more progressive and providing for increased expenditure in the public provisioning of essential services, including social protection. Many economies in the region have failed to raise sufficient tax revenue despite rapid growth, as demonstrated by their low and stagnant tax-to-GDP ratios (see figure 1.21). The stagnant tax-to-GDP ratios when the economy was growing indicate lack of sufficient progressivity of the tax structure.

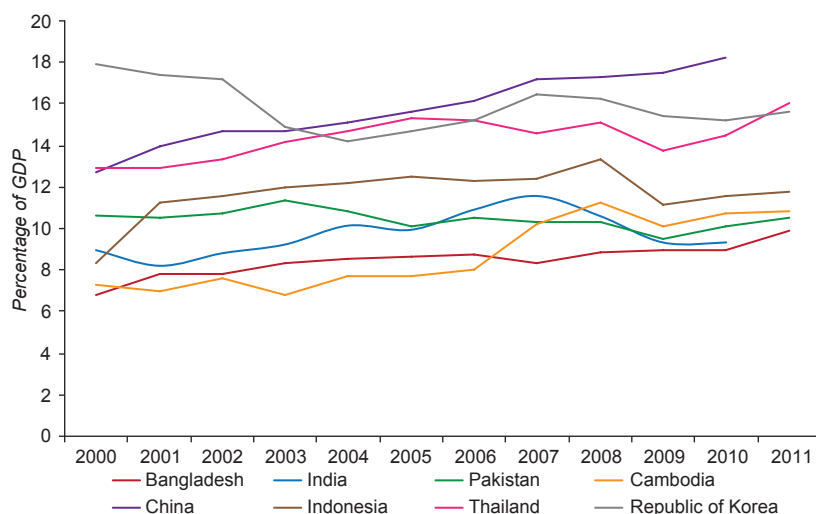
In fact, the Asia-Pacific economies as a group have the lowest tax burden of any developing region in the world (Park, 2012). The dependence

of the region's economies on direct income taxes as opposed to indirect value-added taxes is lower than many countries and far below that of the OECD economies as a whole (Park, 2012). Declines in formal employment and the consequent rise in vulnerable employment are also contributing to the growing inequality through the falling share of wages in GDP. There is a clear negative relationship between the tax burden of countries in the region and their levels of inequality (see figure 1.22).

The negative relationship is more pronounced between public social expenditure and levels of inequality (see figure 1.23). In spite of significant progress in recent years in a number of countries, including through extending provision of basic health-care access and income support to poor workers and households, Asia-Pacific countries still exhibit significant shortcomings in their social protection regimes. Public social security expenditure remains low at less than 2% of GDP in one-half of the countries where data are available (see figure 1.24). In addition, only 30% of persons above the retirement age in Asia and the Pacific receive a pension on average, while only 10% of the unemployed receive any benefits (ILO, 2010c) and (Bonnet, Saget and Weber, 2012).

Vulnerable employment is a persisting issue within the Asia-Pacific region. Despite high rates of economic

Figure 1.21. Tax-to-GDP ratio in selected developing Asia-Pacific economies



Source: ESCAP, based on data from CEIC Data Company Limited. Available from <http://ceicdata.com> (accessed on 8 February 2013).

Scatter plot showing the relationship between General government taxes over GDP (per cent) on the x-axis and Gini coefficient on the y-axis. The x-axis ranges from 0 to 50, and the y-axis ranges from 0 to 70. A negative linear regression line is shown with the equation $y = -0.3017x + 44.964$ and $R^2 = 0.0592$. Data points are labeled with country codes.

Notes: Asia-Pacific economies are highlighted in bold. Country codes - countries and areas of the ESCAP region are available in the explanatory note. - non-ESCAP members; names and codes are as follows: ALB - Albania; ARG - Argentina; AUT - Austria; BEL - Belgium; BGR - Bulgaria; BIH - Bosnia and Herzegovina; BLR - Belarus; BOL - Bolivia; BRA - Brazil; CAN - Canada; CHE - Switzerland; CHL - Chile; COG - Congo, Rep.; COL - Colombia; CRI - Costa Rica; CZE - Czech Republic; DEU - Germany; DNK - Denmark; EGY - Egypt, Arab Rep.; ESP - Spain; EST - Estonia; FIN - Finland; FRA - France; GBR - United Kingdom of Great Britain; GRG - Greece; HND - Honduras; HRV - Croatia; HUN - Hungary; IRL - Ireland; ISR - Israel; ITA - Italy; JAM - Jamaica; JOR - Jordan; LSO - Lesotho; LTU - Lithuania; LUX - Luxembourg; LVA - Latvia; MAR - Morocco; MDA - Moldova; MEX - Mexico; MKD - Macedonia, FYR; NLD - Netherlands; NOR - Norway; PER - Peru; POL - Poland; PRT - Portugal; PRY - Paraguay; ROU - Romania; SLV - El Salvador; SRB - Serbia; SVK - Slovak Republic; SVN - Slovenia; SWE - Sweden; SWZ - Swaziland; SYC - Seychelles; UKR - Ukraine; USA - United States of America; YEM - Yemen Rep.; ZAF - South Africa.

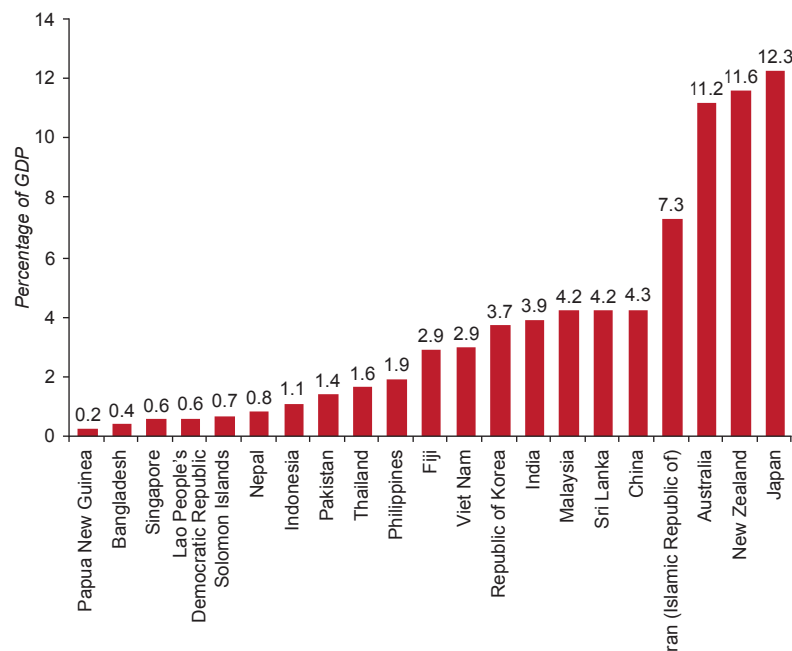
Scatter plot showing the relationship between General government social expenditures over total government outlays (per cent) on the x-axis and Gini coefficient on the y-axis. The plot includes a negative linear regression line with the equation $y = -0.3992x + 56.714$ and $R^2 = 0.3308$. Data points are labeled with country codes.

Country Code	General government social expenditures over total government outlays (per cent)	Gini coefficient
SYC	35	65
ZAF	45	65
BOL	43	56
LSO	35	52
JAM	23	47
CHN	20	42
YEM	23	37
BTN	28	38
GEO	35	40
MDV	33	34
AZE	34	33
IRN	39	38
SLV	48	46
RUS	46	41
TUR	47	40
ISR	49	39
ALB	46	34
KAZ	49	30
BLR	50	29
GRC	51	35
LVA	52	34
ROU	51	33
EGY	53	32
HUN	55	33
BGR	56	31
SRB	57	28
SVK	57	26
CZE	58	25
EST	59	38
ITA	60	37
ESP	59	35
IRL	60	34
POL	61	33
CAN	62	32
LUX	63	31
SVN	64	30
UKR	65	29
LTU	63	37
ISR	64	36
MDA	65	35
DEU	68	28
FIN	66	27
NOR	67	26
DNK	68	25
SVN	66	30
UKR	67	29
LTU	64	37
ISR	64	36
MDA	65	35
DEU	68	28
FIN	66	27
NOR	67	26
DNK	68	25

Note: See notes for Figure 1.22.

inequality and vulnerability have been exacerbated by the failure of governments to raise tax revenue through a progressive tax structure. This has constrained their ability to spend on basic social services, including social protection. Progressive taxation and social protection measures not only reduce inequality, but also lessen vulnerability by acting as automatic stabilizers. The low tax revenue

Figure 1.24. Public social security benefit expenditure (excluding health care) in selected Asia-Pacific economies, latest available data



Source: International Labour Organization, *World Social Security Report 2010/11: Providing Coverage in Times of Crisis and Beyond* (Geneva, 2010).

restricts governments' fiscal space and hence their ability to boost domestic demand when needed. Therefore, reform of the tax structure, including raising efficiency in tax administration and widening of the tax base are of utmost urgency for most Asia-Pacific countries, especially when they have to find domestic drivers of growth in the face of diminished prospects for exports.

Low tax revenues constrain ability for countercyclical response and public investment

The Asia-Pacific region suffers from large infrastructure deficits, although there are significant variations among countries (see tables 1.3 and 1.4). China has near universal access to the electricity network compared with access for only 40% of the population in India. Least developed countries of the region, such as Afghanistan, Cambodia and Myanmar have the largest infrastructure deficits. Even relatively developed Asia Pacific countries suffer from infrastructure shortage as compared to advanced countries. For example, per capita electricity consumption in OECD countries is around

10,000kWh, whereas in Indonesia, it is 600kWh, and outside the island of Java, less than 400kWh. Only 12% of the country's population has access to piped water.

Infrastructure deficit is clearly an impediment to growth, especially in South Asia and the Pacific islands. Investment Climate Assessment surveys of firms in South Asia shows that lack of infrastructure is a "major" or "severe" obstacle to business expansion, ranging from approximately 33% in India to about 80% in Bangladesh. Power is the most critical bottleneck, with transportation a close second. Traffic congestion has become a common feature in most Asian cities; its costs can be as high as percentage points of GDP. For example, Indonesia is losing about 1.2% of its GDP yearly due to severe traffic jams (Indonesia, 2010), while traffic congestion in Bangkok is responsible for a loss of 2.1% of GDP of Thailand (Willoughby, 2000). In 2008, the annual road congestion costs in the Republic of Korea reached 26.9 trillion Korean won (approximately \$23.8 billion), more than 2.6% of the country's GDP (Korea Transport Institute, 2010).

Table 1.3. Comparative indicators of infrastructure in East Asia and the Pacific and in South Asia, latest available data

	East Asia and the Pacific	South Asia
Electricity (percentage of population with access)	90.9	62.2
Water (percentage of population with access to improved water source)	90.8	90.0
Sanitation (percentage of population with access to improved sanitation facilities)	68.8	38.2
Telephone lines (per 100 people)	21.9	2.7
Mobile subscribers (per 100 people)	83.1	68.8
Internet users (per 100 people)	38.6	9.4
Road density (km of road per 100 sq. km of land area)	28.5	98.8

Source: World Bank, World Development Indicators database. Available from <http://data.worldbank.org/> (accessed on 5 March 2013).

Table 1.4. Comparative indicators of infrastructure in selected Asia-Pacific economies, latest available data

	Electricity	Water	Sanitation	Telephone lines	Mobile sub-scribers	Internet users	Road density
Afghanistan	16	50	37	0	54	5	..
Bangladesh	41	81	56	1	56	5	15
Bhutan	..	96	44	4	66	21	18
Cambodia	24	64	31	4	70	3	22
China	99	91	64	21	73	38	..
Fiji	..	98	83	15	84	28	..
India	66	92	34	3	72	10	..
Indonesia	65	82	54	16	98	18	..
Lao People's Democratic Republic	55	67	63	2	87	9	..
Malaysia	99	100	96	15	127	61	44
Myanmar	13	83	76	1	3	1	5
Nepal	44	89	31	3	44	9	..
Pakistan	62	92	48	3	62	9	33
Papua New Guinea	..	40	45	2	34	2	..
Philippines	90	92	74	7	92	29	..
Samoa	..	96	98	..	..	..	..
Singapore	100	100	100	39	149	75	476
Solomon Islands	..	..	..	2	50	6	..
Sri Lanka	77	91	92	17	87	15	174
Thailand	99	96	96	10	113	24	..
Tonga	..	100	96	29	53	25	..
Vanuatu	..	90	57	..	..	..	..
Viet Nam	98	95	76	11	143	35	..

Source: World Bank, World Development Indicators database. Available from <http://data.worldbank.org/> (accessed on 5 March 2013).

Notes: Electricity (percentage of population with access to electricity); water (percentage of population with access to improved water source); sanitation (percentage of population with access to improved sanitation); telephone lines (per 100 people), mobile subscribers (mobile cellular subscriptions per 100 people), Internet users (per 100 people); road density (km of road per 100 sq. km of land area).

Neglect of agricultural sector contributing to poverty, inequality and food insecurity

The neglect of the agricultural sector in the region over past decades has had serious impacts on poverty, inequality and food security of citizens. Agriculture accounts for a quarter of GDP of the developing economies of Asia and the Pacific, employs about 60% of the region's working population and shelters a majority of the poor. Thus, the importance of the agricultural sector is clear. The neglect of agriculture has contributed to the high and volatile food prices seen in the region in recent years. It appears that those countries with significantly high food insecurity, measured by the proportion of people undernourished, also spend far less on social welfare and agriculture. For example, the countries with the highest proportion of undernourished during the period 2010-2012 - Bangladesh (16.8%), Cambodia (17.1%), India (17.5%), Nepal (18%), the Philippines (17%) and Sri Lanka (24%) - spend about 1% of their GDP on agriculture.

The neglect of agriculture has weakened the sector's capacity to cut poverty and inequality

The neglect of agriculture in government policy was analysed in the ESCAP 2008 *Economic and Social Survey of Asia and the Pacific* (ESCAP, 2008). The 2008 Survey noted that "growth and productivity in agriculture have stalled, and the green revolution that boosted agricultural yields in the 1970s has bypassed millions. Farmers are now facing mounting pressure, evident in declining subsidies, rising input prices, intensifying protests over landlessness and an alarming number of suicides among the indebted".

This neglect has weakened the sector's capacity to cut poverty and inequality. The number of people whose livelihood depends on agriculture has not declined as rapidly as the share of agriculture in GDP. So, less income in agriculture has had to be shared by more people. In addition, the land Gini coefficient is high (around 0.6) in many developing

countries of the region, implying that the income generated in agriculture is not shared equitably.

The region has seen a sharp drop in agricultural productivity growth which has been due in significant part to structural factors. Average annual agricultural labour productivity growth in the Asia-Pacific region declined from 2.5% in the 1980s to 2.2% in the 1990s and to 1% during the period 2000-2002. Growth in average annual land productivity also declined, from 8.5% during the period 1961-1994 to 3.5% during the period 1994-2000 and then to 2.1% during the period 2000-2003. Structural impediments for productivity growth in agriculture include lack of human capital development due to limited access to health and education, inequality in land ownership, and inadequate rural infrastructure. These impediments are largely due to anti-agricultural macroeconomic policies that resulted in declines in public investment in agriculture, especially in research and development and extension services, and cuts in agricultural credit and input subsidies.

Macroeconomic policies that encouraged speculative activities in stock markets and created property booms discouraged private investment in agriculture as big landowners waited for property developers to buy up their land. This has not only hampered agricultural productivity growth, but has also reduced arable land at an alarming rate, especially in the urban fringe areas.

The neglect of the rural and agricultural sector is evident from the inequalities in access to health and education and infrastructure. For example, nearly a quarter of the rural population in the region does not have access to safe drinking water, as opposed to 7% in urban areas. Less than a third of people in rural areas have access to improved sanitation, in comparison with 70% in urban areas. Similar gaps also exist in access to education. For example, illiteracy in China stood at 116 million adults in 2005, with those affected mainly from rural areas (Illiteracy, 2007). In South Asia, the share of the rural population living more than two kilometres from an all-weather road stood at 35% in 2006 (ESCAP,

2006). Access to electricity is not available for more than a billion people in Asia and the Pacific, the majority of which are rural poor.

Rural farmers have found their access to finance constrained, in particular as a result of the structural adjustment programmes of the 1980s as well as the removal of subsidized credit schemes. With financial deregulation and changes in monetary policy, schemes of specialized credit and agricultural refinance operated by central banks are no longer available. Rediscount rates are now set by many central banks and specific sectors are not directly supported. Lending for agriculture by commercial banks is naturally curtailed in response to low returns and lack of availability of collateral.

Expenditure on agricultural research and development in Asia-Pacific remains much lower than in developed countries

While expenditure on research and development in the Asia-Pacific region has gradually increased, it remains much lower than in developed countries. Furthermore, in some countries it either declined or remained stagnant. In China, research and development spending decreased in 2000 to 0.4% of value-added in agriculture from 0.57% in the early 1960s. In Thailand, there has been little increase over the decades, with research and development spending remaining at 0.4-0.5% since the 1970s, though there has been some recent upward movement. India increased its research and development expenditure in the 2000s from 0.18% of agricultural value-added to 0.34%.

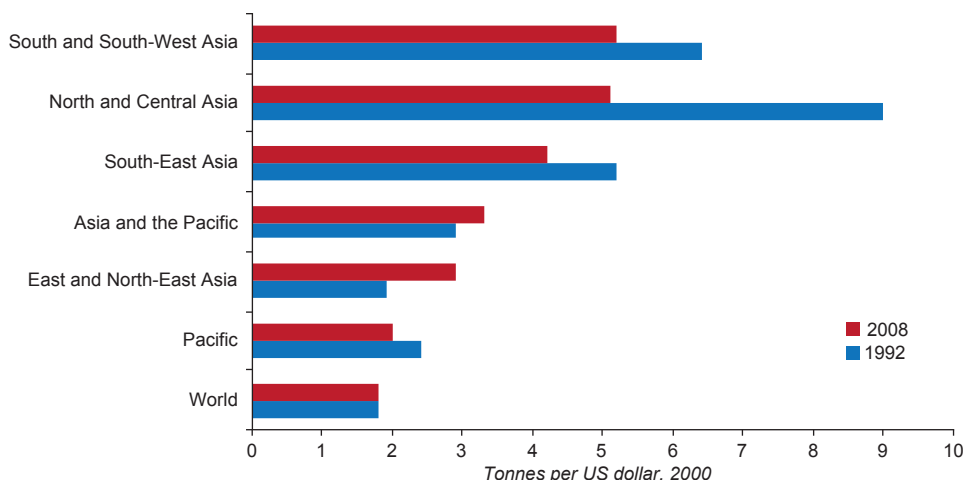
The share of the private sector in agricultural research and development in the Asia-Pacific region is appallingly low at approximately 8% compared with about 54% in developed countries. Therefore, governments have to play a much larger role in lifting agricultural productivity by investing in research and development, rural infrastructure and extension services as well as improving access to education and health for improving human capital.

Improvement in agricultural productivity is critical for not only insulating the region from the volatility of global markets and enhancing food security, but also to reduce poverty and inequality. ESCAP estimates show that a 1% increase in agricultural productivity would lead to a 0.37% drop in poverty in the Asia-Pacific region (ESCAP, 2008). Given the large agricultural labour productivity gaps among countries in the region, the potential gains would be substantial. For example, raising the region's average agricultural productivity to the level of Thailand, could take 218 million people out of poverty. India has the most to gain from accelerated agricultural productivity growth, with nearly two-thirds of the region's poor and a large agricultural productivity gap. In this context, in past years, ESCAP highlighted the need for a second "green revolution" based on sustainable agriculture to raise the region's agricultural productivity (ESCAP, 2009b; and 2010a).

Unsustainable resource use

Industrialization and an expanding and increasingly affluent consumer base have boosted the demand for all kinds of resources. Trends in the use of biomass, energy, construction and other minerals show that while the economies of other regions of the world are becoming less resource-intensive over time, the Asia-Pacific economy is requiring more resources to produce one dollar of GDP as the economy grows (see figure 1.25). One factor behind this is the still-significant unmet needs of developing countries in the region. However, a large part can be attributed to economic growth strategies employed by countries. Notably, the region as a whole in 2008 used almost twice the input of resources¹⁶ to create one unit of GDP as the global economy.

Figure 1.26 shows that while the per capita domestic material consumption in the Asian and Pacific region is still below that of the world, the gap narrowed significantly between 1992 and 2008. The use of resources in economies in the Pacific, East and North-East Asia and North and Central Asia which have more affluent lifestyles, rely heavily

Figure 1.25. Domestic material consumption intensity, Asia and the Pacific, its subregions and the world, 1992 and 2008

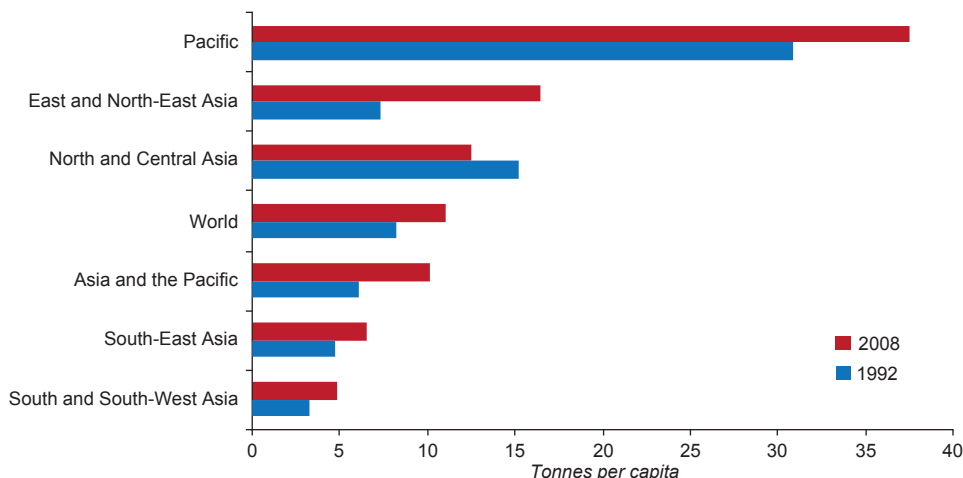
Sources: Commonwealth Scientific and Industrial Research Organisation and UNEP Asia Pacific Material Flows database.

on production of commodities and energy and/or are in a process of rapid infrastructure expansion. This contrasts significantly with the low per-capita use of resources in economies where poverty persists, such as in South and South-West Asia. Future growth of resource use in such countries holds significant implications for overall resource demand.

Construction minerals account for approximately 70% of resource use as of 2005, and is the fastest growing category of material use. Biomass accounts for a diminishing proportion of resource use

overall, but total resource extraction has increased by a factor of three from 1970 to 2005. This has been primarily influenced by changing lifestyles and changing consumption patterns, including increased consumption of animal protein.

The demand for biomass directly influences changes in land cover, and increases risks related to flooding, landslides, biodiversity loss and localized climate impacts. The climate impacts are shown in the dramatic loss of primary forests across the region to agro-industry and forest plantation. Regional plantation forests make up almost the same area as

Figure 1.26. Per capita domestic material consumption, Asia and the Pacific, its subregions and the world, 1992 and 2008

Sources: Commonwealth Scientific and Industrial Research Organisation and UNEP Asia Pacific Material Flows database.

primary forests, the highest proportion in the world, and three times the global proportion. South-East Asia has lost 13% of its forest area over the past 20 years, with the net loss of forest amounting to an area roughly equal to the size of Viet Nam.

Of particular concern in the context of climate risks is the intensity of water requirements. Because of the heavy dependence of economies of the region on agriculture, the water intensity of most Asia-Pacific subregions far exceeds the global figure (see figure 1.27). This signals continued pressures on water resources, vulnerability of these economies to drought, and declining capacity of freshwater systems to meet ecosystem services requirements, including the provision of food to rural communities. While growing affluence is mainly to blame for environmental pressures related to resource use, persistent inequality with regard to the lack of access to basic services is also a factor. Some 800 million people are without access to modern forms of energy, mainly in rural areas. Specifically, the lack of access to electricity limits overall socioeconomic progress and perpetuates a vicious cycle in which the need for wood and other biomass-based forms of energy promotes extraction from the natural environment. This problem is particularly prominent in South Asia, where the annual extraction of wood for fuel wood use has stayed relatively constant for the last forty years, in contrast to declining rates in other regions,

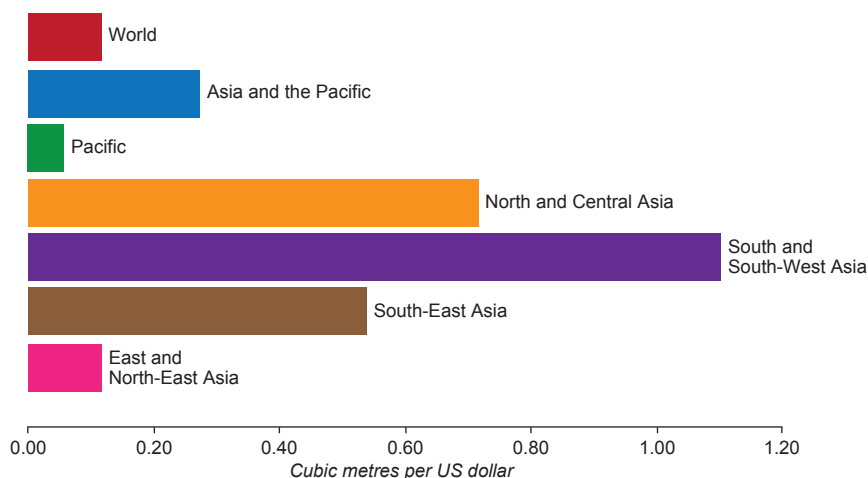
and is linked to the low levels of access to modern forms of energy in that subregion.¹⁷

The perception that intensive resource use and environmental degradation are acceptable phenomena is imposing significant socioeconomic costs

The perception that intensive resource use and environmental degradation are acceptable phenomena in a “grow now, clean up later” approach to development is imposing significant socioeconomic costs – costs that are most often borne by the most vulnerable in society. Extensive deforestation was partially blamed for the flood crisis of 2010 in Pakistan that affected one and a half million people. One out of four deaths globally is attributable to environmental causes, such as polluted air, contaminated water and lack of adequate sanitation (WHO, 2006b). According to a World Bank estimate, China is losing about 5.8% of its GDP due to air and water pollution (World Bank, 2007). In India, 2.6 million premature deaths a year are related to air pollution, contaminated drinking water and other environmental risks (López, Thomas and Wang, 2008).

Extreme weather events, which may be related to climate change, add to these costs. While the region generates 25% of the world’s GDP, it has suffered

Figure 1.27. Water intensity, Asia and the Pacific and its subregions, 2000



Sources: Commonwealth Scientific and Industrial Research Organisation and UNEP Asia Pacific Material Flows database.

42% of the global economic losses due to natural disasters (ESCAP and UNISDR, 2012). The cost of the 2011 floods in Thailand, for example, was estimated at \$45 billion, and recovery and reconstruction at \$25 billion (Tang, 2011), while GDP declined by 9% in the last quarter of 2011 compared with the previous year (Thailand, 2012). These losses will continue as climate change deepens and accelerates. ADB estimates that in South-East Asia, the economic cost of climate change could be equivalent to a loss of 6.7% of GDP per year by 2100 – more than twice the world average (ADB, 2009).

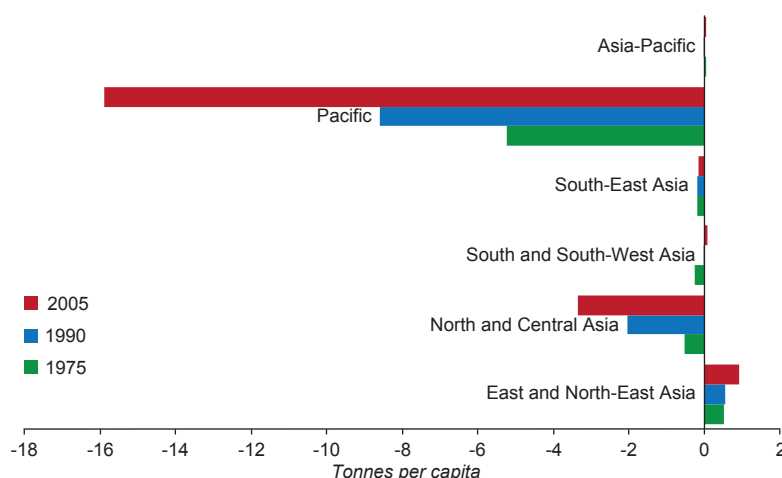
Economic losses are just one facet of the implications of resource-intensive growth patterns for development. The ESCAP-ADB-UNEP joint publication, *Green Growth, Resources and Resilience* (ESCAP, ADB and UNEP, 2012) points out that while there is need to continue to elevate the standard of living, this must be achieved based on resource efficient, rather than resource-intensive growth strategies. In a context of high and volatile resource prices and increasingly evident resource constraints, a resource-intensive growth pattern translates to an economy with higher exposure to risk, especially for the most vulnerable in society. Resource efficiency is increasingly an economic risk management strategy on both economic and social fronts. This is acknowledged in national

development strategies in the Asia-Pacific region as well as elsewhere.

Figure 1.28 highlights the growing dependence of each subregion of the Asia-Pacific region with the exception of the Pacific subregion (which includes Australia) on resources sourced from other parts of the world. This dependence presents an emerging source of vulnerability – the vulnerability of the economy to disasters or other events that may constrain access to resources increasingly sourced from other parts of the world.

Resource-intensive growth is a result of a combination of factors, including lack of access to resource efficient technologies. There are also policy failures, such as fiscal policies and market prices that do not reflect the true cost of resources or the pollution that resource use generates, as well as over-emphasis on resource-intensive export-led growth. An analysis of the factors that have contributed to resource-intensive growth also shows that technological advances have not led to efficiency improvements and are highly unlikely to mitigate future environmental pressures. Fiscal incentives for sustainable production and consumption, public investment in innovation of resource efficient and green technologies and expanding access to basic services based on resource-efficient models are

Figure 1.28. Physical trade balances in Asia-Pacific subregions, 1975, 1990 and 2005



Sources: Commonwealth Scientific and Industrial Research Organisation and UNEP Asia Pacific Material Flows database.

essential for mitigating further risk and ensuring equitable access to resources and opportunity for development. Many smaller countries, especially least developed countries, cannot address these issues by themselves- thus, regional cooperation is critical.

Increased disasters costing lives and development

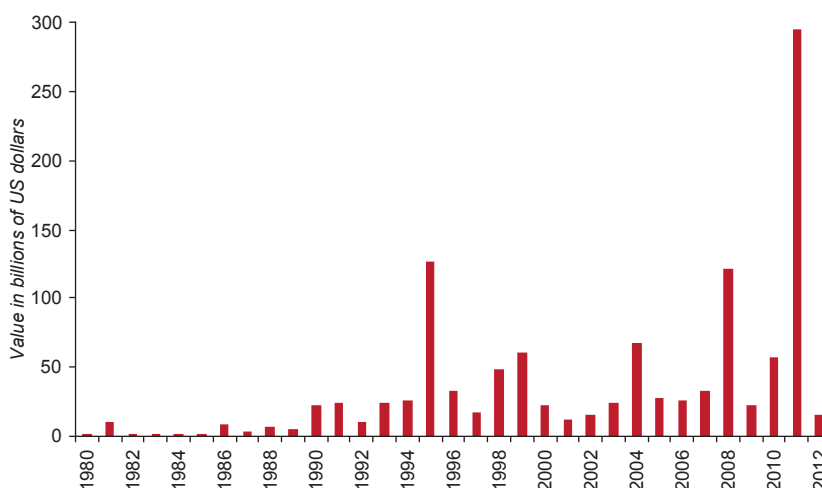
Asia and the Pacific is the world's most disaster-prone region and the Pacific islands subregion is the most disaster-prone subregion in the world. In 2012, floods and storms were the most frequent types of disasters occurring in the region and had the highest human and economic impact, accounting for 54% of the death toll, 78% of people affected and 56% of all economic damages due to disasters. Pakistan suffered large-scale losses from floods for the third successive year. Floods in China affected more than 17 million people and caused the highest economic losses (\$4.8 billion). In South Asia, South-East Asia and East Asia, they accounted for 57% of total deaths, 74% of affected people and 34% of the total economic damages caused by disasters in the first ten months of 2012, amounting to an estimated \$15.1 billion (UNISDR, 2012). The disaster losses in 2012 were relatively much lower in comparison to 2011, the year in which the Great East Japan Earthquake, tsunami

and the ensuing nuclear disaster occurred, as well as the South-East Asian floods, which contributed to the staggering \$294 billion in regional economic losses - representing 80% of global losses due to disasters in 2011 (see figure 1.29). Large-scale post-disaster recovery and reconstruction efforts have been taken up in 2012 in Japan and Thailand.

The Democratic People's Republic of Korea, Sri Lanka, the Philippines, China and Pakistan, all of which suffered from extensive floods for the third successive year, were among the top five ranking countries in 2012 as per the total number of people killed and affected by disasters per 100,000 inhabitants (UNISDR, USAID and CRED, 2012). Typhoon Bopha was the strongest tropical cyclone to ever hit the island of Mindanao of the Philippines. Cyclone Evan, which severely affected Fiji and Samoa, was considered to be the worst tropical cyclone to affect Samoa since 1991.

Vulnerability to disasters continues to increase while economic development is exposing ever-growing numbers of people and assets to disasters. The *Asia Pacific Disaster Report 2012: Reducing Vulnerability and Exposure to Disasters* (ESCAP and UNISDR, 2012), published by ESCAP in partnership with UNISDR, provides recent analysis of these trends. From 1970 to 2010, the population in Asia and

Figure 1.29. The profile of economic damages due to disasters in Asia, 1980-October 2012



Source: EM-DAT: The OFDA/CRED International Disaster Database. Available at www.emdat.be.

the Pacific almost doubled from 2.2 billion to 4.2 billion. In the same period, the average number of people exposed to yearly flooding more than doubled from 29.5 million to 63.8 million and the number of people living in cyclone-prone areas also went up, from 72 million to more than 120 million people.

Disaster losses since 1980 have increased by 16 times in Asia while GDP per capita has grown by only 13 times. The rate at which wealth is being lost is faster than the rate at which it is being generated. Never before has the need for collaborative action to reduce risk, vulnerability and exposure of populations and assets been more obvious and necessary for the common good. The shared challenge in Asia and the Pacific is to control both the growing rate of exposure and rising vulnerability. Exposure to hazards has multiplied as urban centres grow and people and economic activities expand into increasingly exposed and hazard-prone land. It is also a concern that smaller economies, those that have less diversified economic structures, and countries with high fiscal deficits, show greater vulnerability even when faced with relatively small-scale disasters.

Well-targeted investment in disaster risk reduction and management can reduce vulnerability and exposure to disasters. Social protection, designed in a more resilient manner by taking into account poverty alleviation and focusing on the underlying causes can reduce people's vulnerability during and after a disaster event. Scaling up vulnerability reduction measures in high-risk areas, land-use planning, supply chain management and targeted social safety nets for the most vulnerable have the potential to reduce disaster risks significantly. Furthermore, regional cooperation can be used for cost effective sharing of highly sophisticated and sometimes costly ICT and space technologies. Guiding principles for policymaking should be to focus on development strategies that reduce exposure to hazards and to invest more in disaster risk reduction policies to achieve greater resilience against disasters.

POLICY OPTIONS

Supporting growth and achieving inclusive and sustainable development

Despite a slowdown in economic activity from the global recession 2008-2009, Asia and the Pacific has demonstrated relative resilience as a region in comparison to other parts of the world. However, this economic resilience masks rising social inequities, slow job creation, persistent employment informality, insufficient development of domestic demand and regional infrastructure, as well as high resource-intensity of the region's production structure.

The solution to improving the quality of growth in the region lies in boosting domestic demand through government policies that are directed towards strengthening social and environmental pillars of sustainable development. In the social sphere, making development more inclusive will spur consumption by the majority of the population in many developing economies, including the poorest and most vulnerable members of society. In the environmental sphere, the current failure of countries to tackle degradation in their natural environment and to reduce high-resource intensity of their production structure is impeding the ability of their economies to perform at full potential. Issues that have a direct bearing on the quality of economic growth include deforestation, damage to water and energy sources, and air pollution.

Governments need to take the leading role in tackling the problems of falling demand and long-term structural impediments by synergizing action on economic, social and environmental fronts to address critical risks through supportive fiscal and monetary policies (see box 1.6). In the short-term, governments should engage in stimulatory policies to provide a floor to the impact of constrained global growth prospects. Most countries in the region have both the fiscal and monetary space to undertake such policies without adverse macroeconomic consequences. This endeavour, however, is challenging in the face of instabilities associated with capital flows, insufficient financial regulation and inadequate access to direct

Box 1.6. Synergizing action on economic, social and environmental fronts to address critical risks

Implementing policies that facilitate investment in natural capital and allow the economic benefits and costs of disaster risk mitigation to be reflected in the economy is an important long-term strategy for economic system change. Policies that “recalibrate” prices of natural capital so that social and environmental costs and economic and social benefits are internalized in the economy are critical for changing growth paths. This requires policy reform, sustainable consumption and lifestyles, and most importantly a focus on changing price signals. This goes beyond advocating more taxes, but focusing policy design on achieving a double dividend for both the economy and environment through revenue-neutral environmental tax reform.

The simple, but powerful concept of revenue neutrality promotes a shift in the tax base from income to resource consumption. By doing this, environmental tax reform can change market price signals without damaging the economy. Proper policy design can also avoid harming the poor. This has been practiced by some European countries, such as Germany, Sweden, Denmark, and the United Kingdom of Great Britain and Northern Ireland. Environmental fees and taxes are being explored by governments of the region, including those of China, Indonesia, Thailand, Vanuatu and Viet Nam. They stand to form an important basis for implementing a more strategic approach geared to synergizing the three pillars of sustainable development.

A study commissioned by ESCAP further illustrates the potential for a double dividend in developing countries in the region. A modelling exercise explored the impacts of introducing a tax of \$10 per ton of CO₂ at the same time as reducing corporate tax in seven countries – Cambodia, China, India, Japan, Malaysia, the Republic of Korea and Thailand. The result was that there could be an increase in GDP, depending on the scenario and countries. For Thailand, the figure was 1.53% higher GDP growth and up to 6.72% lower carbon reduction vis-à-vis a business-as-usual scenario.

In locations where food price trends are increasingly coupled to energy price trends, due to the increasing energy intensity of agricultural production, a critical intervention is required in order to energize rural economies through a renewed emphasis on sustainable agriculture and eco-efficient agricultural models instead of those that are resource-intensive. This will involve applying sustainable production methods, increasing the productivity of basic agricultural production and improving the value-added content of agricultural products by moving up the value chain. The relative neglect of government spending devoted to agricultural research and development in recent decades should be reversed to harness indigenous knowledge to preserve agricultural diversity and boost competitiveness based on expanding opportunities presented by global markets which are increasingly sensitive to the health impacts of an increasingly industrialized food industry.

Following years of easy credit and overinvestment before the crisis, the world now faces overcapacity in most profitable economic sectors, and hence, an understandable reluctance for the private sector to invest in green technology. In this situation, only well-coordinated cross-border public investments can fund the needed green public goods, and induce complementary private investments through public-private partnerships. Besides contributing to a sustained economic recovery, such investments would also enhance climate change mitigation while advancing the region’s developmental aspirations and ensuring food security.

taxation revenues. Therefore, these policies need to be supplemented with capital flows management measures and trade, investment and other structural policies as noted at various parts in this chapter.

Governments need to take the leading role in tackling the problems of falling demand and long-term structural impediments

Just as critical as the quantum of such policies is the judicious design of the policies to ensure maximum impact. Fiscal and monetary stimulus should be directed towards enhancing productive investments in infrastructure, in particular in rural areas, labour-intensive SMEs and agriculture as well in green technologies. As argued in the *ESCAP 2009 Economic and Social Survey of Asia and the Pacific* (ESCAP, 2009a), the support measures should be designed in such a way that they also address long-term structural impediments. Critical areas from which higher public investment can attain both short-term and long-term objectives are employment guarantee schemes linked to active labour market programmes (ALMP), social protection, including income support for elderly and persons with disabilities, education, health and renewable energy for energy security. A government employment guarantee, linked to ALMP, is an important instrument to cushion the business cycle and preserve skill sets of the workforce. Besides being an automatic stabilizer, it can preserve skilled labour during the time of economic slowdown to be available when economic conditions improve. Greater investment in social protection is needed to reduce economic insecurity and vulnerability and thereby foster inclusive and balanced growth by sustaining domestic demand, particularly during an economic downturn.

Chapter IV contains a detailed analysis of a policy package involving these elements. The analysis shows that such policies are fiscally sustainable and would not lead to accelerating inflation. The chapter includes a discussion on some key macroeconomic policy dilemmas that arise in efforts to support growth

in the short to medium-term and achieve inclusive and sustainable development in the long-run.

Debt, inflation and fiscal sustainability

Higher levels of public debt and inflation in a number of countries, especially in South Asia, are often viewed as factors restricting expansionary fiscal and monetary policies. Yet, this should not necessarily be the case. To begin with, policymakers need to consider what could happen to their respective economies' debt levels or debt-GDP ratio if growth falters, especially if fiscal consolidation is attempted when growth is slowing, in the light of the experience of crisis-hit European countries. It is worth referring to the recent observation by the IMF that "there is no single threshold for debt ratios that can delineate the "bad" from the "good" (IMF, 2012c).

As argued in chapter III, there is no intrinsic harm in having relatively high levels of debt when it supports spending on productive uses. It can be seen from studies that the negative relationship between debt and GDP is small.¹⁸ On the other hand, the positive relationship between debt-financed spending and other variables such as years of schooling is relatively high (IMF, 2010). Therefore the growth-inhibiting effects of a given percentage increase in debt-to-GDP ratio can be easily overcome by a given percentage increase in growth-promoting variables achieved through public spending in areas such as education, health, physical infrastructure and energy efficiency.

This highlights the key point that policymakers should be concerned with the composition of debt-financed spending rather than the aggregate level of such debt (Chowdhury and Islam, 2010). Spending that is directed to productive uses can increase growth along with an increase in debt and therefore eventually have a neutral or positive impact on debt-to-GDP ratios. In sum, policymakers should be aware of the developmental role of fiscal policy and not remain excessively focused on its stabilization role, a key message of *forward-looking macroeconomics*.

Policymakers should be concerned with the composition of debt-financed spending rather than the aggregate level of such debt

It is also important to examine whether higher debt-GDP ratios are a result of past failure to collect enough revenues despite decades of higher growth and/or due to unproductive expenditure. If this is the case, then policymakers need to reprioritize public programmes and improve efficiency of public expenditure as well as take steps to improve revenue collection by broadening the tax base and enhancing the efficiency of tax administration. If tax revenues are earmarked for socially desirable expenditure, there will be incentives for tax payments. In this context, the recent experience of the “Tax for Development” campaign implemented in Bangladesh is very encouraging; the tax-to-GDP ratio in Bangladesh has risen from approximately 9% to approximately 13%.

Similarly, it is not clear that monetary policies should not be eased even in a climate of relatively high inflation if such policy easing is supportive of growth. If such easing is undertaken in an environment in which other structural barriers that hamper the returns to investment, such as energy shortages, are removed, the cheaper price of credit can spur the activities of the private sector. Reducing the cost of credit by expansionary monetary policy will not necessarily lead to increased inflation if it is ensured that credits are directed through regulatory measures to productive investments, especially to agriculture and not to speculative investments in assets.

Indeed, the relationship of inflation with growth is found to be non-linear in numerous large cross-country studies (Chowdhury and Islam, 2012b). It becomes negative only beyond moderate rates of inflation, ranging from 13% to 17%. Historical evidence based on the experiences of Indonesia and the Republic of Korea during their rapid transformation also reveals that such moderate inflation rates do not harm growth; nor do they dampen poverty reduction.

The above observation is critical for *forward-looking macroeconomics* for monetary policy to balance stabilization and developmental needs. It is pertinent to point out here that the IMF's Article of Agreement acknowledges the developmental role of monetary policy. For example, the preamble of Article IV (i) states, “each member shall: endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances” (IMF, 2011).

Regional cooperation for addressing infrastructure deficits

A key underlying need in order to increase the inclusive and sustainable nature of growth is to address the yawning infrastructure gaps for many economies in the region, which, according to an ADB study in 2009, are estimated to be in the order of \$800 billion per annum.¹⁹ Recent analysis by the World Bank estimates the annual need for infrastructure in East Asia and the Pacific at \$407 billion, with the current spending on infrastructure far below the requirement, standing at around \$200 billion (Brereton-Fukai, 2013). In addition, Asia and the Pacific needs to spend approximately \$290 billion on specific regional infrastructure projects in transport and energy that are in the pipeline. If the required investment toward pan-regional connectivity is made in transport, communications, and energy infrastructure during the period 2010–2020, the real income of developing Asia during that period and beyond could reach \$13 trillion (ADB and ADBI, 2009). The infrastructure financing gap in the region has recently become a concern for the Group of Twenty (G20), with countries pledging to give the issue attention during the grouping's deliberations during 2013 (Brereton-Fukai, 2013).

*Interregional infrastructure connections
offer a powerful avenue to pool
resources as well as boost trade*

The need to improve infrastructure goes beyond national boundaries as interregional connections offer a powerful avenue to pool resources as well as boost trade. The region consists of both resource-rich and resource-poor countries which can be brought together through cross-country infrastructure in a host of areas. The challenge is to bridge the enormous infrastructure needs of the region with sufficient sources of investment. In addition to lending by multilateral development banks, such as ADB and bilateral development banks, a number of subregional initiatives are ongoing such as the SAARC Development Fund and the ASEAN Infrastructure Fund. As ESCAP has proposed (ESCAP, 2012c), such existing forms of investment could be complemented with a new large-scale regional lending facility for infrastructure. This facility could help coordinate other sources of lending, such as by multilateral and bilateral development agencies and private financial institutions. Its backing for infrastructure projects could also signal opportunities to private investors. As a regional body, the facility could also be in a position to keep track of intraregional spillovers and finance economically significant cross-border projects. Another possible function of the facility could be to extend advisory services and technical assistance. Its capital base could be funded by contributions made by central banks and funds raised through issuing bonds. The ESCAP secretariat is currently engaged in elaborating elements of a regional financial architecture for supporting infrastructure investment.

Endnotes

¹ The most influential view is that fiscal austerity now is necessary because it will instill “market confidence” that lies at the core of private sector spending decisions. Nobel Laureate Paul Krugman has often lamented this as an undue faith in the “confidence fairy” to spur growth. The advocates of the “market confidence” thesis

overlook the fact that rating agencies typically include growth variables in their assessment of sovereign risk analysis. More importantly, studies have shown that the impact of a growth contraction on measures of sovereign risks is higher than the impact of debts and deficits on such risks. Hence, when fiscal consolidation leads to growth contractions they reduce rather than raise market confidence. See Cottarelli and Jaramillo (2012). Also, see Krugman (2012).

² Bagaria, Holland and van Reenen (2012). Also see, Chowdhury and Islam (2012a).

³ A credit event for sovereign debt could occur as a result of either failure to pay a coupon or principal on a bond or loan; a distressed debt restructuring, meaning a restructuring that changes the terms of a debt obligation to the disadvantage of investors; and debt repudiation, meaning the announcement by an authorized official of the intention to suspend payments.

⁴ Borrowing costs are at a historic low for advanced countries, such as the United Kingdom, the United States and Japan, despite high public debt. As pointed out by Krugman (2012), this probably reflects the fact that there is a flight to safe assets issued by advanced country governments that “still own their currency”.

⁵ ILO estimates from official national sources.

⁶ ILO estimates based on Samoa Bureau of Statistics (2012) and Vanuatu National Statistics Office (2010).

⁷ ILO estimates based on Marshall Islands (2012).

⁸ Subregions as defined by ILO are as follows: South Asia refers to Afghanistan; Bangladesh; Bhutan; India; Maldives; Nepal; Pakistan; and Sri Lanka; South-East Asia and the Pacific refers to Brunei Darussalam; Cambodia; East Timor; Indonesia; the Lao People's Democratic Republic; Fiji; Malaysia; Myanmar; the Philippines; Singapore; Thailand; Viet Nam; Fiji; Papua New Guinea; and Solomon Islands; and East Asia refers to, China; Democratic People's Republic of Korea; Mongolia; Republic of Korea; China, Hong Kong; Macau, China, and Taiwan Province of China.

⁹ ILO (2011b), table R8. Developed economies include: Australia, Canada, Iceland, Israel, Japan, New Zealand, Norway, Switzerland, the United States and the economies of the European Union.

¹⁰ Such an episode is defined by the ratio of net private capital inflows to GDP in the year after the episode ends being more than 5% lower than that of the episode.

¹¹ Analysis in the following section is drawn from ESCAP, Asia-Pacific Trade and Investment Report (2012).

¹² Under this type of transaction, domestic value-added is very low. The imported inputs and the finished outputs remain property of the foreign supplier.

¹³ ASEAN+3 comprises the 10 ASEAN countries plus China, Japan and the Republic of Korea; ASEAN+6 comprises ASEAN+3 plus Australia, India and New Zealand.

¹⁴ When examining intraregional FDI flows, data availability becomes a limiting factor. In particular, data on South-South investment flows are very limited. Thus, for this part, the analysis is also based chiefly on greenfield investment flows. The analysis of intraregional flows in ASEAN relies on data for total FDI flows.

¹⁵ Dutch disease is a phenomenon where a rapid expansion of the natural resources sector leads to currency appreciation, thereby reducing the competitiveness of other industries. See, for example, Moran (2011).

¹⁶ Reference is the direct use by the economy (domestic material consumption) of four categories of resources (biomass, fossil fuels, metal ores and industrial minerals, and construction minerals) and 11 subcategories.

¹⁷ Food and Agriculture Organisation (2011). It should be noted that the FAO-defined Asia-Pacific region is different from the ESCAP-defined region.

¹⁸ See, for example, Ostry and others (2010b).

¹⁹ ADB and ADBI (2009). This is in line with an earlier estimate by ESCAP of \$600 billion per annum (ESCAP, 2006).