CHAPTER 1

Economic outlook and policy challenges

1. Introduction

Average GDP growth in the developing economies of the Asia-Pacific region continues to steadily improve, while inflation remains stable. Sustaining the investment recovery and further enhancing the drivers of economic growth are key considerations in going forward. There is a risk, however, of a short-lived recovery from protectionist trade measures, financial market disruptions, natural disasters and geopolitical tensions.

Moreover, the region's medium-term prospects rest on the ability to lift potential economic growth and ensure shared prosperity. Lifting potential growth will require higher productivity growth. Technology, a key driver of productivity, poses both opportunities and challenges, particularly with respect to how new technologies, such as artificial intelligence and robotics, will reshape the future of work and global and regional production patterns. A risk which calls for attention is that of increased job polarization and premature deindustrialization, which could widen inequality within and across countries.

In the light of the above-mentioned near- and medium-term challenges, three policy considerations are highlighted.

Monetary and financial policy should be focused on supporting a smooth transition to the expected gradual pickup in inflation and financial tightening prompted by stronger global growth, while addressing systemic risks in the financial system through appropriate macroprudential measures. The latter are important in view of the region's high level of private debt and distressed bank loans, which are also constraining robust investment.

Fiscal policy should be focused on supporting medium-term objectives of lifting productivity growth and reducing inequalities as the need for near-term stimulus diminishes. Beyond allocating more resources to education, health, social protection and infrastructure, greater progress is needed to enhance expenditure efficiency and ensure equal access to public services. Progressive taxation could help increase fiscal space.

While there are sector-specific ways to improve expenditure efficiency, a cross-cutting factor is good governance. One of the ways in which Governments could improve fiscal governance is by leveraging technology; for instance, countries which proactively use e-government tools tend to perform better in terms of the perception of corruption.

Parallel efforts are needed to foster innovation and ensure that its benefits are widely shared. Leading innovative countries take a "whole-of-government approach" and invest in relevant skills and infrastructure, but efforts are needed to leave no country behind. Competition policy, labour market policy and fiscal policy should be calibrated to support inclusive innovation. Universal basic income could be considered as well.

Without improving the quality of economic growth, economic resilience too will be compromised. Governments should strengthen social protection as a strategic way of enhancing economic resilience and economic dynamism, not least in view of demographic transitions (risk of skills shortage among youth on one hand, and risk of old-age poverty on the other) and labour market disruptions associated with reforms and technological innovations.

At the same time, Governments should mainstream resources efficiency targets into national plans and budgets as well as into sectoral policies, and establish appropriate legal and regulatory measures to enforce standards and to promote awareness. Carbon tax and emission trading systems could play a critical role in transitioning to a low-carbon, climate-resilient economy.

Addressing these challenges and implementing many of these policies will require better use of existing resources but also mobilization of additional resources, including through tax reforms, prudent sovereign borrowing and leveraging of private finance – the focus of chapter II.

2. Economic performance and outlook

2.1. Global context – stronger economic growth and associated challenges

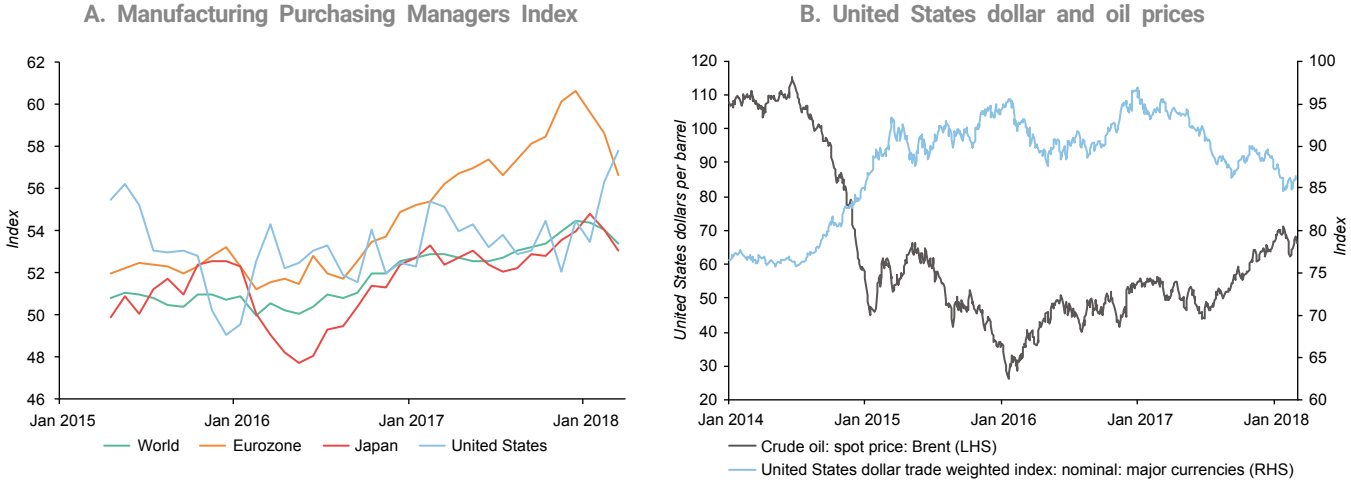
In 2017, there was a broad-based recovery in global manufacturing, investment and trade, resulting in the fastest global output expansion in five years. The upturn was evident in the United States, the eurozone and Japan (figure 1.1), along with continued strong performance by China and gradual recovery in major commodity exporters. This momentum is expected to be largely sustained, although there is an element of uncertainty. Global output is projected to grow by 3 and 3.1 per cent in 2018 and 2019 respectively, on par with an estimated 3 per cent growth in 2017; slight easing in growth in developed economies is expected to be offset by a rebound in developing economies, including commodity exporters in Africa and Latin America (figure 1.2). The eurozone is expected to further transition from recovery to expansion (European Commission, 2018). In the United States, reduced statutory corporate tax rates, from 35 to 21 per cent, are expected to boost investment in the forecast period (IMF, 2018). Global trade volumes, which rebounded and grew by 4.3 per cent in 2017, are expected to moderate only slightly to 4 and 3.9 per cent in 2018 and 2019 respectively (WTO, 2018; World Bank, 2018a).

While the recent upturn in the global economy is encouraging, it is worth noting that this follows an extended period of weak investment and low productivity growth (United Nations, 2017). Thus, there is an element of uncertainty in terms of continuation of these trends. Moreover, the belated but stronger-than-anticipated recovery brings its own challenges. The expectation of a faster rise in interest rates could trigger financial market volatility, as has already been seen recently in equity markets. While the weak United States dollar has provided some space for other countries to adjust gradually to financial tightening, the dollar could easily revert to its recent trend of strengthening on the back of a

strong United States economy (figure 1.1). For other countries, this could provide a boost in exports but also increase pressure on external financing and undermine further recovery in investment (Avdjiev and others, 2018). Similarly, corporate tax reform in the United States could result in a large-scale repatriation of some $2 trillion held abroad by United States multinationals (UNCTAD, 2018).

Inflation and wage growth, which have remained relatively subdued despite the closing of output gaps and low unemployment rates, are expected to rise gradually. In January 2018, average hourly earnings in the United States grew at the fastest pace since 2009 (United States Department of Labor, 2018). Global oil prices averaged $67 per barrel in the first two months of 2018 compared with $30 per barrel two years previously (figure 1.1).

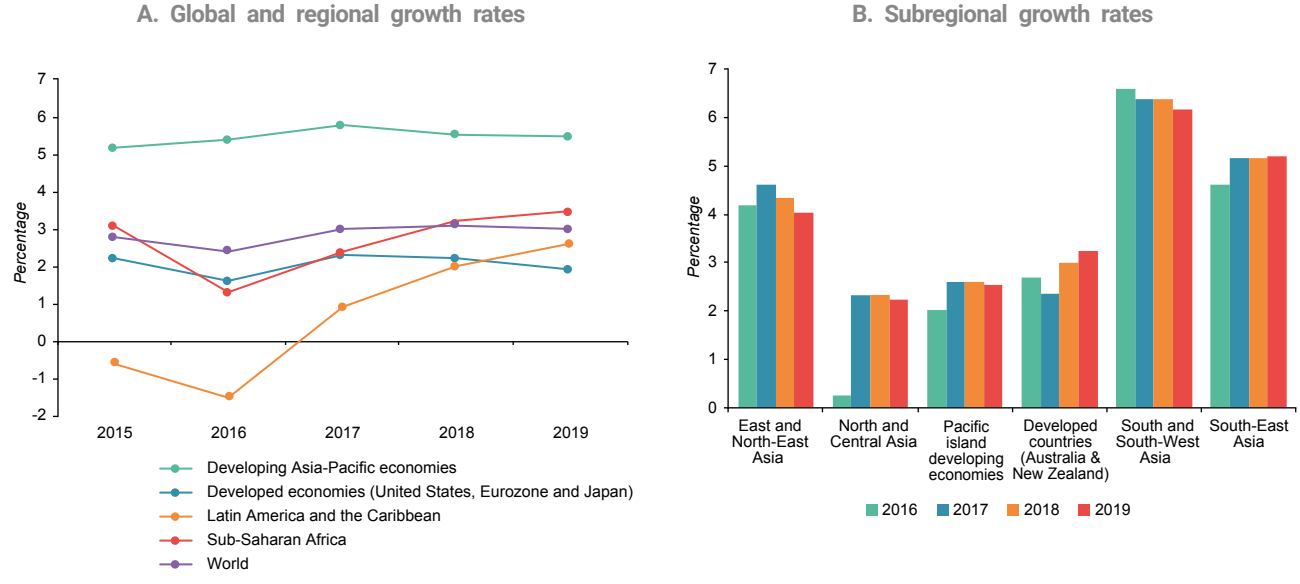
Figure 1.1. Global context



Source: ESCAP, based on CEIC Data. Available from www.ceicdata.com (accessed 1 March 2018).

Note: A PMI value higher than 50 indicates that the manufacturing economy is expanding, while a PMI value of less than 50 indicates that the manufacturing economy is contracting.

Figure 1.2. Economic growth



Source: United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2018*, see table I.1, p. 1. (Sales No. E.18.II.C.2). Available from www.un.org/development/desa/dpad/wp-content/uploads/sites/45/publication/WESP2018_Full_Web-1.pdf; and World Bank, *Global Economic Prospects, January 2018: Broad-based Upturn, but for How Long?* (Washington, D.C., 2018). Available from https://openknowledge.worldbank.org/bitstream/handle/10986/28932/9781464811630.pdf.

While the price is expected to moderate to about $60 per barrel, higher oil prices pose downside risks for large oil importers, such as India which benefited greatly from the low oil prices for the last three years but now is experiencing higher inflation and wider current account deficit (India, Ministry of Finance, 2018). These and other broader risks to the economic outlook are discussed further in section 4.1.

2.2. Economic growth in Asia and the Pacific – a broad-based upturn and stable outlook

Developing Asia-Pacific economies benefited from the global tailwind, growing by an estimated 5.8 per cent in 2017 compared with 5.4 per cent in 2016 (figure 1.2). About two thirds of the regional economies, accounting for 80 per cent of the region's GDP, achieved faster economic growth in 2017 (table 1.1). In China, strong global demand, resilient private consumption and service activities continued to drive economic growth, but investment moderated amid efforts to curb pollution and overcapacity in certain industries. In India, the recently introduced goods and services tax as well as weak corporate and bank balance sheets resulted in modest economic growth, but signs of recovery emerged in the second half of the fiscal year. The Russian Federation resumed growth after a two-year recession on the back of higher oil prices and more stable inflation and credit conditions. Least developed countries in the region grew by 6.8 per cent, the fastest in a decade, supported by stronger trade and investment flows, although they remain vulnerable to terms-of-trade shocks and natural disasters and face skills and infrastructure bottlenecks (box 1.1).

The outlook for economic growth in the Asia-Pacific region in 2018 and 2019 is looking broadly stable. Improved global economic prospects, a broad-based pickup in exports and robust domestic consumption support this positive economic outlook. Developing Asia-Pacific economies are projected to grow by 5.5 per cent in both 2018 and 2019, with a slight moderation in China offset by a recovery in India and steady performance in the rest of the region. Recently firmed economic activities in China could provide the authorities with more room to continue deleveraging and rebalancing towards a services and consumption-driven economy, which suggests that the region's largest economy would have steadier but slower economic growth. A comparison across ESCAP subregions reveals that South and South-West Asia continues to lead the region's economic growth, followed by South-East Asia, in part reflecting their demographic dividend. Economic recovery is under way in North and Central Asia and in the Pacific island developing economies (table 1.1; for more details, see subregional updates in section 3).

2.3. Inflation – picking up but still low

In line with higher global oil prices and strong aggregate demand, consumer price inflation in the developing economies of the Asia-Pacific region is projected to rise to 3.5 per cent in both 2018 and 2019 respectively compared with 3.2 per cent in 2017, with inflation accelerating in about 60 per cent of the regional economies (table 1.1). In China, Japan and the Republic of Korea, a recovery in producer prices is also expected to contribute to higher consumer price inflation. However, inflation has subsided in North and Central Asia, from 7.8 per cent in 2016 to 4.5 per cent in 2017; it is expected to remain stable in the forecast period in view of more stable commodity prices and exchange rates.

Despite some increase, inflation is likely to remain steady at low levels. Aside from country-specific factors, such as good harvests and stable food prices, there are a few global reasons for this situation related to the energy sector, currencies, capacity utilization and technology. First, despite the OPEC-plus agreement to cut oil production, oil prices are unlikely to rise significantly higher given the reduced cost of extracting shale oil in the United States where oil output exceeded 10 million barrels per day, the highest level since 1970 (United States Energy Information Agency, 2018) as well as the dramatic decline in renewable energy prices such that the average cost of electricity from certain renewables now falls within the range of that produced with fossil fuels. Second, currency appreciation in several economies has eased price pressures

Table 1.1. Economic growth and inflation, 2016-2019

	Real GDP growth				Inflation[a]			
(Percentage)	2016	2017[b]	2018[c]	2019[c]	2016	2017[b]	2018[c]	2019[c]
East and North-East Asia[d]	**4.2**	**4.6**	**4.3**	**4.0**	**1.2**	**1.2**	**1.6**	**1.8**
East and North-East Asia (excluding Japan)[d]	**6.1**	**6.3**	**6.1**	**5.9**	**1.9**	**1.6**	**2.0**	**2.2**
China	6.7	6.9	6.6	6.4	2.0	1.6	2.1	2.2
Democratic People's Republic of Korea	..	..	..	..	..	..	..	..
Hong Kong, China	2.0	3.8	3.3	3.5	2.4	1.5	2.1	2.4
Japan	0.9	1.6	1.3	0.8	-0.1	0.5	0.9	1.1
Macao, China	-0.9	9.1	7.0	6.1	2.4	1.2	2.2	2.4
Mongolia	1.5	5.1	6.0	6.7	1.1	4.3	6.0	6.5
Republic of Korea	2.8	3.1	3.0	2.9	1.0	1.9	1.7	2.0
North and Central Asia[d]	**0.3**	**2.3**	**2.3**	**2.2**	**7.8**	**4.5**	**4.4**	**4.4**
North and Central Asia (excluding Russian Federation)[d]	**2.2**	**4.2**	**3.9**	**4.2**	**10.9**	**8.3**	**6.5**	**6.1**
Armenia	0.9	7.4	3.3	3.4	-1.4	1.0	3.4	4.0
Azerbaijan	-2.7	-1.1	0.9	1.5	12.4	12.9	5.9	7.0
Georgia	2.8	4.8	4.5	4.7	2.2	6.0	3.2	3.2
Kazakhstan	1.0	4.5	3.7	3.8	14.7	7.4	6.6	5.7
Kyrgyzstan	4.3	4.6	4.2	4.6	0.4	3.2	3.0	3.0
Russian Federation	-0.2	1.9	1.9	1.8	7.1	3.7	3.9	4.0
Tajikistan	6.9	6.6	7.2	7.2	6.0	7.4	6.3	6.0
Turkmenistan	6.2	6.4	6.3	6.3	3.6	6.0	6.2	6.2
Uzbekistan	7.8	6.2	5.6	6.3	8.0	10.5	9.0	8.0
Pacific[d]	**2.7**	**2.3**	**3.0**	**3.2**	**1.3**	**2.0**	**2.3**	**2.5**
Pacific island developing economies[d]	**2.0**	**2.6**	**2.6**	**2.5**	**5.5**	**6.1**	**6.2**	**4.5**
Cook Islands	8.8	5.0	5.0	5.0	-0.1	-0.1	0.5	0.5
Fiji	0.4	4.2	3.6	3.2	3.9	2.8	3.0	3.2
Kiribati	1.1	3.1	2.3	2.4	1.9	2.2	2.5	2.5
Marshall Islands	1.9	4.0	2.5	2.4	-1.5	0.5	1.0	1.5
Micronesia (Federated States of)	-0.1	2.0	2.0	0.9	-1.0	1.5	2.0	2.0
Nauru	10.4	4.0	-4.0	0.2	8.2	6.0	2.0	2.0
Palau	0.5	-0.5	3.5	3.0	-1.3	1.5	2.0	2.0
Papua New Guinea	2.0	2.2	2.4	2.4	6.7	7.5	7.5	5.1
Samoa	7.1	3.0	1.0	1.8	0.1	1.7	2.0	2.5
Solomon Islands	3.2	3.0	3.0	3.2	1.1	0.5	1.0	2.5
Tonga	3.1	2.8	3.5	2.9	2.5	2.5	2.5	2.5
Tuvalu	4.0	3.2	3.0	2.2	3.5	2.9	2.5	2.5
Vanuatu	4.8	4.0	3.4	3.0	0.9	3.1	4.8	4.8
Developed countries in the Pacific subregion[d]	**2.7**	**2.3**	**3.0**	**3.2**	**1.2**	**1.9**	**2.3**	**2.4**
Australia	2.5	2.3	3.0	3.2	1.3	2.0	2.3	2.5
New Zealand	4.1	2.7	3.0	3.5	0.6	1.9	2.0	2.0

Table 1.1. *(continued)*

	Real GDP growth				Inflation[a]			
(Percentage)	2016	2017[b]	2018[c]	2019[c]	2016	2017[b]	2018[c]	2019[c]
South and South-West Asia[d,e]	**6.6**	**6.4**	**6.0**	**6.2**	**5.8**	**6.4**	**6.7**	**6.5**
Afghanistan	2.4	2.5	3.0	3.1	2.2	6.0	6.0	6.5
Bangladesh	7.1	7.3	7.4	7.4	5.9	5.4	5.9	5.5
Bhutan	6.4	6.8	7.0	7.3	4.0	4.5	5.0	4.8
India	7.1	6.6	7.2	7.4	4.6	3.7	5.0	5.2
Iran (Islamic Republic of)	13.4	4.5	5.1	5.3	9.0	10.0	10.9	10.5
Maldives	6.2	6.9	6.0	6.1	0.5	2.8	3.3	3.5
Nepal	0.4	7.5	4.6	5.1	9.9	4.5	6.0	5.8
Pakistan	4.5	5.3	5.6	6.0	2.9	4.2	4.9	5.2
Sri Lanka	4.4	3.7	4.8	4.9	4.0	7.7	5.2	5.0
Turkey	3.2	7.0	4.0	4.0	7.8	11.1	9.1	8.0
South-East Asia[d]	**4.6**	**5.1**	**5.1**	**5.2**	**2.2**	**2.9**	**2.9**	**3.2**
Brunei Darussalam	-2.5	0.1	1.0	1.5	-0.7	-0.1	0.3	0.5
Cambodia	6.9	6.8	6.9	6.8	3.0	3.1	3.6	3.3
Indonesia	5.0	5.1	5.3	5.4	3.5	3.8	3.5	4.0
Lao People's Democratic Republic	7.0	6.7	6.6	6.9	1.6	0.8	1.0	1.3
Malaysia	4.2	5.9	5.3	5.3	2.1	3.8	2.7	2.9
Myanmar	5.9	6.9	7.2	7.4	7.2	4.6	6.0	6.5
Philippines	6.9	6.7	6.8	6.9	1.8	3.2	4.1	3.5
Singapore	2.4	3.6	3.0	3.0	-0.5	0.6	1.0	1.3
Thailand	3.3	3.9	4.1	4.0	0.2	0.7	1.1	1.9
Timor-Leste	5.0	3.0	5.0	6.0	-1.3	1.0	2.7	3.6
Viet Nam	6.2	6.8	6.7	6.5	2.7	3.5	4.2	4.0
Memorandum items:								
Developing Asia-Pacific[f]	**5.4**	**5.8**	**5.5**	**5.5**	**3.4**	**3.2**	**3.5**	**3.5**
Least developed countries	6.0	6.8	6.8	6.9	5.8	4.9	5.6	5.5
Landlocked developing countries	2.2	4.4	4.0	4.3	10.2	7.8	6.4	6.1
Small island developing States	2.6	3.3	3.3	3.2	4.7	5.5	5.7	4.4
Developed Asia-Pacific economies[g]	**1.3**	**1.7**	**1.6**	**1.3**	**0.2**	**0.8**	**1.2**	**1.4**
Total ESCAP region	**4.2**	**4.7**	**4.5**	**4.3**	**2.5**	**2.5**	**2.8**	**2.9**

Source: ESCAP.

a Changes in the consumer price index.
b Estimates.
c Forecasts (as of 1 March 2018).
d Aggregate growth rates were calculated using 2015 GDP at 2010 United States dollars as weights, which is a change from the previous calculation method using 2010 GDP at 2010 prices. The update better reflects the current structure of economies. Largely reflecting the increase in China's weight, the shift in the base year resulted in increased aggregate growth by approximately 0.2 percentage points compared with the previous base year.
e The estimates and forecasts for countries relate to fiscal years defined as follows: 2017 refers to the fiscal year spanning the period from 1 April 2017 to 31 March 2018 in India; from 21 March 2017 to 20 March 2018 in Afghanistan and the Islamic Republic of Iran; from 1 July 2016 to 30 June 2017 in Bangladesh, Bhutan and Pakistan; and from 16 July 2016 to 15 July 2017 in Nepal.
f Developing Asia-Pacific economies consists of all countries listed in the table excluding Australia, Japan and New Zealand.
g Developed Asia-Pacific economies consists of Australia, Japan and New Zealand.

through cheaper imports, although this trend could be reversed, as discussed in section 5.1. Third, economies may still be operating below their potential, with slack capacity as mirrored in subdued growth in real wages and formal employment. Fourth, global value chains and e-commerce may be meeting demand at lower costs, while the increased use of robots in production processes places downward pressure on wages and prices (ESCAP, 2017b).

Box 1.1. Prospects for least developed countries

The Asia-Pacific region is home to 12 least developed countries. Achieving 7 per cent annual GDP growth is a target under Sustainable Development Goal 8, but only some of these countries are meeting this target. In 2017, Bangladesh, Cambodia, the Lao People's Democratic Republic, Myanmar and Nepal benefited from the favourable global and regional economic conditions and grew at or close to 7 per cent. The trade share of the Asia-Pacific least developed countries in world exports has risen in the last few years, indicating the increased role of trade in the economic development of these countries (figure A below).

Economic growth among least developed countries in the region is expected to remain robust in 2018 and 2019, with most least developed countries growing by 6-7 per cent or higher, with the exception of Nepal and the small island least developed countries. Bangladesh, Cambodia and Myanmar continue to benefit from the migration of low-cost manufacturing from such higher-wage economies as China, with positive spillover effects on their consumption and investment. Robust growth in Bhutan and the Lao People's Democratic Republic is supported by hydropower exports and investments, and large-scale transport infrastructure in the case of the Lao People's Democratic Republic. Nepal on the other hand will see growth moderate with the unwinding of post-earthquake reconstruction and subdued remittance flows. Small island least developed countries will also see growth moderate, including from weaker timber earnings in Solomon Islands and the unwinding of cyclone reconstruction in Vanuatu.

Figure A. Percentage share of Asia-Pacific least developed countries in world exports 2005-2016

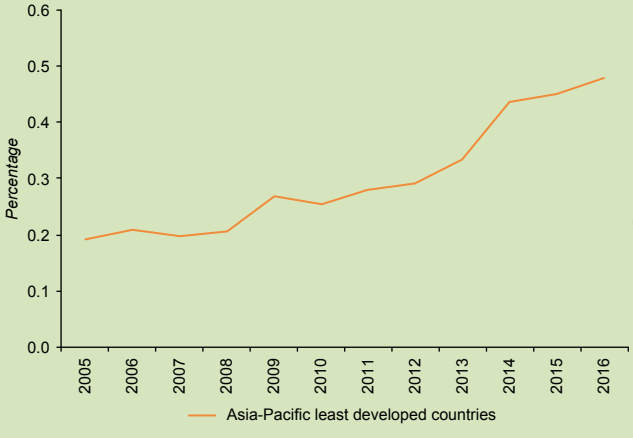
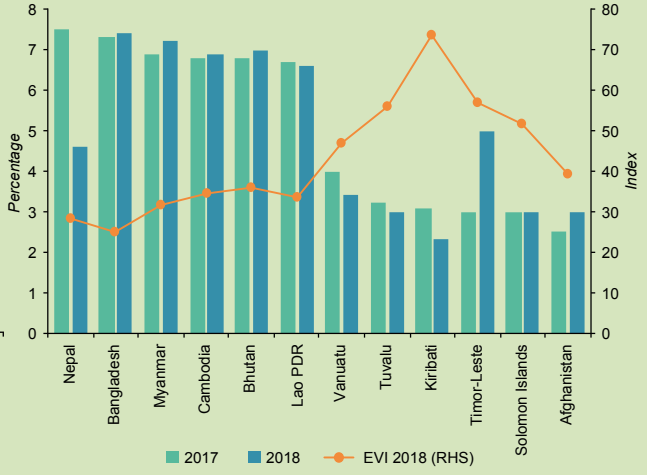


Figure B. Economic growth and vulnerability



Source: Table 1.1; United Nations Committee for Development Policy Secretariat, Triennial Review dataset 2000-2018. Available from www.un.org/development/desa/dpad/least-developed-country-category/idc-data-retrieval.html. (accessed 31 March 2018); and United Nations Comtrade Database. (accessed 31 March 2018).

Note: Economic Vulnerability Index (EVI), is a measure of structural vulnerability to economic and environmental shocks. A higher EVI represents a higher economic vulnerability. High vulnerability indicates major structural impediments to sustainable development.

Box 1.1. *(continued)*

Despite the generally positive near-term outlook, least developed countries remain highly vulnerable to terms-of-trade shocks and natural disasters, as reflected in high Economic Vulnerability Index (EVI) scores in figure B. Higher global oil prices, while providing a positive boost to oil exports from Timor-Leste, pose a downside risk for other least developed countries in the region through higher price pressures and adverse impacts on real incomes and consumption. Moreover, most least developed countries in the region are already faced with current account deficits due to large imports of capital goods for infrastructure projects; with higher oil prices, such deficits could further widen.

Least developed countries are also highly vulnerable to the impacts of environmental degradation and climate change through natural disasters and unusual weather patterns which have direct impacts on their agricultural output and productive capacity. Floods in Bangladesh and Nepal in the latter half of 2017 resulted in higher food prices. In 2015, the earthquake in Nepal and the cyclone that swept through Tuvalu and Vanuatu resulted in considerable loss of life, as well as damage to shelters and infrastructure, potentially pushing parts of the population into poverty. Furthermore, this year's Asia-Pacific Countries with Special Needs Development Report will examine how external shocks could trigger conflict and potentially result in a vicious cycle which undermines peace and development (ESCAP, 2018a).

The medium-term economic outlook for least developed countries depends critically on addressing infrastructure and skills deficits. While there has been positive progress, least developed countries face the challenge of raising sufficient resources to fund much needed infrastructure investments, as they have a small private sector and underdeveloped capital markets and thus rely on limited domestic public finance and on official development assistance (ESCAP, 2017c). At the same time, lack of high-skilled labour to capitalize on technological innovation is affecting their productivity growth as well as their prospects for expanding decent jobs. In Cambodia and Nepal, for instance, employment in high-skilled labour constitutes a mere 5 per cent of total employment. Thus, there is a need to develop human resources capacity to take on more skilled labour. Otherwise, there is risk of a slower catch-up and widening gap with more developed economies which are taking advantage of new technologies to further boost their productivity growth.

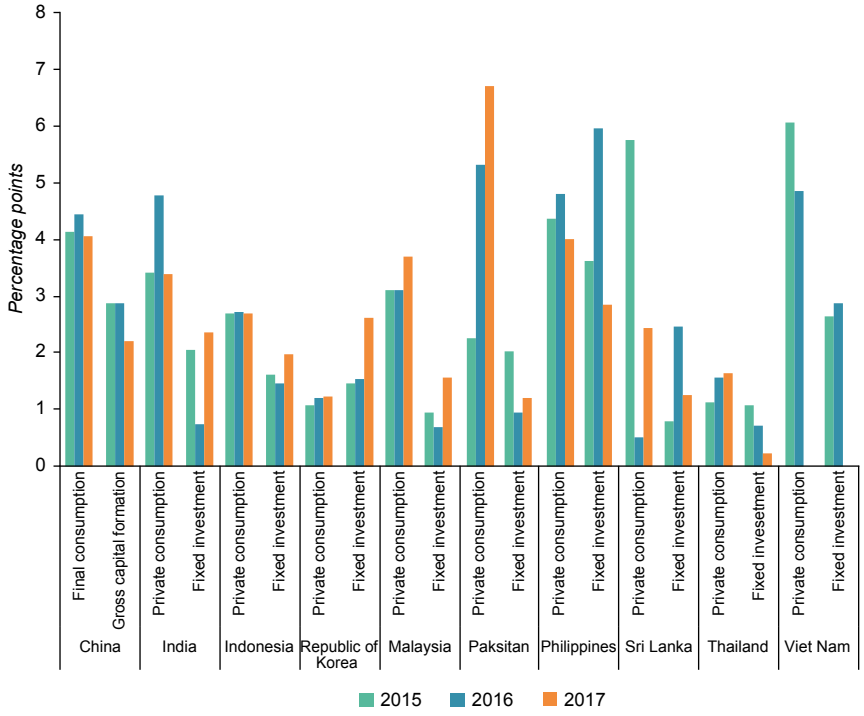
2.4. Consumption, investment and trade dynamics – strengthening the drivers of growth

Consumption

In line with the region's growing purchasing power, domestic private consumption has been the major economic growth driver in recent years (figure 1.3). Such consumption has been supported by low inflation and ease of borrowing at low interest rates as well as stable labour market conditions. Over the past year, in line with the broader economic recovery, consumer confidence indicators have also been rising in several countries. In China, rapidly expanding e-commerce and mobile payments are supporting consumption growth. Consumption also strengthened in India as the impacts of demonetization faded and in the Russian Federation, as inflation and unemployment rates declined. Another contributing factor has been the recovery in remittance flows, especially in North and Central Asia.

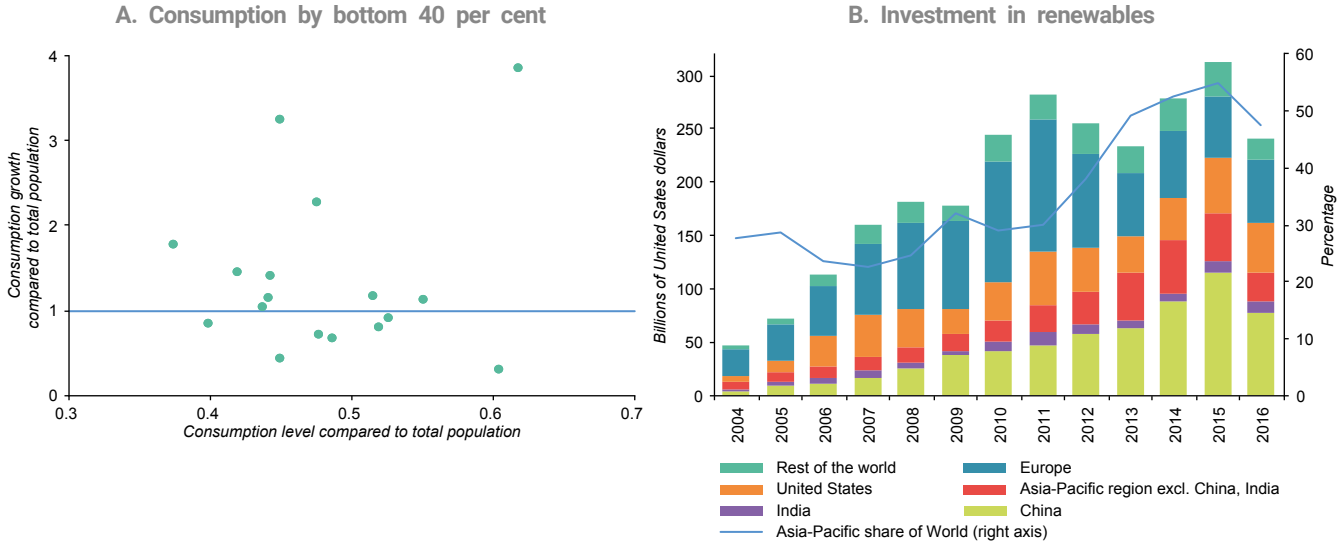
The relatively strong performance in consumption may come as a surprise given that exports and investments were relatively sluggish in recent years. A possible reason is that, compared with subdued wage growth, property and financial asset prices were buoyant, fuelling consumption by the rich, as reflected in strong sales of luxury goods. Indeed, the consumption share of the top quintile has been increasing while the other quintiles have seen their shares decrease since the 1990s. More recent data reveal that, in nearly half of the countries in the region, consumption of the bottom 40 per cent, already substantially low, grew at a slower pace than that of the average household (figure 1.4). Thus, beyond the

Figure 1.3. Contribution to GDP growth of private consumption and fixed investment



Source: ESCAP, based on CEIC Data. Available from www.ceicdata.com (accessed 1 March 2018).

Figure 1.4. How inclusive and sustainable is domestic demand?



Source: ESCAP, based on Global Database of Shared Prosperity and International Renewable Energy Agency.

Note: Panel A: blue dots below the blue line (1 on the y-axis) indicate countries where consumption of the bottom 40 per cent grew at a slower pace than the average household. The x-axis shows that consumption level of the bottom 40 per cent is less than half of that of the average household in many countries. Panel B: the bars and left axis show that the region's investment in renewable energy (combined light green, purple and red bars) has steadily increased to reach $171 billion in 2015. The dark blue line and right axis show that the region now accounts for half of the world's investment in renewable energy, such as solar and wind.

aggregate figures, assessment is needed on just how broad-based is consumption growth and whether or not particular groups are left behind.

Consumption-led economic growth may turn out to be rather fragile over time. This is because, without consistent increases in real wages backed by rising productivity, such growth can lead to debt accumulation and entail financial vulnerability. Robust investment is critical for sustained income growth, on which consumption ultimately depends. Thus, having a balanced aggregate demand mix is important, and some progress seems to be taking place. In South Asia, where the nominal share of investment is relatively low, investment growth is projected to outpace private consumption growth in the coming years, while in East Asia, particularly in China, where investment rates are relatively high, private consumption growth is projected to outpace investment growth (World Bank, 2018a).

Investment

Investment performance was relatively weak in recent years amid heightened global uncertainty. In India, weak corporate and bank balance sheets also contributed to a sharp slowdown in investment; thus, simply lowering policy interest rates was not enough to revive investment in that country. Over the past year, there has been a welcome recovery in investment. In line with firmer global demand and stronger trade, investment in export-oriented manufacturing sectors picked up. Increased public infrastructure outlays have also supported strong investment in such countries as Indonesia and Pakistan.

While leading indicators, such as the Purchasing Managers Index (PMI), would suggest further recovery in private investment in 2018, it could be short-lived due to protectionist trade measures and expected tighter financial conditions. Persistently low tax revenues and higher sovereign borrowing costs could also weigh on public investment. In China, investment growth is expected to ease further as financial stability gains higher policy priority and government efforts to curb pollution and overcapacity in certain industries continue. However, investment in high-technology manufacturing is expected to remain strong (ESCAP, 2017a). In India, the new bankruptcy code and the recapitalization package for public sector banks are expected to support a gradual recovery in private investment.

Beyond cyclical recovery, policy attention is needed concerning the long-term determinants of investment. Countries which successfully transformed their economies sustained high investment rates for an extended period. How did they do it? Based on the literature and the region's own experience, aggregate demand, cost of capital, financial development, trade openness, macroeconomic stability and regulatory quality turned out to be key determinants (box 1.2). Moreover, given that investment slowdowns tend to incur high economic loss and last for a long time if associated with balance sheet difficulties, appropriate support measures for swift recovery may be required (India, Ministry of Finance, 2018).

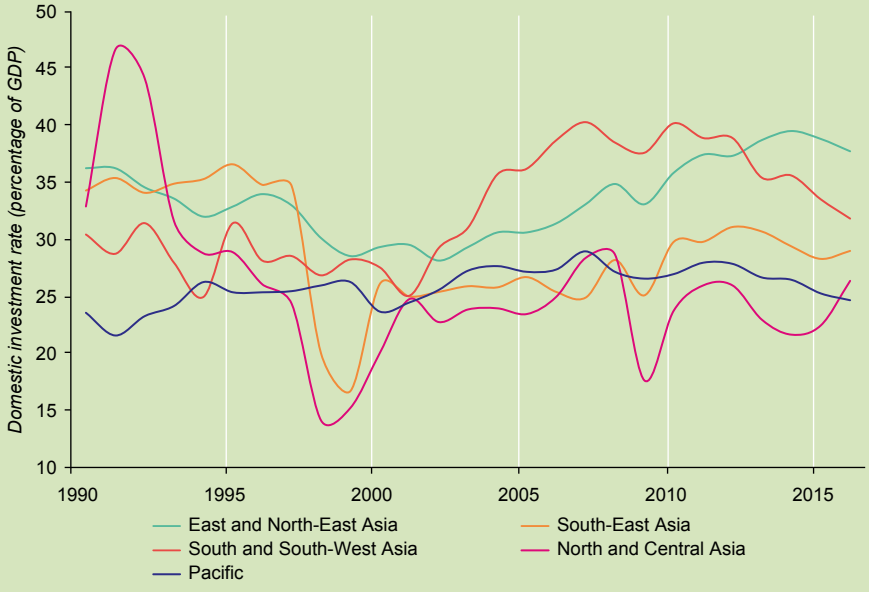
At the same time, there is a need to better assess the economic, social and environmental impacts of investment, including FDI. While the aggregate economic benefits of FDI are well known (including formal sector jobs, technology transfer and participation in global value chains), inequality and carbon emissions could increase if there are no complementary policy measures. As illustrated through a computable general equilibrium analysis, an integrated approach which includes implementation of income transfers and carbon-reducing technologies would deliver greater benefit (ESCAP, 2017d). Countries should scale up investments directly linked to sustainable development. For instance, the Asia-Pacific region's investment in renewable energy has grown rapidly in the past decade, reaching $171 billion in 2015; the region's share in global investment in renewable energy has risen from less than 30 per cent to about 50 per cent in the past decade (figure 1.4). Similarly, stimulating investment in innovative, higher value-added sectors could expand decent jobs.

Box 1.2. Investment trends and their determinants

The Asia-Pacific region's rapid economic growth in recent decades was supported by high savings and investment rates. After suffering a setback during the 1997/98 Asian financial crisis, investment rates, as a percentage of GDP, rose steadily in the 2000s before stabilizing at about 35 per cent, which is significantly higher than the global average of 23 per cent. This was, however, largely driven by China, which increased its investment rate by some 20 percentage points between the early 1990s and the early 2010s, and which now accounts for more than half of total investment in the region. Excluding China, the region had an investment rate of 26 per cent, only marginally higher than the global average and with a declining trend in recent years. An assessment of ESCAP subregions further reveals that South and South-West Asia experienced a significant slowdown since the early 2010s, largely owing to banking sector problems in India. This is worrying in view of the subregion's low productivity levels and wide infrastructure gaps.

What might explain these divergent trends? A panel regression analysis of 29 countries in the region over the period 1990-2016 shows that, in line with the literature, output level and growth positively affect investment, whereas the cost of capital (as proxied by the real interest rate) has a negative effect. Trade openness turns out to be significant, but financial openness (proxied by the Chinn-Ito index) is insignificant; this situation likely reflects the region's high trade integration and relatively low levels of capital account liberalization, including in major economies, such as China and India. Financial development is positive and significant when proxied by domestic credit extended to the private sector, but insignificant when proxied by stock market size, which likely reflects bank dominance and underdeveloped capital markets in the region. Macroeconomic stability (proxied by inflation) has a negative effect; high inflation could increase information costs and currency risks for foreign investors.

Figure A. Investment rate by ESCAP subregions



Source: ESCAP Statistical Database.

What are the policy implications? Given that investment is highly elastic to aggregate demand, countercyclical fiscal policy could support investment during economic downturns. While promoting financial development, including capital markets, adequate financial oversight is needed to avoid "boom-bust" cycles. Enhanced trade integration could help firms gain intermediate inputs for investment and provide economies of scale. Moreover, better governance, including in regulatory quality, would create an enabling environment for robust investment (ESCAP, 2017a).

Trade

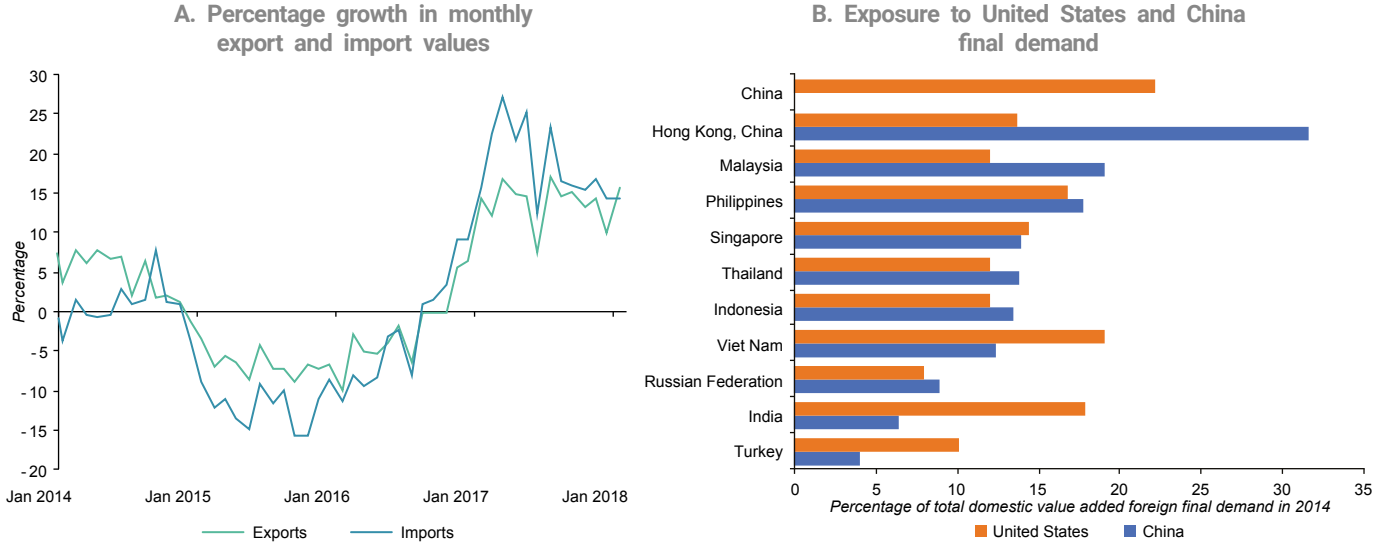
Following two years of unusually weak performance, global trade growth rebounded in 2017 from a low base. Developing countries in the Asia-Pacific region experienced a broad-based pickup in trade (figure 1.5), with export and import volumes expanding by an estimated 6.6 and 9 per cent respectively (table 1.2). Along with a firmer recovery in developed economies, stable growth in China supported regional trade. The strong rebound in electrical and electronic goods trade was a major booster, given its extensive use of regional production networks.

Despite the improved global trade outlook, some moderation is expected in 2018, with the region's export and import volumes projected to grow by 4 and 4.3 per cent respectively (table 1.2). This is because a high "base effect" will kick in, contrary to the uptick in 2017, which was measured against the previous year's weak performance. Also, given that intraregional trade takes up more than half of total trade, with China playing a central role as a production network hub and increasingly as source of final demand (figure 1.5), growth moderation in China could be reflected in its import demand, especially for metals and other investment-related goods.

The medium-term trade outlook is uncertain. On one hand, the explosive growth in global trade in the decade following China's accession to the World Trade Organization (WTO) will not be replicated. China's industrial upgrading has also reduced its import demand for intermediate goods, which are now being sourced domestically. On the other hand, substantial scope remains for greater trade integration of South Asian economies and least developed countries. It is encouraging that the share of least developed countries in global exports has steadily increased, albeit from very low levels (box 1.1). Technological progress and trade facilitation could also support small firms' integration into global value chains.

Trade has contributed to the region's rapid economic growth and poverty reduction in recent decades, but has come under increased scrutiny in recent years amid rising income inequality and wealth concentration. Trade liberalization measures, pursued in a multilateral manner, are needed. However, the debate over the benefits of trade is getting diluted in dealing with rising

Figure 1.5. Trade performance and final demand



Source: ESCAP based on CEIC Data. Available from www.ceicdata.com (accessed 1 March 2018); and OECD-WTO, Trade-in-Value Added Database.

Note: Panel A shows the average value for 10 major regional economies. Panel B shows that China is now on par with the United States in terms of final demand for regional exports, especially for South-East Asian economies.

Table 1.2. Export and import growth, 2017-2019

(Annual percentage change)

	Exports									Imports								
	2017			2018[a]			2019[a]			2017[a]			2018[a]			2019[a]		
	Value	Price	Volume	Value	Price	Volume	Value	Price	Volume	Value	Price	Volume	Value	Price	Volume	Value	Price	Volume
Australia	18.3	9.0	8.5	-4.0	-9.3	5.9	5.6	0.6	4.9	8.2	2.8	5.3	3.1	1.3	1.8	4.8	1.7	3.1
Azerbaijan	22.1	..	..	5.3	..	..	-3.4	..	..	-3.0	0.0	-3.0	4.0	2.0	2.0	4.9	2.0	2.8
Bangladesh	5.0	3.6	1.4	7.2	1.4	5.7	6.0	1.7	4.2	18.8	0.7	18.0	3.8	-1.5	5.4	3.9	-1.2	5.2
China	9.4	4.0	5.2	7.9	3.9	3.8	7.6	3.2	4.3	16.2	6.6	9.0	6.6	2.6	3.9	7.2	3.9	3.2
Hong Kong, China	8.1	1.5	6.5	7.0	2.2	4.7	6.8	2.3	4.4	8.2	1.6	6.5	6.8	2.9	3.8	6.9	2.5	4.3
India	11.9	-4.7	17.4	10.3	-5.5	16.7	3.3	-2.1	5.5	18.2	6.4	11.1	13.1	3.5	9.3	1.6	-0.3	1.9
Indonesia	16.4	5.7	10.1	16.1	6.2	9.4	10.9	3.5	7.2	15.5	6.6	8.4	19.4	6.7	11.9	16.2	7.3	8.3
Iran (Islamic Reppublic of)	18.0	9.3	8.0	10.3	7.1	3.0	6.0	-1.0	7.1	21.0	25.9	-3.9	9.2	12.9	-3.3	9.0	12.0	-2.7
Japan	7.7	5.6	2.0	8.4	5.6	2.6	9.8	12.0	-2.0	9.4	10.0	-0.6	10.1	11.7	-1.4	9.0	6.8	2.1
Kazakhstan	32.2	21.7	8.6	16.7	10.7	5.4	1.0	-2.1	3.2	13.1	8.3	4.5	8.8	5.0	3.6	5.6	2.2	3.3
Malaysia	14.3	4.4	9.5	11.5	3.3	8.0	9.5	3.1	6.2	16.9	5.2	11.1	13.0	2.5	10.3	11.8	4.2	7.3
New Zealand	13.7	13.2	0.4	0.6	-4.9	5.8	3.8	-0.8	4.6	11.0	5.3	5.4	0.7	-0.6	1.3	4.2	1.5	2.6
Pakistan	6.4	2.0	4.3	6.2	1.2	4.9	4.5	0.7	3.8	21.9	5.2	15.9	5.7	2.4	3.3	1.3	-6.9	8.8
Philippines	14.3	-5.8	21.3	16.8	4.2	12.1	13.7	2.5	10.9	13.3	-5.1	19.4	10.9	0.9	9.9	10.5	1.9	8.5
Republic of Korea	25.5	15.5	8.6	11.7	8.7	2.7	3.1	-0.7	3.8	24.2	3.9	19.5	5.8	4.1	1.6	5.2	1.2	3.9
Russian Federation	10.0	9.5	0.4	8.5	6.7	1.7	4.2	3.4	0.8	14.8	8.2	6.1	9.6	6.9	2.5	3.7	-1.0	4.7
Singapore	12.8	8.9	3.5	6.5	9.1	-2.4	7.2	5.3	1.8	16.4	9.3	6.4	5.0	3.9	1.1	4.6	1.3	3.3
Sri Lanka	10.6	5.6	4.8	8.6	3.4	5.0	7.6	2.1	5.4	9.6	6.6	2.9	10.2	4.0	5.9	6.5	1.4	5.0
Taiwan, Province of China	12.1	4.6	7.2	5.6	2.1	3.4	4.4	2.0	2.4	11.6	7.6	3.7	6.6	3.4	3.1	4.8	0.7	4.1
Thailand	13.4	6.2	6.8	4.8	2.7	2.0	2.7	1.0	1.6	15.8	5.4	9.8	5.9	3.3	2.6	4.9	0.6	4.3
Turkey	10.9	1.3	9.4	9.0	4.0	4.8	6.6	2.1	4.5	17.7	7.5	9.5	7.6	2.0	5.5	5.4	1.3	4.1
Viet Nam	20.2	5.5	13.9	10.1	3.2	6.7	8.7	2.4	6.1	26.8	9.3	16.1	10.3	3.6	6.5	9.4	2.9	6.3
Asia-Pacific[b]	11.8	5.6	6.1	8.0	4.0	3.9	6.8	3.4	3.4	14.9	7.3	7.6	8.0	4.5	3.5	6.6	2.8	3.8
Developed Asia-Pacific[b]	10.3	6.7	3.6	5.1	1.5	3.6	8.6	8.5	0.1	9.2	8.2	1.0	8.0	8.6	-0.6	7.9	5.5	2.3
Developing Asia-Pacific[b]	12.0	5.4	6.6	8.4	4.4	4.0	6.5	2.5	4.0	15.9	6.9	9.0	8.0	3.7	4.3	6.4	2.3	4.1

Source: United Nations, Economic and Social Commission for Asia and the Pacific, *Asia-Pacific Trade and Investment Report 2017* (March 2018 update).

Note: The estimated growth rates are calculated based on constant prices (in 2010 terms).

a Projections.

b Regional trade growth is the trade-weighted, time-varying average growth rate.

inequalities. Trade is key to implementing the 2030 Agenda, but just as is the case with economic growth, it cannot be a sufficient condition for achieving sustainable development. Efforts are needed to make trade more inclusive and eco-friendly, including through complementary policy measures to help adversely affected workers and firms through their transition.

3. Subregional economic updates – diversity of the region

3.1. East and North-East Asia

The East and North-East Asian subregion accounts for a large share of the region's total GDP and trade. With a rapidly ageing population and as a leader in technology and innovation, the subregion also has a relatively high income and large surplus savings. Most countries in the subregion are net energy importers.

In 2017, economic growth in this subregion accelerated to 4.6 per cent, from 4.2 per cent in 2016, on the back of strong domestic consumption and recovery in external demand. China achieved faster economic growth for the first time since 2010. Consumption grew faster than investment and services faster than industry in line with ongoing rebalancing efforts. In Japan, the unemployment rate declined to a record low. In the Republic of Korea, such export sectors as semiconductors experienced strong growth. Similarly, the economy of Hong Kong, China benefited from stronger global demand, and the gambling sector in Macau, China profited from stronger tourist arrivals. Mongolia's economy rebounded despite budget cuts, benefiting from non-mining construction, the price hike for coal and stronger external demand for this commodity (partly due to reductions in China's coal production). While the Democratic People's Republic of Korea does not release official economic statistics, international sanctions are likely to be having a significantly negative impact on its economy.

In 2018 and 2019, the subregion's economies are likely to continue benefiting from an improved external environment as well as strong domestic demand, but at a slower pace of 4.3 and 4 per cent respectively. Notably, growth in China is expected to ease steadily as financial stability gains higher policy priority. Japan is expecting continued moderate recovery on the back of supportive monetary and fiscal policy measures; however, a widening primary deficit and very high government debt raise concerns. In the Republic of Korea, the planned increase in employment and social spending are expected to boost household income and consumption. Higher minimum wages will support equity objectives but could weaken competitiveness if there are no commensurate productivity gains. Mongolia remains vulnerable to commodity price swings. A three-year programme of the International Monetary Fund (IMF) in that country is aimed at strengthening the banking sector and improving fiscal policymaking.

Inflation in most countries was subdued in 2017, except for Mongolia where the depreciation of the currency and a tax hike on fuel pushed up the inflation rate. Inflation in the subregion is projected to accelerate in 2018 and 2019, but to still manageable rates of 1.6 and 1.8 per cent respectively compared with 1.2 per cent in the previous two years.

While China and the Republic of Korea have relatively strong fiscal positions, spending on health care and pensions is expected to increase significantly in the future in line with rapid population ageing. There is scope for the subregion's surplus savings, including pension fund assets, to be better channelled to the rest of the region's investment needs, which could provide high returns and thus be mutually beneficial. Outbound investments from this subregion already account for a large share of intraregional FDI. On trade, China is promoting the vision of the proposed "Free Trade Area of the Asia-Pacific", which would build on the proposed "Regional Comprehensive Economic Partnership", an ASEAN+6 trade deal currently under negotiation. In the absence of the United States, Japan championed negotiations on the Trans-Pacific Partnership (TPP), another

mega trade deal which also includes, among other countries, Australia, Brunei Darussalam, Malaysia, New Zealand, Singapore and Viet Nam in the ESCAP region. The modified TPP was signed in March 2018 and is now called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

3.2. South and South-West Asia

The South and South-West Asian subregion accounts for a large share of the region's total population and an even greater share of its youth population. The incidence of poverty and the share of vulnerable employment in the subregion are relatively high, and there are wide infrastructure gaps. There is significant scope for greater trade integration. Most countries in the subregion are net energy importers.

In 2017, economic growth decelerated to 6.4 per cent, from 6.6 per cent in 2016. Despite the slowdown, it remains the fastest-growing subregion in Asia and the Pacific. In fact, growth accelerated in all but two countries: India and Sri Lanka. The recently introduced goods and services tax (GST) as well as protracted issues of corporate and bank balance sheet problems pushed the growth rate of India downward. For Sri Lanka, growth moderated further due to severe weather disruptions. In Bangladesh, robust growth has been supported by domestic demand, especially large infrastructure projects and new initiatives in the energy sector. Remittance flows have also started to increase with the increase in global oil prices.

Economic growth is forecast to further moderate to 6 per cent in 2018 before picking up to 6.2 per cent in 2019. Further moderation this year is largely due to Turkey and to a lesser degree Nepal, where the effects of fiscal stimulus and reconstruction are fading; however, growth elsewhere will accelerate. In India, a gradual recovery is expected; private investment is expected to revive as the corporate sector adjusts to GST, infrastructure spending increases and corporate and bank balance sheets improve with government support. Further growth acceleration is projected for Pakistan on the back of increased infrastructure investment; however, wide fiscal and current account deficits raise concerns. Similarly, while Bangladesh is expecting faster growth, the banking sector has been plagued by financial scams, non-performing loans and weak monitoring problems, which might cause a macroeconomic risk in the near term. Sri Lanka's exports are likely to benefit from the reinstatement of the GSP+ component of the European Union's Generalized Scheme of Preferences for developing countries. Growth in the Islamic Republic of Iran is expected to pick up slightly, with higher investment growth offset by lower oil production and limited access to finance.

Inflation accelerated in 2017 mainly as a result of increased food and fuel prices following severe floods in several countries and rising global oil prices. In India, higher inflation was also due to the housing rent allowances for civil servants and military staff recommended by the Seventh Pay Commission. While inflation is expected to remain stable in the forecast period, risks are posed by global oil prices (box 1.4). If higher oil prices require tighter monetary policy to meet the inflation target, real interest rates could exert a drag on consumption.

At the same time, fiscal space is relatively limited in most countries, owing to persistently low tax revenues and high debt-servicing costs. In the wake of upcoming national elections in several countries (Afghanistan, Bangladesh, India, Maldives and Pakistan), effective fiscal management is even more important. Despite progress, the subregion suffers from wide development gaps, especially in social indicators of education and health but also in infrastructure and energy. While the subregion is home to some of the most successful social programmes in Asia and the Pacific, including cash transfers and employment guarantee schemes, further progress is needed to reduce leakage, including by leveraging technology. India has announced in its new budget a major plan to extend health insurance to some 500 million people in financially vulnerable households. Further progress is also needed to improve female labour participation and working conditions (ESCAP, 2016a).

3.3. North and Central Asia

The North and Central Asian subregion accounts for a large share of the region's energy supply. With limited economic diversification, however, most economies in the subregion remain vulnerable to commodity price swings, as has been witnessed in recent years. Most countries are landlocked, posing an additional constraint for integration into the global economy. The economy of the Russian Federation has experienced wide spillover effects through trade, investment and remittances.

In 2017, economic growth rebounded to 2.3 per cent, from 0.3 per cent in 2016, led by the Russian Federation, which emerged from a two-year contraction, and stronger growth in Kazakhstan. The upturn was clearly driven by higher oil prices and more stable inflation, credit and employment conditions as countries recovered from the 2014 terms-of-trade shock. In the Russian Federation, prudent fiscal management and bank recapitalization supported macroeconomic stability, while structural reforms, including the reorganization of agricultural business entities, have helped to increase productivity. However, Azerbaijan underwent another year of recession as banking sector problems constrained credit growth, and external stability concerns prompted monetary tightening.

The economic outlook is stable, with growth expected to be sustained at 2.3 and 2.2 per cent in 2018 and 2019 respectively. This positive situation is underpinned by stable growth in the Russian Federation. Growth will ease in Kazakhstan as one-off effects of increased oil production and fiscal stimulus start to wane. The market integration process driven by the Eurasian Economic Union is expected to support greater intrasubregional trade and facilitate stable remittance flows. The 2017 accession of India and Pakistan to the Shanghai Cooperation Organisation offers an opportunity for the subregion to connect with South Asia along with several regional energy projects, such as the Central Asia-South Asia electricity transmission system, commonly known as CASA-1000. Gas trade with South Asia could be expanded though the Turkmenistan-Afghanistan-Pakistan-India pipeline. The recently agreed Lapis-Lazuli Corridor would also strengthen transit and transport cooperation between Afghanistan, Azerbaijan, Georgia, Turkey and Turkmenistan.

Inflation decelerated to 4.5 per cent in 2017, from 7.8 per cent in 2016, and the outlook is stable. The deceleration was due to more stable exchange rates in Kazakhstan and the Russian Federation. Inflation remained high in Azerbaijan but is expected to ease in the forecast period. Overall, lower inflation has enabled more accommodative monetary stances, supporting the subregion's economic recovery.

While most countries have low government debt-to-GDP ratios, the terms-of-trade shock in 2014 had significant revenue implications and has turned the debt trajectory towards an upward trend. Thanks to prudent fiscal management during the commodity boom years, many countries had fiscal space for economic stabilization against the shock. However, diversification of revenue sources is a priority in going forward. Several countries, including Azerbaijan and Tajikistan, also need to address problems in the banking sector. Strengthening the subregion's financial sector will be important for supporting entrepreneurship, economic diversification and infrastructure development.

3.4. South-East Asia

In 2017, several economies in South-East Asia experienced higher-than-expected economic growth owing to the rebound in global trade and domestic stimulus measures. For example, in Thailand the Fiscal Policy Office upgraded its economic growth forecast for 2018 to 4.2 per cent, from 3.8 per cent (Chaitrong, 2018). Other economies, such as Malaysia and Singapore, expanded at a slightly slower pace in the fourth quarter of 2017, but their prospects for growth in 2018 remain solid.

Overall for the subregion, economic growth in 2018 and 2019 is expected to be strong at 5.1 and 5.2 per cent respectively. Some economies are particularly buoyant: Cambodia, Myanmar and Viet Nam will continue to record growth

rates exceeding 6 per cent owing mainly to relatively low wage costs and their advantageous geographical locations. Economic performance is clearly supported by exports, which are expected to remain steady and continue contributing to economic growth in 2018 (table 1.2). However, macroeconomic risks identified in section 4 could weigh on South-East Asia's outlook, including trade protectionist measures and financial risks related to capital flows and domestic private debt.

Currently, most countries in the subregion show relatively low and stable inflation, including some that in the past struggled due to natural disasters, which disrupted the supply chain and pushed prices upward. For instance, the Philippines central bank, which has an annual inflation target of 2-4 per cent, met its goal six times in the past eight years; in the two times that it did not, prices were low. In the context of ongoing monetary normalization in the United States, further policy rate cuts are unlikely, especially given that monetary policy stances are already very accommodative, with policy rates at a historic low in some countries. Only Indonesia has reduced its policy rate in recent months.

Several policy developments are worth noting. FinTech is picking up momentum. In 2017, Indonesia recorded foreign investment in the digital economy worth $4.8 billion (Jakarta Post, 2018). The country's central bank launched the National Payment Gateway (*Gerbang Pembayaran Nasional*), an integrated electronic payment system that reduces the cost that banks charge customers from 2-3 per cent to 1 per cent. Also in the realm of FinTech, other countries, such as Thailand, are currently studying how to regulate such segments as cryptocurrencies.

Infrastructure investment remains an important priority. In the Lao People's Democratic Republic, issuing bonds is one of the steps that have been taken to address the budget deficit and ease budgetary tensions: in 2018, the Government plans to issue domestic bonds worth 3.3 trillion kip and other bonds worth 3.2 trillion kip ($400 million). There have also been several trade enhancement measures. In December 2017, the central banks of Indonesia, Malaysia and Thailand announced the launching of a local currency settlement framework between them, which is aimed at boosting trade and operational efficiency. In January 2018, China and Thailand extended for two more years a currency swap agreement initially agreed in 2014.

Several countries in South-East Asia are part of major trade negotiations, including the proposed "Regional Comprehensive Economic Partnership". In March 2018, Brunei Darussalam, Malaysia, Singapore and Viet Nam joined other countries from Asia and the Pacific as well as other regions to become parties to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership, which will come into force in 2019. Others such as Indonesia and the Philippines have expressed interest as well. In this new TPP agreement, also known as TPP11, remarkably few of the original provisions were frozen, making the agreement "one of the world's most exacting trade pacts, measured by openness to investment from other members, the protection of patents and environmental safeguards" (Economist, 2018). Only a few concessions have been made; for instance, Malaysia will not immediately have to liberalize its State-owned enterprises, and Viet Nam can put on hold new rules about resolving labour disputes and allowing independent trade unions.

3.5. Pacific

Pacific island developing economies are typically small in terms of population and land area and have limited resources. When combined with their narrow economic base, these conditions make them especially vulnerable to external shocks, including natural disasters, which have become more frequent. A sizeable proportion of Pacific islanders, particularly in rural and outer islands, lack access to basic public services, such as safe drinking water, sanitation, reliable sources of energy, education and health care. As a result, levels of hardship remain relatively high in most of these countries, exacerbated by youth unemployment and limited private sector development.

The subregion's ability to sustain economic growth has been hampered by a range of

factors. Limited access to, and the costs of, connectivity through transport, energy and information and communications technology infrastructure networks, and low human and institutional capacities remain key constraints. External factors include the impacts of natural disasters, variable and limited investment, trade and aid flows.

In 2017, Pacific island developing economies collectively grew by 2.6 per cent, up from 2 per cent in 2016, broadly supported by tourism activities, resource and agricultural production and infrastructure upgrades. Economic growth remained highly uneven across economies. Improved agricultural and mineral production boosted growth as did spending in preparation for hosting the 2018 Asia-Pacific Economic Cooperation (APEC) meetings in Papua New Guinea, a country which accounts for close to 60 per cent of the total GDP of the Pacific island developing economies. In Fiji, tourism, retail trade, manufacturing, construction activity and infrastructure upgrades supported growth. Similarly, Vanuatu's economy benefited from ongoing infrastructure upgrades, as well as from tourism activity. The economies of Marshall Islands and the Federated States of Micronesia rebounded, based on higher spending on infrastructure, while growth remained solid in Solomon Islands and Tonga based on retail trade and construction output. The smaller atoll economies of Kiribati and Tuvalu received windfall fishing licence revenue, which resulted in increased public spending and infrastructure projects in support of growth. The economies of Cook Islands, Nauru, Palau and Samoa slowed for several reasons, including lower tourism and retail trade activities and the tapering of public spending. In 2018 and 2019, the subregion's economies are expected to benefit from a supportive domestic and external environment, with growth remaining stable at 2.6 and 2.5 per cent respectively.

Inflation in most countries was subdued in 2017, except for Papua New Guinea where currency movements and drought affected the local food supply, and for Nauru where food and fuel prices raised the inflation rate. In 2018 and 2019, inflation in the subregion is forecast at 6.2 and 4.5 per cent respectively compared with 6.1 per cent in 2017, being still at manageable levels for most countries, except Papua New Guinea due to expected spillover effects of the drought.

Economies in the subregion have comparative advantages in certain niche and higher value-added industries, such as sustainable tourism, organic agriculture and fishery activities. At the same time, further reforms are needed to move away from producing and exporting primary commodities, while boosting entrepreneurship and innovation to increase countries' competitiveness. In addition, to raise household income levels, global employment opportunities in the security industry, sports, caregiving, seafaring and various seasonal work schemes can be further tapped.

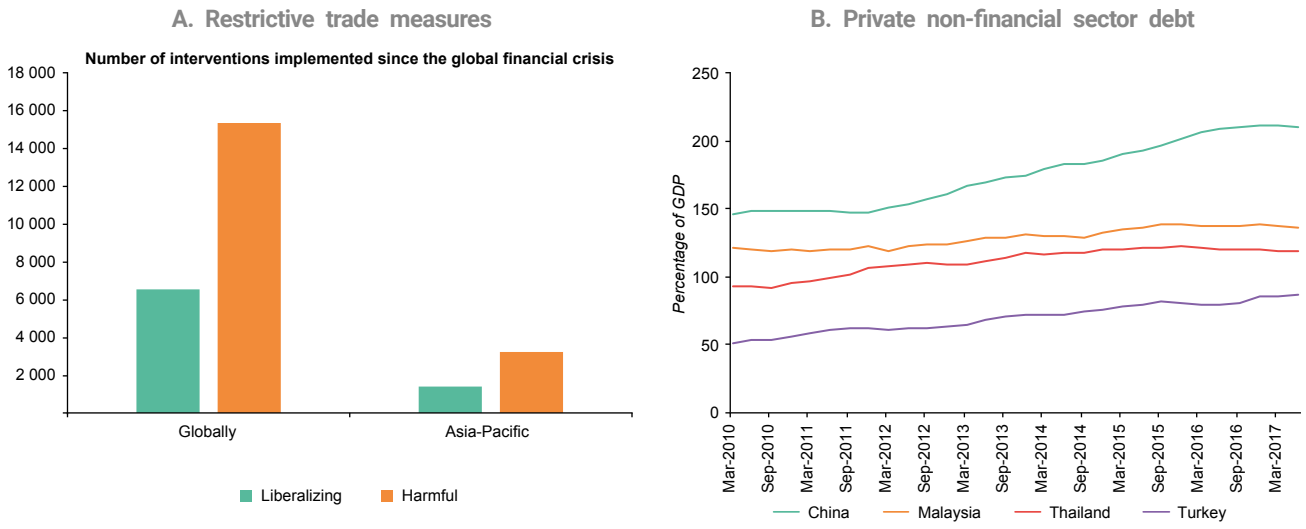
4. Macroeconomic risks and medium-term challenges to the economic outlook

4.1. Protectionism, financial risks and commodity prices – examples of key macroeconomic risks

While the region's economic outlook for 2018 and 2019 is broadly stable, uncertainties and risks loom on the horizon. Elevated levels of policy uncertainty continue to cloud prospects for global trade, migration and climate targets, and may delay a more broad-based rebound in global investment and productivity (United Nations, 2017).

Trade protectionism casts a shadow on the chances for a consistent revival in trade. In the aftermath of the global financial crisis that started almost a decade ago, the use of trade-restrictive measures rose considerably (figure 1.6), including non-tariff measures, which are less transparent and could be more harmful than other measures. According to WTO data (which are based on what member States report to WTO), there was a moderation in trade intervention in 2017 in terms of both restrictive and liberalization measures. Based on an alternative source, such as the Global Trade Alert, however, it is estimated that, for each

Figure 1.6. Trade barriers and financial vulnerabilities



Source: ESCAP, based on Global Trade Alert. Available from www.globaltradealert.org (accessed 1 March 2018); and Bank for International Settlements. Available from www.bis.org (accessed 1 March 2018).

Box 1.3. Steel tariffs by the United States: A prelude to a trade war

On 8 March 2018, the President of the United States, signed an executive order that would impose tariffs of 25 and 10 per cent on imports of steel and aluminum respectively. Imposition of steel tariffs is not new for the United States, nor is it the only measure having impacts on this sector. This time, however, the rationale behind the action refers to "national security", permitted under Article XXI (entitled "Security Exceptions") of the General Agreement on Tariffs and Trade 1994. As Article XXI has never been subjected to the dispute settlement mechanism and the "national security" rationale cannot be challenged in the World Trade Organization (WTO) – despite the fact that Unites States military requirements for steel and aluminum account for only 3 per cent of local production – the only option left is retaliatory action, potentially leading to a trade war.

There are rarely good economic arguments for imposing import tariffs, particularly when looking beyond a narrow sectoral/group protectionist interest. Indeed, tariffs imposed during the presidency of George W. Bush, which were applied for only 21 months, while linked to an increase of 3,500 jobs in steel industry employment, came at a staggering cost of $400,000 per job created or preserved. The current tariffs are also likely to result in job losses in sectors depending on competitively priced steel and aluminum, such as automobile manufacturing and the production of beverages. Judging by the impact of the 2002 tariffs, the latest round of tariffs could result in the loss of 200,000 jobs.

The tariffs on steel and aluminum, as well as other protectionist measures invoked or threatened, should be seen as continuation of the current United States Administration's unorthodox negotiating tactics that started with its withdrawal in January 2017 from the Trans Pacific Partnership, promising much "better" deals to be negotiated bilaterally. It appears that the United States Administration has decided to first raise the barriers to trade and then remove them in a selective manner, based on concessions captured by the negotiating parties. Indeed, 65 per cent of imported steel is excluded from paying these new tariffs (China accounts for just over 3 per cent of United States imports of steel) and 55 per cent of aluminum (China accounts for 16 per cent), because imports from Argentina, Australia, Brazil, Canada, Mexico, the Republic of Korea and the European Union are excluded under the current arrangements. The Republic of

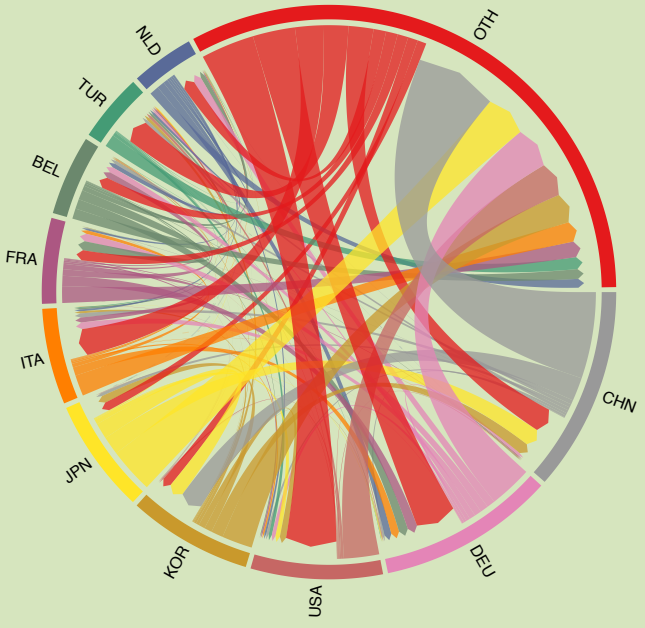
Box 1.3. *(continued)*

Korea agreed to renegotiate its free trade agreement with the United States to expand its import quota for cars and extend the phasing out of some tariffs while promising to restrain steel exports by 70 per cent of their recent levels. This move effectively re-introduced voluntary export restraint arrangements which were banned in 2002 by WTO. Similarly, Australia has reached a "security agreement" with the United States to qualify for an exemption.

In a broader context, it is the United States bilateral trade imbalance with China which has driven these measures. The current merchandise trade deficit of $375 billion is blamed on unfair trade, mainly associated with practices involving technology transfer, use of intellectual property and innovation. As the trade in steel with China (already subject to safeguard measures) is relatively small (see figure below), the United States announced on 22 March 2018 tariffs of up to $60 billion on imports from China, and on 3 April 2018 it announced an additional 25 per cent tariff on a list of 1,300 products worth $50 billion. In response, China announced a proposed list of 128 products imported from the United States, valued at about $3 billion as the target for the "tit for tat" tariffs, followed by a further list of 106 products with an import value of $50 billion which would face a 25 per cent tariff in retaliation for the second wave of tariffs.

Large and persistent current account deficits often lead to blaming trade partners about unfair trade practices. However, there are several points worth noting, including how current accounts are measured and what factors really drive current account deficits. First, the reported trade balances are based on the gross commercial value of cross-border flows of goods and services, which do not capture the complex nature of global trade today where countries often import intermediate goods and services for adding value locally before they are (re)exported. Adjusted by the value added, flows reveal a significant reduction in the bilateral trade deficit between developed and developing countries, including between China and the United States. Second, the current account deficit may not indicate competitiveness levels but rather a low level of national savings relative to investment. This means that current account deficits can occur in a country that is highly productive and rapidly growing or in a country where fiscal policy is mismanaged or where there is overconsumption. The savings-investment imbalance implies that the deficit is unlikely to respond to protectionist policies because there is no obvious connection between protectionism and savings or investment. In fact, a deficit can be desirable or undesirable for a country at a particular time depending on the factors underlying the trend.

Global steel trade pattern, 2016



Source: ESCAP calculations using data from UN Comtrade database (accessed March 2018): chapter 72 (iron and steel) imports and mirror imports, 2016.

Note: CHN = China, DEU = Germany, USA = United States of America, KOR = Republic of Korea, JPN = Japan, ITA = Italy, FRA = France, BEL = Belgium, TUR = Turkey, NLD = Netherlands, OTH = Others.

liberalizing trade measure that economies in the Asia-Pacific region implemented between 2014 and 2017, an average of 3.7 restrictive measures were adopted. Recent measures, such as tariffs imposed by the United States on imports of solar cells and washing machines, and on steel and aluminium imports from certain countries, also suggest that trade protectionism remains a risk (box 1.3). A rise in trade barriers may disrupt cross-border production networks, thus adversely affecting trade, and may provoke retaliatory measures. Even if many of the fears of a "trade war" are not realized, rising uncertainties could be a disincentive for long-term investment and trade (ESCAP, 2017c).

At the same time, a prolonged period of abundant global liquidity and low borrowing costs have contributed to a further rise in global debt levels and a build-up of financial vulnerabilities. Many developing countries, especially those with more open capital markets, remain vulnerable to spikes in risk aversion, a disorderly tightening of global liquidity conditions and sudden capital withdrawal (United Nations, 2017). In view of the ongoing economic recovery in the United States and the eurozone, faster-than-expected interest rate increases cannot be ruled out. This could dampen capital flows to the region and increase exchange rate volatility. Countries which rely heavily on external financing, such as Malaysia, Sri Lanka and Turkey, are particularly vulnerable. While the weak United States dollar has provided some space for gradual adjustment to financial tightening, the dollar could easily revert to its recent trend of strengthening on the back of a strong United States economy.

A related source of financial vulnerability is the high or rising private debt in some economies (figure 1.6). Rapid increases in private debt can easily affect whole financial systems, as experienced during the Asian financial crisis that started in 1997 (ESCAP, 2017b). In China, non-financial corporate debt, held largely by State-owned enterprises, is at a record high while shadow banking, including in wealth products, has emerged as a source of vulnerability. Effectively addressing these challenges will be important for securing financial stability and ensuring efficient allocation of resources. Failing to do so could also have adverse spillover effects on the Asia-Pacific region through trade and confidence channels, as had been observed in 2015 and early 2016 (ESCAP, 2016a).

In some countries, overall private debt levels remain relatively low, but there are considerable financial sector problems, which impose a heavy cost on the economy and have direct fiscal

Box 1.4. Potential impacts of higher oil prices

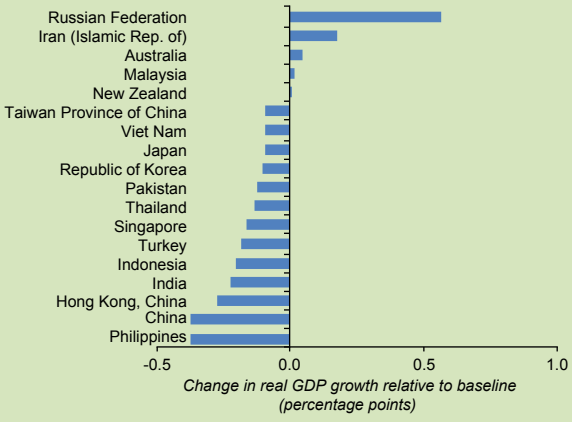
Global oil prices have broad macroeconomic implications, producing roughly the opposite effects on oil exporters and importers. The commodity boom of the 2000s provided a significant boost for commodity exporters, but the end of the "supercycle", particularly the oil price slump in 2014, had severe consequences. Sharp currency losses and high inflation on one hand and extensive revenue losses on the other prompted tighter monetary and fiscal conditions at a time when some economies were already struggling from a collapse in private investment. At the other end of the spectrum, net commodity importers enjoyed a positive terms-of-trade shock. Lower oil prices provided ample breathing space for importers suffering from current account and fiscal account deficits. Low and stable inflation also enabled an accommodative monetary stance, boosting domestic demand. In addition, lower oil prices encouraged both exporters and importers to phase out their domestic fossil fuel subsidies, which had a positive environmental impact and opened up more fiscal space.

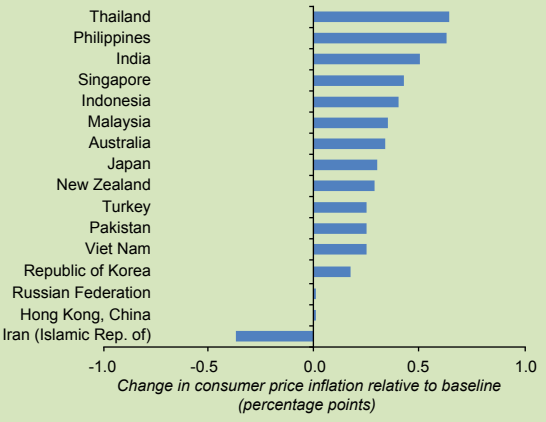
A faster-than-anticipated pickup in global oil prices in recent months has supported the economic recovery of oil exporters but raised worries among oil importers. For India, it is estimated that a $10 per barrel increase in oil prices reduces GDP growth by 0.2-0.3 percentage points, increases inflation by about 1.7 percentage points and worsens the current account balance by about $9-10 billion (India, Ministry of Finance, 2017).

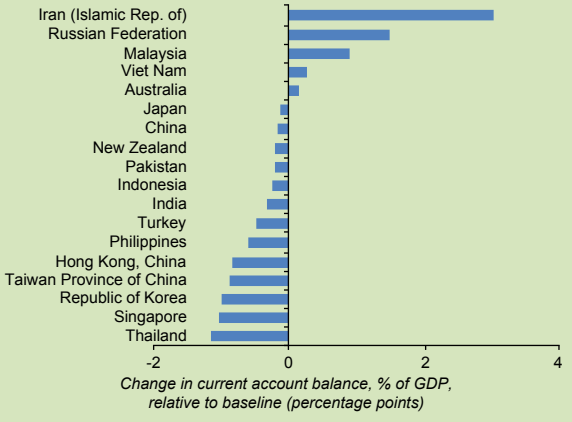
Box 1.4. *(continued)*

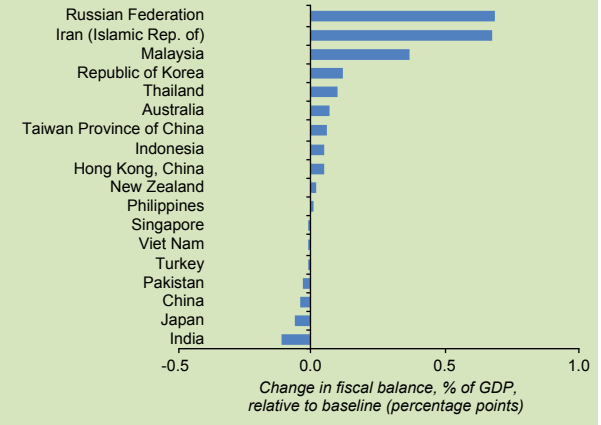
A similar simulation was considered for 18 economies in the region (see figures below). An increase in the oil price by $10 per barrel would dent GDP growth of oil importers in the region by 0.1-0.4 percentage points, but boost growth by 0.7 percentage points for the Russian Federation. Inflation would increase by 0.5-0.7 percentage points for oil importers, such as India, the Philippines and Thailand. Deterioration in the current account balance by an average of 0.5-1 percentage points is evident in large oil importers, such as the Republic of Korea and Thailand, but by only 0.2 percentage points in China, perhaps due to the rapidly increased share of renewables in its energy mix. Fiscal balance would improve by more than half a percentage point in large oil exporters, such as the Islamic Republic of Iran and the Russian Federation, while a decline by 0.1 percentage points or less would be experienced by oil importers in the region. The phasing out of fossil fuel subsidies in recent years seems to have mitigated the impact of higher oil prices on the national budgets of oil importers.

Average change in 2018/19 of a rise in the oil price by $10 per barrel, relative to baseline (percentage points)









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

Note: The simulation assumes that global crude oil price (Brent) in 2018 and 2019 is $10 per barrel higher than the baseline. The baseline prices (as projected by the Oxford model) are $67.75 per barrel in 2018 and $65 in 2019.

implications if government support is required. In India, the share of non-performing loans has doubled, and defaults on corporate bonds and syndicated loans have surged in recent years. By mid-2017, distressed bank loans reached a record high of 9.5 trillion rupees ($148 billion), but more recent revelations suggest that the actual figure may be even higher. In Bangladesh, eight State banks had a capital shortfall of approximately $1.55 billion, or nearly 1 per cent of GDP. In Tajikistan, four banks were facing a liquidity crisis due to bad loans.

Another macroeconomic risk is related to commodity prices. As already noted, global oil prices reached $70 per barrel in January 2018 compared with $30 per barrel two years previously. While prices are expected to moderate to about $60 per barrel, there is considerable uncertainty over their trajectory and net impact. Higher oil prices pose downside risks for large oil importers, such as India, which benefited greatly from the low oil prices for the last three years but now is experiencing higher inflation and a wider current account deficit (box 1.4). Therefore, in the light of such macroeconomic risks to the near-term outlook, prudent policies will be needed, as discussed in section 5.

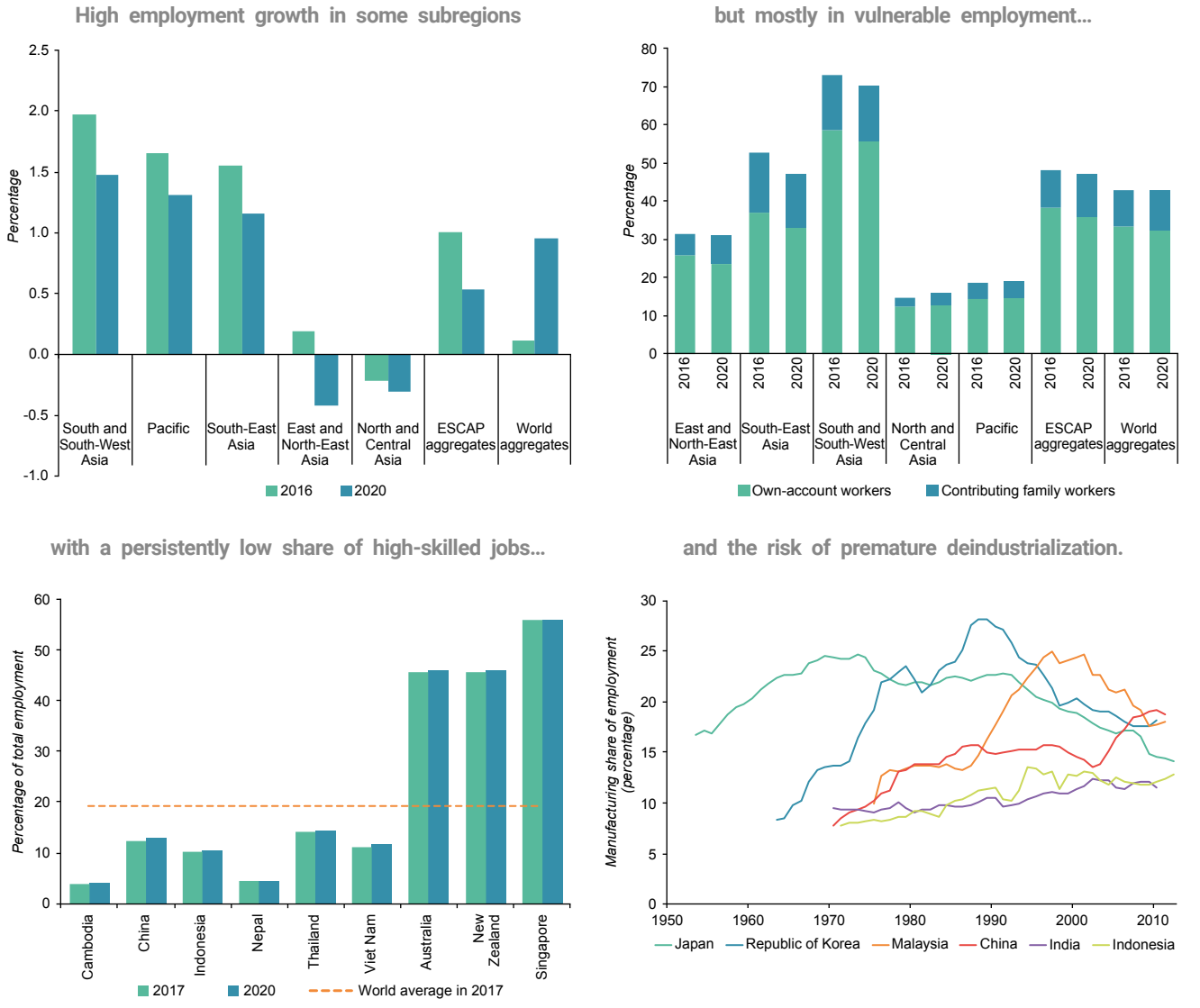
4.2. Potential growth, technology and future of work

A medium-term priority is to lift the region's potential for economic growth, which is on a downward trend in some countries owing to demographic changes, slower capital accumulation and modest productivity growth. Notably, China's potential growth rate fell sharply from about 10 per cent during the period 2003-2007 to about 7-8 per cent during the period 2013-2017 (World Bank, 2018a), and further declines are projected through 2030 (see section 4.3). Potential growth has also declined in India over the past decade owing to a sharp slowdown in capital accumulation; recent estimates of the country's potential growth range from 6 to 8 per cent (ADB, 2016a).

Potential growth is determined largely by demographic transitions and technological progress. Demographic trends could subtract 0.5 to 1 percentage points from annual GDP growth over the next three decades in such countries as China and Japan, while adding 1 percentage point to annual GDP growth in such countries as India and Indonesia (IMF, 2017). However, there is significant uncertainty concerning this forecast. Countries which have already realized their demographic dividend are proactively taking advantage of new technologies to offset shrinking working-age populations with increased labour productivity, but several "late convergers" are struggling to catch up, constrained by wide gaps in skills and infrastructure. In some sense, this latter group is doubly challenged; they have failed to provide even the basic education necessary for structural transformation, and that failure will prove to be increasingly costly because the human capital frontier for the new structural transformation induced by new technologies has probability shifted further away (India, Ministry of Finance, 2018).

The risk of not being able to realize the demographic dividend is most evident in labour markets. South and South-West Asia, followed by South-East Asia, have the highest employment growth rates, but also very high vulnerable employment shares, which are not expected to improve significantly in the forecast period (figure 1.7; table 1.3). Although the share of working poor has been largely improved (from 35.3 per cent in 2010 to 9.4 per cent in 2016 for developing countries in the Asia-Pacific region), a large number of the jobs created remain of poor quality and are highly concentrated in own-account employment or as contributing family workers who are usually employed in informal arrangements, lack income stability and job security and are not covered by legal and social protection systems (ILO, 2018). Young people face greater challenges to find decent jobs, as shown in the high youth unemployment rates in table I.3. Importantly, the share of highly skilled employment remains relatively low, at less than 5 per cent in Cambodia and Nepal (figure 1.7). In China, Indonesia, Thailand and Viet Nam, this share was less than 15 per cent, which is below the global average and significantly below that of Australia, New Zealand and Singapore, where one of every two persons is employed in highly

Figure 1.7. Inadequate decent jobs in countries with a youth bulge



Source: ESCAP, based on ILOSTAT. Available from www.ilo.org/ilostat (accessed 19 February 2018); and the GGDC 10-Sector Database.

Note: Vulnerable employment in 2020 is a model-based projection by the International Labour Organization.

skilled occupations (figure 1.7). A related concern is that, whereas the share of manufacturing in total employment used to peak at more than 20 per cent in countries which now enjoy a high income, this share has fallen to 13-15 per cent for a typical developing country today (figure I.7, bottom right panel).

Lifting potential growth will require higher productivity growth. However, the past decade was marked by only modest productivity growth. In the developing countries of the Asia-Pacific region, growth in total factor productivity (TFP) declined by more than half between the periods 2000-2007 and 2008-2014, while growth in labour productivity declined by a third over the same time frame (ESCAP, 2016a). Factors constraining higher productivity growth include skills and infrastructure deficits, inefficient allocation of resources and weak technological innovation and diffusion.

Technological progress is critical for productivity growth. New technologies, such as three-dimensional printing, big data, robotization of production processes and artificial intelligence, are making rapid inroads in production processes and could induce an economic growth spurt

Table 1.3. Labour market indicators

	Youth unemployment rate % 2017	Vulnerable employment % of total employment Latest	Minimum wage % of monthly average wage Latest	Labour productivity 2017
East and North-East Asia				
East and North-East Asia (excluding Japan)				
China	10.8	13.7 (2014)	27.2 (2013)	27 153
Democratic People's Republic of Korea	11.7	..	..	2 752
Hong Kong, China	9.2	5.9 (2016)	..	106 210
Japan	4.6	8.6 (2016)	0.3 (2016)	74 427
Macao, China	4.5	3.3 (2010)	..	93 007
Mongolia	18.9	46.9 (2016)	30.7 (2013)	28 925
Republic of Korea	10.7	25.5 (2016)	0.2 (2013)	67 956
North and Central Asia				
North and Central Asia (excluding Russian Federation)				
Armenia	39	41.9 (2015)	42.9 (2014)	19 863
Azerbaijan	13.7	55.0 (2016)	42.8 (2013)	31 780
Georgia	29.3	56.3 (2016)	2.8 (2014)	18 675
Kazakhstan	4.7	25.6 (2015)	..	47,317
Kyrgyzstan	15.7	34.7 (2016)	..	8 565
Russian Federation	16.3	6.2 (2016)	29.8 (2013)	49 552
Tajikistan	18.9	47.1 (2009)	31.5 (2013)	7 544
Turkmenistan	6.5	..	..	36 606
Uzbekistan	14.6	..	..	14 168
Pacific				
Pacific island developing economies				
Cook Islands	..	14.3 (2011)	..	..
Fiji	18.8	16.5 (2016)	61.6 (2012)	22 043
Kiribati	..	55.6 (2010)	..	..
Marshall Islands	..	..	..	..
Micronesia (Federated States)	..	..	..	..
Nauru	..	..	..	..
Palau	..	..	..	..
Papua New Guinea	5	..	..	7 044
Samoa	18	31.4 (2014)	..	27 806
Solomon Islands	4.4	..	..	3 984
Tonga	2.8	..	..	..
Tuvalu	..	..	..	..
Vanuatu	10.6	70.2 (2009)	..	5 508
Developed countries				
Australia	12.6	10.7 (2017)	..	91 149
New Zealand	12.8	12.2 (2016)	62.1 (2013)	66 064
South and South-West Asia				
Afghanistan	17.7	..	..	..
Bangladesh	11.4	57.7 (2016)	41.2 (2013)	9 572
Bhutan	10.2	73.3 (2015)	..	16 339
India	10.5	..	..	16 774
Iran (Islamic Republic of)	30.3	41.4 (2016)	..	61 310
Maldives	13.8	22.6 (2014)	38.1 (2010)	24 882
Nepal	4.3	79.0 (2008)	84.3 (2013)	4 134
Pakistan	7.7	60.0 (2016)	69.0 (2013)	14 066
Sri Lanka	20.7	31.9 (2014)	41.5 (2009)	30 409
Turkey	20.3	27.9 (2016)	54.0 (2016)	68 676
South-East Asia				
Brunei Darussalam	28.1	4.7 (2014)	..	167 876
Cambodia	0.4	53.6 (2012)	66.1 (2013)	6 177
Indonesia	15.6	48.2 (2016)	93.4 (2013)	23 788
Lao PDR	1.7	83.9 (2010)	73.4 (2013)	10 973
Malaysia	10.8	22.2 (2016)	48.1 (2013)	55 528
Myanmar	1.7	57.7 (2016)	..	11 758
Philippines	7.9	35.4 (2016)	120.1 (2014)	18 618
Singapore	4.6	8.3 (2016)	..	141 425
Thailand	5.9	48.1 (2016)	60.5 (2013)	28 303
Timor-Leste	11.6	54.7 (2013)	..	20 672
Viet Nam	7	55.9 (2016)	..	10 232

Source: ESCAP, based on ILOSTAT. Available from www.ilo.org/ilostat (accessed 1 March 2018).

Note: Youth unemployment refers to 15-24 years of age; Labour productivity is measured by GDP in 2011 international $PPP.

in the future (Brynjolfsson and McAfee, 2014). Furthermore, technology is a key enabler of sustainable development – for example, clean technology improves energy efficiency, curbs carbon emissions and reduces negative environmental impacts (Beder, 1994); FinTech businesses could largely improve financial inclusion; and using e-governance can also help reduce leakages in taxation and social transfer (ESCAP, 2017b). If well managed, such technologies could also contribute to expansion of decent jobs.

Nevertheless, there are concerns about how technology will shape the future of work. Technology has features that favour capital over labour and favour skilled over unskilled labour (Kanbur, Rhee and Zhuang, 2014). Therefore, technology advancement could potentially lead to job polarization and put downward pressure on wages, especially for unskilled labour, which could lead to a worsening of income distribution. Between 1995 and 2009, the global income share of low- and middle-skilled labour dropped by more than 7 percentage points (IMF, 2017; United Nations, 2017). In the Asia-Pacific region, it has been estimated that labour income share declined by more than 5 percentage points between the early 1990s and the late 2000s (ESCAP, 2016a).

The features of technology are also reshaping global production patterns. The pattern of global trade depends on the availability and price of production factors. Low transport costs, the transferability of technology and the availability of cheap labour and capital attracted a substantial share of industrial production moving to the region (Bluth, 2017). However, technology advancement and automation might call into question whether the region will maintain its comparative advantage. Some have forecast that industrial production is likely to return to the developed world, that is, "reshoring" (Shih, 2013). This practice could reduce the scope for some developing countries' industrialization through a traditional focus on labour-intensive manufactures and limit opportunities to create more jobs. This situation could have implications for such countries as India, which intends to increase manufacturing value added to 25 per cent by 2020, from 16 per cent in 2015.

Globally and primarily in China, Japan and the Republic of Korea, many firms are investing in artificial intelligence and automation as a strategy to remain competitive. With the rapid adoption of such technology, it is estimated that about 56 per cent of all employment in Cambodia, Indonesia, the Philippines, Thailand and Viet Nam are at high risk of automation in subsequent decades (Chang and Huynh, 2016). Arguably, this is not an imminent risk. Increasing labour productivity and the resulting rise in wages in China are creating opportunities for poorer developing countries in labour-intensive manufacturing where the use of robots is not economically viable, such as in major segments involved in the manufacture of garments. In these industries, automation has yet to create competitive pressure, and countries with a surplus of low-cost labour retain a cost advantage. Many other sectors within manufacturing, however, could provide ample scope for automation. It is notable that the same industries where robots are being introduced are the ones that were susceptible to the fragmentation of production in the global value chain (Frey and others, 2016).

Thus, to realize the opportunities and mitigate the risks presented by new technologies, countries will need to strengthen innovation and technology policies and pursue necessary structural reforms, as discussed in section 5.3. Equipping workers with the right skills and assisting them through disruptive changes will be critical, especially given the high share of vulnerable employment in the region.

4.3. China's economic transformation: impacts on Asia and the Pacific

An assessment of the medium-term outlook should recognize the regional dimensions of economic growth. While structural changes are happening all across the Asia-Pacific region, the case of China is outstanding in terms of pace and scale, as well as the potential impacts on the rest of the region through its growing domestic market, evolving trade structure and expanding outbound investment.

In the last four decades, China's economy has been transformed from a predominantly agricultural one to an industrial powerhouse; now it is increasingly becoming service oriented. Average incomes grew ninefold since 1990, and some 800 million people were lifted out of poverty during that period. China's economic performance accounted for a third of global economic growth over the past decade.

Strains from rapid structural changes, however, have become clearer. Prominent among these are the country's slowing population growth and labour force expansion, its slowing productivity growth as available technologies approach the technological frontier, distributional tensions resulting from rising inequality and strains on the carrying capacity of the natural environment.

While a trend decline in economic growth is inevitable in the coming decades, the quality of economic growth will differ significantly depending on the policy choices made. China's ongoing rebalancing from export- and investment-led growth to consumption-led growth is important. Without such rebalancing, the efficiency of investment is projected to decline further such that 20 per cent more capital inputs are needed by 2030 to generate the same amount of output as in 2015. This implies that debt levels will also remain high. At the same time, without forceful measures, urban-rural income gaps as well as inequality within urban and rural areas will remain wide, leaving pockets of poverty. China's energy consumption and carbon emissions will continue to rise. These aspects are shown as the baseline scenario in figure 1.8.

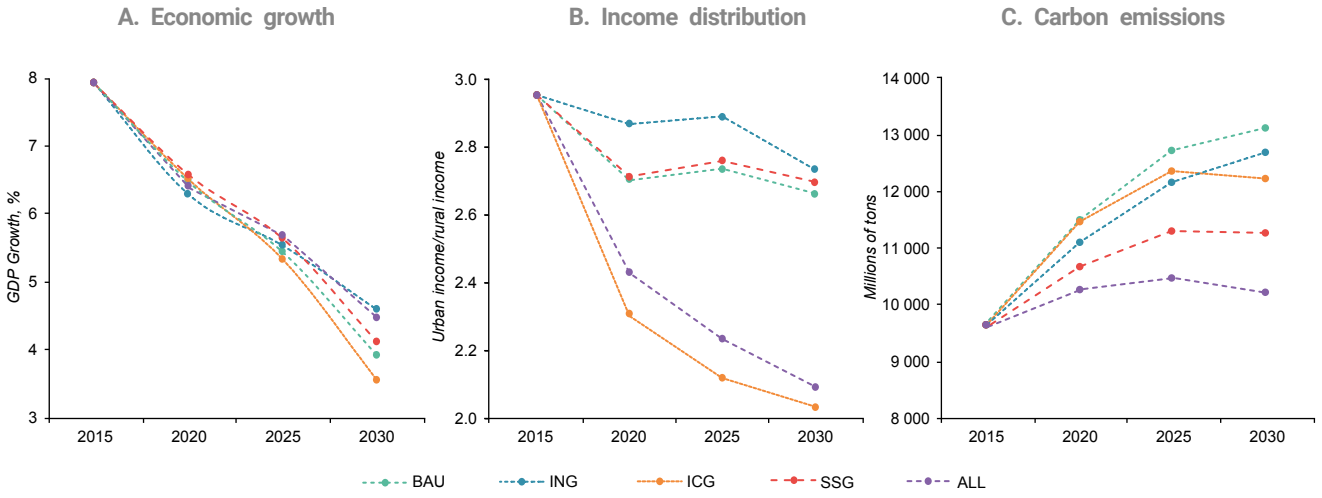
However, there is an alternative scenario, which better reflects the policy directions set out by the Government of China, including in its national action plan on the 2030 Agenda for Sustainable Development. Under this "innovative, inclusive and sustainable growth" scenario, China is pursuing holistic structural reform, which helps the country to sustain relatively high rates of economic growth even as the labour force shrinks and capital accumulation slows, while it realizes shared and green development.

First, the Government has established objectives for China to become an "innovative nation" by 2020, an "international innovation leader" by 2030 and a "world powerhouse of scientific and technological innovation" by 2050. China is moving aggressively on advanced manufacturing and the digital economy, with the support of government initiatives, such as "Made in China 2025" and "Internet Plus". The country is also pursuing supply-side reforms to enhance the efficiency of resource allocation, including tax reforms and interest rate liberalization. Under this "innovative growth" scenario, total factor productivity would overtake capital formation to become the major driver of economic growth, and the service sector would account for 70 per cent of GDP by 2030, close to current levels in developed economies.

Second, the Government has established objectives for eliminating absolute poverty by 2020 in order to deliver a "moderately prosperous society". At the end of 2016, there were still more than 40 million people living below the national poverty line (equivalent to about $2.40 per day). The Government has increased fiscal transfers to enhance social protection while deploying more funds for financing rural infrastructure, agricultural subsidies and discounted loans. This "inclusive growth" scenario is also tied to more rapid urbanization, which is expected to rise to 70 per cent by 2030. Ongoing hukou (household registration) reforms will also facilitate labour mobility to areas with better jobs and enable more equal access to public social services. Under this scenario, income inequality would moderate, and average households would use more of their incomes for expenditures.

Third, the Government has declared war on pollution while speeding up the transition to clean energy. Four decades of breakneck economic growth turned China into the world's largest carbon emitter. Air pollution is estimated to have contributed to 1.6 million deaths per year. Now the Government is trying to change that without damaging the economy – and perhaps even use its green policies to become a leader in technological innovation. China has been the

Figure 1.8. Alternative scenarios for China in 2030



Source: ESCAP, based on DRC-CGE model.

Note: BAU = baseline scenario; ING = innovative growth scenario; ICG = inclusive growth scenario; SSG = sustainable growth scenario; and ALL = innovative, inclusive and sustainable growth scenario. The baseline scenario (BAU) is based on the historic trend of China's economic development to simulate economic growth without structural reforms; the innovative growth scenario (ING) assumes that China will improve economic efficiency through technological progress and efficient resource allocation; the inclusive growth scenario (ICG) projects China's growth with assumptions of policies to focus on narrowing income inequalities and providing social protection; the sustainable growth scenario (SSG) assumes that China will increase the share of non-fossil fuel in its energy composition and introduce more market mechanisms to improve energy and carbon intensity, such as a carbon tax; the innovative, inclusive and sustainable growth scenario (ALL) combines the assumptions of ING, ICG and SSG scenarios. China's economic growth simulation is based on a computable general equilibrium model.

global leader in electric vehicle sales since 2015 and is aiming for 7 million annual sales by 2025. It intends to acquire 20 per cent of its energy from renewables by 2030; in 2016 alone, China installed 35 gigawatt hours of new solar generation capacity, equal to Germany's total capacity. Under this "sustainable growth" scenario, China would make proactive use of carbon pricing such that its total energy consumption and carbon emission levels would peak before 2030.

Such structural changes in China are expected to have important ramifications for the Asia-Pacific region. China's growing domestic market, evolving trade structure and expanding outbound investment are likely to present both opportunities and risks for other countries in the region.

China remains a hub for regional production networks, for assembly and re-exporting to North American and European markets. However, China's final demand has become increasingly important over the past decade as external demand collapsed in the wake of the global financial crisis. China's huge stimulus, focused on investment largely in real estate and infrastructure, was an important source of regional final demand. More recently, China's demand mix has been shifting towards consumption, a trend that is expected to continue through 2030. Moreover, as incomes rise, consumption patterns are likely to shift towards higher-end goods and more services. Such changes have several implications for regional trading partners.

While China accounts for a fifth of total exports by its regional trading partners, gross export figures could overestimate their exposure to Chinese markets. Analysis using the OECD-WTO Trade in Value Added database reveals that for every $10 the region exports to China, $8 is the domestic value-added component (the rest are foreign inputs), of which $6 caters to Chinese final demand (the rest are re-exported to third markets) (figure 1.9). Nevertheless, China is now on par with the United States as a source of final demand for several countries, especially in South-East Asia. Thus, continued expansion of

the Chinese economy could be beneficial for regional exporters.

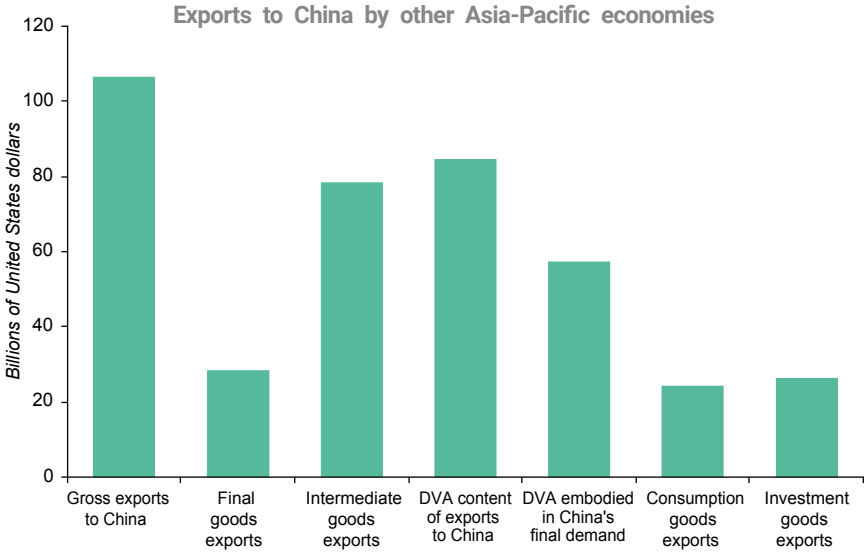
However, China's ongoing rebalancing from investment to consumption may have adverse effects at least in the near term, as further disaggregation of data reveals that regional exports cater more to Chinese investment demand rather than consumption demand. This includes energy and metal exporters in the region. Even those that export consumer goods to China may find few opportunities if they specialize in necessity goods or low-technology goods. Moreover, given that services trade is relatively underdeveloped in the region, countries may find it difficult to penetrate China's growing services market, such as in e-commerce. The degree to which trade potential is realized will depend on whether countries have market access and the capacity to trade in growing sectors.

This situation naturally draws attention to the supply side. As China moves up the value chain, such countries as Bangladesh and Viet Nam could enjoy greater opportunities to engage in low-skilled, labour-intensive manufacturing. If indeed a large-scale relocation of some 100 million Chinese manufacturing jobs takes place, this could significantly boost employment prospects and support economic diversification in those countries, including through services that complement the manufacturing chain. It is also possible, however, that assembly plants would relocate to China's inland provinces in view of their relatively low wage levels and proximity to the suppliers of parts and components and to the country's large domestic market.

For existing technology exporters in the region, China's industrial upgrading also increases competition. China is increasingly becoming an exporter of high-technology products and equipment and has distinguished itself as a major emerging capital exporter. The decreasing share of components and parts in China's total imports and increasing Chinese value addition in other countries' exports in particular mark the transition in China's position in the global value chain from a final product assembler to a supplier of high-value-addition intermediaries. This development could increase competition and result in opportunities for further specialization, or for increased innovation.

Meanwhile, commodity exporters in the region could be adversely affected, if significant efforts are not made to increase economic diversification and leverage on such initiatives as the One Belt One Road. China's resource-intense production and significant economic growth fuelled a boom in commodities in the 2000s. More recently, infrastructure spending to support growth helped

Figure 1.9. Trade linkages with China



Source: ESCAP, based on OECD-WTO Trade in Value Added database.

Note: Calculation is based on 2011 data, the latest available year; DVA refers to Domestic Value Added.

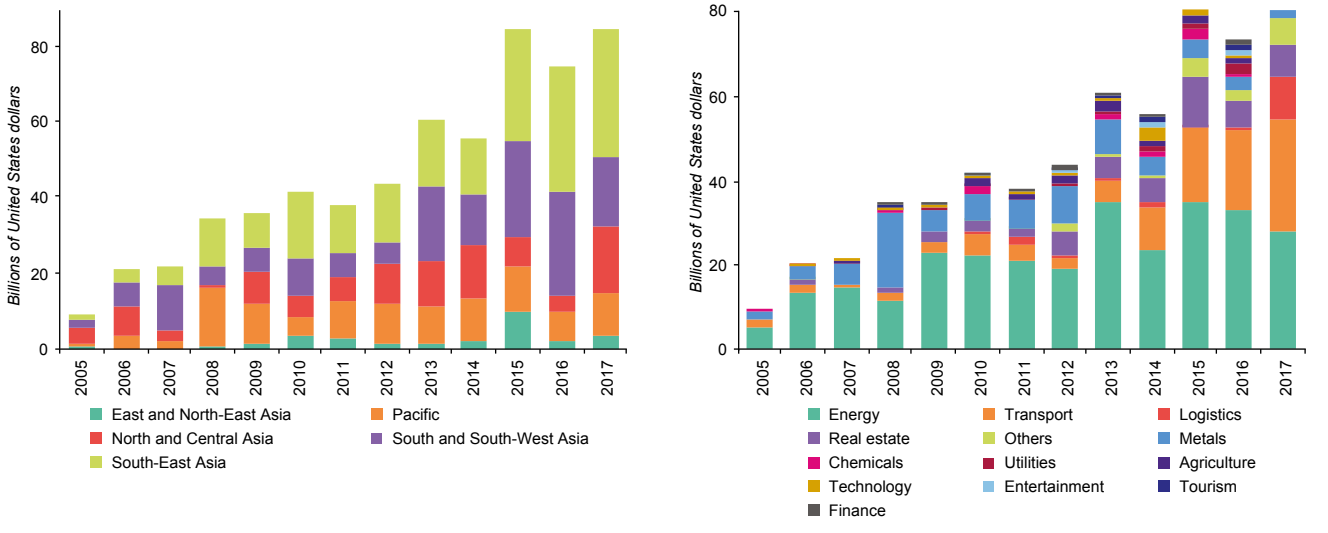
stabilize commodity prices. China's closing of inefficient and polluting producers of metals and energy products has also forced the country to buy more iron ore and coal from abroad. Nevertheless, China's ongoing economic rebalancing and its transition to clean energy imply that fossil fuel-based energy exporters face the prospect of lower long-term demand from China.

China's outbound investment to economies in the Asia-Pacific region has steadily increased over the past decade. It is worth noting that data reported by China and the recipient countries often differ significantly, as do those reported by international organizations and private sources. Significant amounts of investments are also channelled to their ultimate destinations through Hong Kong, China; and Singapore. Based on transaction-based data compiled by the American Enterprise Institute, Chinese investments in the Asia-Pacific region reached a value of $84.6 billion in 2017, with cumulative investment since 2005 reaching $605.6 billion (figure 1.10). The largest recipient by ESCAP subregion was South-East Asia, followed by South and South-West Asia. By sector, the top five were energy, transport, real estate, logistics and metals, in that order. The emphasis seems to have shifted in recent years from securing raw materials towards broader productivity cooperation and infrastructure development.

While there is no comprehensive assessment on the quality of Chinese investments, several concerns have been raised. It is often pointed out that linkages with the rest of the economy are often minimal in the case of construction deals, given that labour and capital inputs are procured mostly from China. It has been estimated that, unlike other foreign investments, Chinese investments do not seem to contribute positively to the recipient country's economic upgrading, perhaps due to limited technological transfers (Gui-Diby , Renard and Fouedjio, forthcoming). There are also concerns about Chinese financial investments (loans) undermining recipient country's debt sustainability.

In going forward, the quality as well as quantity of Chinese investments will be important. It could be the case that, as the quality of China's own economic growth improves, this will also be reflected in China's overseas investments. China's innovation drive could potentially increase technological transfers to other countries. China's shift to clean energy could expand opportunities in green infrastructure investments. Enabling other developing countries, especially its geographic neighbours and potential trading partners, in terms of their economic growth and industrial development would in turn create a broader market for China's upgraded industrial products, unlock new investment opportunities for outgoing Chinese

Figure 1.10. Investment linkages with China



Source: ESCAP, based on American Enterprise Institute and Heritage Foundation.

firms and provide more diversified consumption choices for Chinese consumers.

Domestic and regional policy initiatives will be important to maximize new opportunities and mitigate risks as all economies, including that of China, undergo further structural transformation. Countries in the region should harness the potential complementarities arising from different levels of economic development and factor endowments. Further deepening economic ties could serve as a new driver of growth. They could also contribute to shared prosperity in the region, but many poorer countries may be unable to take advantage of trade opportunities without strengthening their productivity capacities.

5. Economic policy considerations

5.1. Monetary and financial policy – securing macrofinancial stability

The fundamental role of monetary policy and central banks in sustaining economic growth over long periods is to contribute to macroeconomic and financial stability. Of the 15 major central banks in the Asia-Pacific region, 13 have explicit numerical targets for inflation and 5 have made exchange rate stability a policy objective. While financial stability is not an explicit objective for most central banks, it is clearly an issue of concern given its implications for the real economy.

Monetary policy environment

Monetary policy stances in the Asia-Pacific region remained accommodative in 2017. This was possible because, despite better-than-expected economic growth and the spurt in oil prices, inflation was benign and well within the target range of central banks in most countries. At the same time, exchange rates were stable, with major regional currencies gaining against the United States dollar as capital inflows to the region rebounded. This was despite the narrowing differential between interest rates in the region and the United States federal funds rate, as risk premiums were compressed on the back of financial market calm and the search for yield continued. With the rebound in capital inflows and exports, most countries were able to rebuild their foreign exchange reserves. For instance, reserves in India and Indonesia have risen to about 9.8 and 8.6 months of import cover respectively (table 1.4). In this context, most countries did not unwind the expansionary stances that they had adopted in recent years, keeping their policy rates unchanged or even reducing them further as in the case of India, Indonesia, the Russian Federation and Viet Nam (figure 1.11; table 1.4).

In going forward, consumer inflation in developing countries in the Asia-Pacific region is expected to accelerate, from 3.2 per cent in 2017 to 3.5 per cent in both 2018 and 2019. Despite the recent economic upturn, there is little risk of overheating; thus, the inflation outlook will depend largely on non-demand factors, such as global oil prices and exchange rates. Although oil prices are expected to stabilize at about $60 per barrel, there is more uncertainty over capital flows and exchange rates in the forecast period. Further normalization of monetary policy in the United States could increase financial market volatility. At the same time, China's ongoing deleveraging could slow economic growth and increase corporate defaults. A combination of such developments could trigger investor risk aversion, resulting in capital reversal and currency depreciation in the region. The likelihood of such a scenario seems to have increased in recent months with the corporate tax reform and infrastructure plan in the United States, which could boost that country's near-term economic growth and accelerate the pace of interest rate hikes. New tariffs on steel and aluminium and increased rhetoric of a trade war could also trigger investor risk aversion.

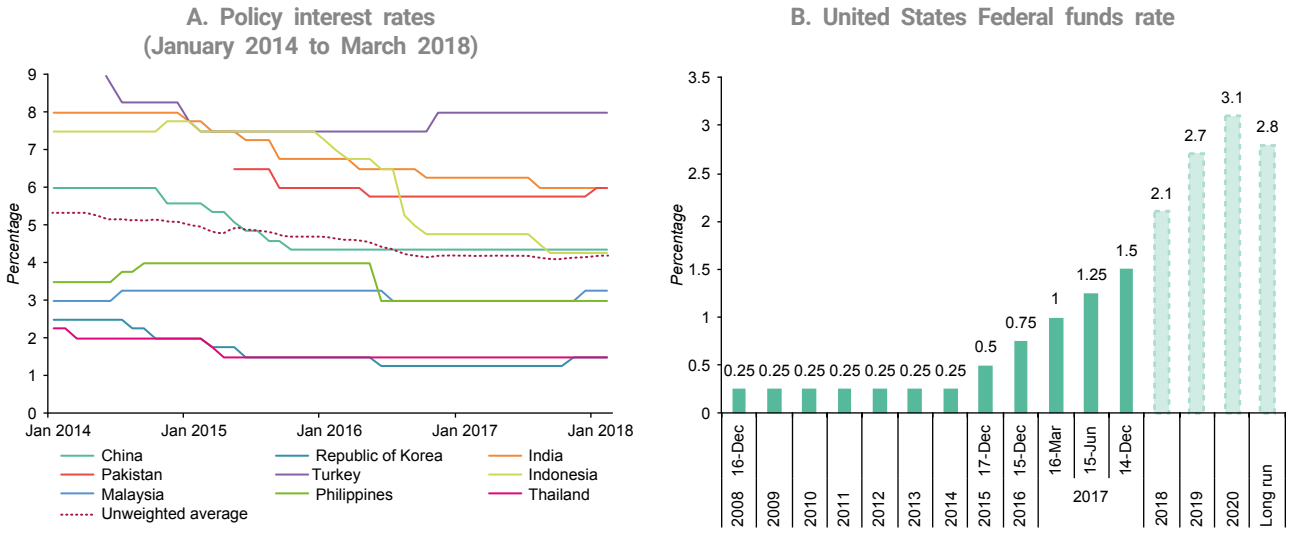
Therefore, gradual increases in interest rates, as introduced by Malaysia and Pakistan recently, should not be ruled out. These two countries are experiencing relatively strong economic growth; moreover, they face high external financing requirements owing to the sizeable short-term external debt in the former and widening fiscal and current account deficits in the latter. Other countries with high external debt or low levels

Table 1.4. Monetary and financial indicators

	Policy rates %	Domestic credit growth %	Real effective exchange rate %	Foreign exchange reserves, months of import
East and North-East Asia				
East and North-East Asia (excluding Japan)				
China	16.5 *Feb-2018*	12.0 *Feb-2018*	127.6 *Feb-2018*	22.7 *Feb-2018*
Democratic People's Republic of Korea	.. ..	.. ..	.. ..	.. ..
Hong Kong, China	1.8 *Feb-2018*	20.4 *Nov-2017*	114.2 *Feb-2018*	9.0 *Jan-2018*
Japan	-0.1 *Feb-2018*	3.3 *Jan-2018*	74.3 *Feb-2018*	19.0 *Jan-2018*
Macao, China	1.8 *Feb-2018*	.. ..	.. ..	19.4 *Jan-2018*
Mongolia	11.0 *Feb-2018*	-1.0 *Jan-2018*	.. ..	6.4 *Dec-2017*
Republic of Korea	1.5 *Feb-2018*	6.5 *Jan-2018*	112.3 *Feb-2018*	9.3 *Feb-2018*
North and Central Asia				
North and Central Asia (excluding Russian Federation)				
Armenia	6.0 *Feb-2018*	18.1 *Dec-2017*	.. ..	7.0 *Jan-2018*
Azerbaijan	15.0 *Jan-2018*	-12.0 *Dec-2017*	.. ..	6.5 *Dec-2017*
Georgia	7.3 *Feb-2018*	11.0 *Jan-2018*	.. ..	4.4 *Feb-2018*
Kazakhstan	9.8 *Feb-2018*	-4.0 *Jan-2018*	.. ..	7.1 *Jan-2018*
Kyrgyzstan	5.0 *Feb-2018*	17.2 *Jan-2018*	.. ..	4.2 *Dec-2017*
Russian Federation	7.5 *Feb-2018*	6.9 *Jan-2018*	85.7 *Feb-2018*	24.0 *Jan-2018*
Tajikistan	14.8 *Feb-2018*	-30.6 *Dec-2017*	.. ..	2.1 *Dec-2017*
Turkmenistan	.. ..	.. ..	.. ..	.. ..
Uzbekistan	.. ..	.. ..	.. ..	.. ..
Pacific				
Pacific island developing economies				
Cook Islands	.. ..	.. ..	.. ..	.. ..
Fiji	.. ..	.. ..	.. ..	.. ..
Kiribati	.. ..	.. ..	.. ..	.. ..
Marshall Islands	.. ..	.. ..	.. ..	.. ..
Micronesia (Federated States)	.. ..	.. ..	.. ..	.. ..
Nauru	.. ..	.. ..	.. ..	.. ..
Palau	.. ..	.. ..	.. ..	.. ..
Papua New Guinea	.. ..	.. ..	.. ..	.. ..
Samoa	.. ..	.. ..	.. ..	.. ..
Solomon Islands	.. ..	.. ..	.. ..	.. ..
Tonga	.. ..	.. ..	.. ..	.. ..
Tuvalu	.. ..	.. ..	.. ..	.. ..
Vanuatu	.. ..	.. ..	.. ..	.. ..
Developed countries				
Australia	1.5 *Feb-2018*	2.5 *Dec-2017*	90.8 *Feb-2018*	2.2 *Jan-2018*
New Zealand	1.8 *Feb-2018*	4.5 *Jan-2018*	104.6 *Feb-2018*	5.6 *Jan-2018*
South and South-West Asia				
Afghanistan	.. ..	.. ..	.. ..	.. ..
Bangladesh	6.8 *Feb-2018*	14.3 *Jan-2018*	.. ..	7.5 *Dec-2017*
Bhutan	.. ..	.. ..	.. ..	.. ..
India	6.0 *Feb-2018*	8.1 *Jan-2018*	100.0 *Feb-2018*	9.8 *Jan-2018*
Iran (Islamic Republic of)	.. ..	25.8 *Feb-2017*	.. ..	.. ..
Maldives	.. ..	.. ..	.. ..	.. ..
Nepal	7.0 *Feb-2018*	21.7 *Jan-2018*	.. ..	9.2 *Jan-2018*
Pakistan	6.0 *Feb-2018*	13.5 *Jan-2018*	.. ..	2.8 *Feb-2018*
Sri Lanka	7.3 *Feb-2018*	12.5 *Dec-2017*	.. ..	3.3 *Jan-2018*
Turkey	8.0 *Feb-2018*	16.4 *Jan-2018*	70.0 *Feb-2018*	4.1 *Jan-2018*
South-East Asia				
Brunei Darussalam	.. ..	-3.8 *Sep-2017*	.. ..	8.7 *Sep-2017*
Cambodia	.. ..	15.6 *Dec-2017*	.. ..	8.2 *Sep-2017*
Indonesia	4.3 *Feb-2018*	6.8 *Jan-2018*	88.9 *Feb-2018*	8.6 *Feb-2018*
Lao People's Democratic Republic	4.0 *Feb-2018*	14.4 *Sep-2017*	.. ..	2.2 *Sep-2017*
Malaysia	3.3 *Feb-2018*	5.6 *Jan-2018*	91.8 *Feb-2018*	5.4 *Jan-2018*
Myanmar	.. ..	22.1 *Nov-2017*	.. ..	.. ..
Philippines	3.0 *Feb-2018*	13.5 *Jan-2018*	99.5 *Feb-2018*	8.3 *Jan-2018*
Singapore	.. ..	9.5 *Jan-2018*	106.6 *Feb-2018*	9.6 *Jan-2018*
Thailand	1.5 *Feb-2018*	4.6 *Jan-2018*	105.7 *Feb-2018*	10.2 *Jan-2018*
Timor-Leste	.. ..	.. ..	.. ..	.. ..
Viet Nam	4.3 *Feb-2018*	16.3 *Nov-2017*	.. ..	2.2 *Nov-2017*

Source: CEIC Data. Available from www.ceicdata.com; and Bank for International Settlement (BIS).

Figure 1.11. Policy interest rates



Source: ESCAP, based on CEIC Data. Available from www.ceicdata.com (accessed 1 March 2018); and United States Federal Reserve. Available from: www.federalreserve.gov.

of reserves include the Lao People's Democratic Republic, Sri Lanka and Turkey. Economies with currencies pegged directly to the United States dollar, such as Hong Kong, China; and Singapore, could also be more prone to a negative impact. Of course, not all countries are in a similar situation, and some may still have room for further interest rate reduction. Nevertheless, interest rates are already at historically low levels in most countries, and further reduction could have implications for domestic financial stability. In such countries as the Republic of Korea and Thailand, low interest rates for an extended period have contributed to high household debt. On the other hand, in India and Indonesia, policy rate reductions did not translate into lower commercial lending rates due to banking sector problems. Further rate cuts would not do much good in either case.

Macroprudential frameworks, regulation and supervision

Given the current environment of relatively robust economic growth and benign inflation, central banks and other relevant authorities should focus especially on aspects of financial stability. Macroprudential measures could critically complement monetary policy in this regard. Rather than changing the cost of borrowing for an entire economy, macroprudential measures are targeted at specific areas of financial excess, for instance the housing sector. At the same time, macroprudential measures are aimed at reducing systemic risks and safeguarding the stability of the financial system as a whole. In view of the high degree of interconnectedness among financial institutions, a shock could spread rapidly across the entire system. Hence, there has been growing consensus that financial regulation should move from a "micro" approach based on individual institutions towards a "macro" framework (table 1.5).

Macroprudential measures could be classified as those that affect the demand for and the supply of credit, or those that are borrower-targeted and lender-targeted (table 1.6). Among the former, commonly used tools include loan-to-value ratios, which impose a minimum down payment and discourage speculators from taking multiple loans, and debt-to-income ratios, which restrict an unaffordable increase in debt. These tools are associated with a reduction in credit growth, most notable in the housing sector in developing countries. Among the latter, reserve requirements are the most popular, but there are also sectoral capital requirements which force lenders to hold extra capital against loans to a specific sector, thus discouraging heavy exposure to that sector. Such measures targeting liquidity

Table 1.5. Macroprudential vs. microprudential measures

	Macroprudential	Microprudential
Proximate objective	Limit financial system-wide distress	Limit distress of individual institutions
Ultimate objective	Avoid output (GDP) costs	Consumer (investor/depositor) protection
Model of risk	Endogenous (in part)	Exogenous
Correlations and common exposures across institutions	Important	Relevant
Calibration of prudential controls	In terms of system-wide distress, top-down	In terms of risks of individual institutions, bottom up

Source: Claudio Borio, "Towards a macro-prudential framework for financial supervision and regulation?" BIS Working Papers, No. 128 (Basel, Switzerland, Bank for International Settlements, 2003). Available from www.bis.org/publ/work128.pdf.

risks tend to restrain leverage and excessive growth in asset prices. Some lender-targeted measures, such as limits on foreign currency loans, are aimed at reducing the sensitivity of domestic credit cycles to cross-border capital flows. Overall, in the literature it is found that the effectiveness of macroprudential measures is contingent on such aspects as the development of financial markets, the potential for domestic and cross-border leakage and coordination with monetary policy. For instance, China has been raising money market rates in order to discourage riskier lending practices, but at the same time it keeps markets well supplied with funds.

Most countries in the Asia-Pacific region already had macroprudential measures in place prior to the financial crisis that started in 2008, but several countries have introduced additional measures in the wake of the crisis, many of which were targeted at the housing sector (Cerutti, Claessens and Laeven, 2015; ESCAP, 2016a). Moreover, many countries have been improving their macroprudential frameworks, that is, not just the quantity of those frameworks but their quality as well. Macroprudential measures need to be formulated to respond appropriately to evolving economic and financial developments. In addition to known sources of systemic risks, policymakers should keep an eye on new and emerging sources of risk, such as shadow credit. For instance, China recently introduced a range of prudential measures aimed at slowing growth in banks' supply of shadow credit, reducing dependence on interbank funding and containing regulatory arbitrage. Such measures help reverse the growth in off-balance sheet shadow credit in the form of wealth management products (IMF, 2017).

Although banks in the region are generally well capitalized, it is likely that mortgage delinquencies and corporate defaults will rise as financing costs rise. Non-performing loan ratios remain

Table 1.6. Macroprudential measures targeting demand for and supply of credit

Tools affecting the demand for credit	Tools affecting the supply of credit
• Loan-to-value ratios • Margin requirements • Loan maturities • Tax policy and incentives	• Lending rate ceilings • Interest rate ceilings • Reserve requirements • Capital requirements • Portfolio restrictions • Supervisory pressure

Source: Douglas Elliott, Greg Feldberg and Andreas Lehnert, "The history of cyclical macroprudential policy in the United States" Finance and Economics Discussion Series, No. 2013-29 (Washington, D.C., Divisions of Research and Statistics and of Monetary Affairs, Federal Reserve Board, 2013). Available from www.federalreserve.gov/pubs/feds/2013/201329/201329pap.pdf.

relatively low in most countries where private debt has increased most, but there are some signs of deterioration in asset quality. Thus, bank supervision should be strengthened with respect to the quality of loans as well as exposure to foreign exchange and interest rate shocks. Stress tests could be introduced to ensure that banks not only have sufficient capital levels to absorb losses but also governance structures and risk management processes that promote banking stability. At the same time, improving the credit history information of households and firms – for instance, through credit registers – could help lenders become better informed about the current debt of potential borrowers; in this regard, India's central bank recently proposed a new public credit registry. Efforts to enhance financial access for low-income households and small firms should be accompanied by financial education to inform borrowers of potential risks.

Addressing China's high debt and India's bad loans

While many countries in the region are addressing their domestic financial vulnerabilities, China and India stand out in terms of their scale. Given that their respective challenges have notable differences (for instance, China is curbing credit growth while India is reviving credit growth), a comparison of their experiences could also shed light on the appropriate policy mix for different types of problems, including some measures which go beyond monetary and macroprudential policies.

China has seen a significant increase in non-financial private debt over the past decade. Several China-specific factors – high savings, current account surplus, small external debt and various policy buffers – can help mitigate the near-term risks of disruptive adjustments and buy time to address risks. These factors would likely not eliminate the eventual adjustment, however, but make the boom larger and last longer (Chen and Kang, 2018). With the economy on a sufficiently high growth path, policymakers are focusing more on securing financial stability. In 2017, the growth of the money supply (M2) slowed amid measures to curb excessive credit growth, especially non-bank credit, and to reduce debt held by State-owned enterprises. China's improved macroprudential framework also is aimed at addressing the increased reliance of banks on short-term wholesale funding and the increased opacity of intermediation. Finally, to contain regulatory arbitrage, China established a new committee on financial stability and development, members of which include the central bank and regulators of the banking, securities and insurance sector. In China, improving credit allocation and restricting State-owned enterprises are also critical measures for achieving private sector debt sustainability.

In India, the share of non-performing loans has doubled, and defaults on corporate bonds and syndicated loans have surged in recent years. By mid-2017, distressed bank loans reached a record high of 9.5 trillion rupees ($148 billion), but more recent revelations suggest that the actual figure may be higher. The banking problem is closely related to high corporate leverage; thus, the two problems are known as the "twin balance sheet" challenge. If it does not effectively address that challenge, India will continue to face weak private investment and modest economic growth. The Government's policy initiatives have centred around the so-called 4Rs – recognition, resolution, recapitalization and reforms (India, Ministry of Finance, 2018). The central bank strengthened its asset quality review in 2015, which found significant quantities of non-performing assets. It introduced new schemes to facilitate debt-to-equity swaps and other forms of loan restructuring. Importantly, its new bankruptcy code has provided a resolution framework that will help corporates to clean up their balance sheets and reduce their debts. The Government also announced in late 2017 a large recapitalization package, equivalent to about 1.2 per cent of GDP, to strengthen the balance sheets of public sector banks.

In going forward, given the diminished need for demand management, central banks in the region should focus more on addressing domestic financial vulnerabilities and building resilience to cope with potential external shocks. They could assign high priority to enhance macroprudential frameworks, regulation and supervision.

5.2. Fiscal policy – making effective use of fiscal space

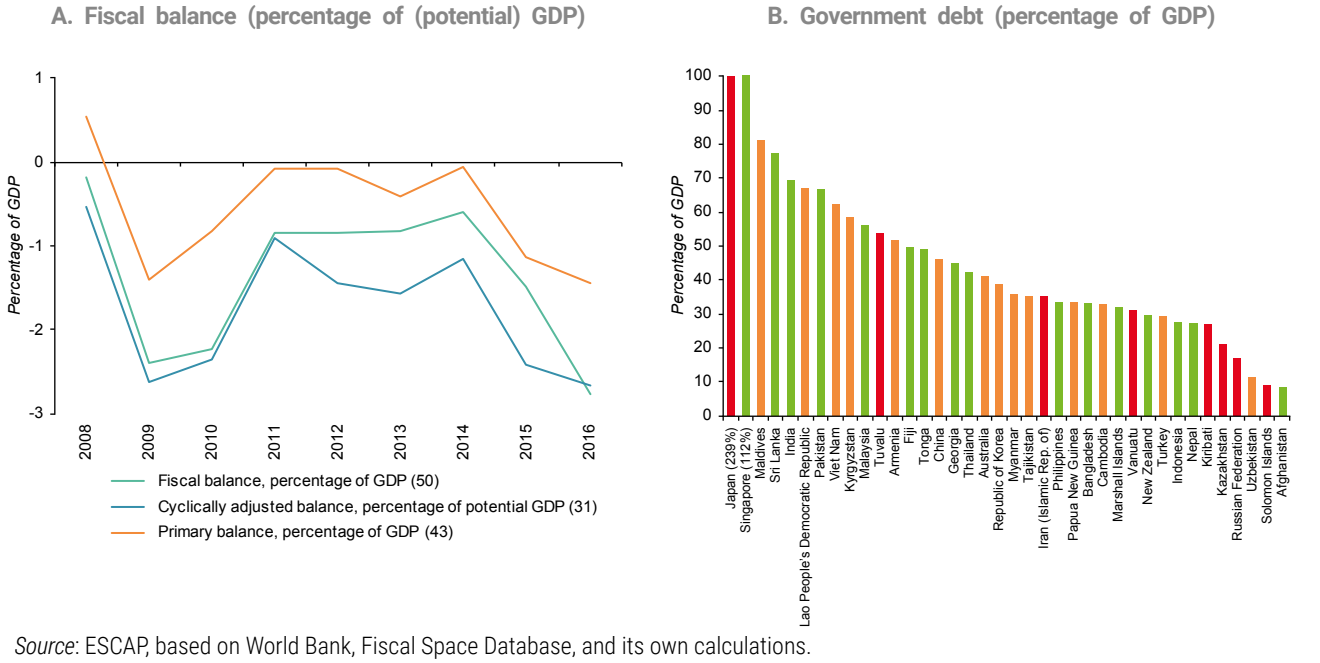
As the need for near-term stimulus diminishes with stronger economic growth, fiscal policy could be focused more on supporting the medium-term objectives of lifting productivity growth and reducing inequalities. In this section, stock is taken of recent fiscal developments in the context of fiscal space, before providing a discussion on how Governments could spend more and better in order to facilitate sustained, inclusive and sustainable economic growth.

Recent fiscal developments

A countercyclical fiscal stance, including tax relief for small and medium-sized enterprises and increased public infrastructure outlays, has contributed to the region's economic resilience in recent years. This position has led to a widening of budget deficits to an estimated 3 per cent of GDP on average, although stronger economic growth as a result of such measures limited the increase in government debt-to-GDP ratios (figure 1.12). Fiscal sustainability gap analysis by ESCAP would suggest that debt ratios will stabilize or decline in most countries under current economic growth and financing conditions (ESCAP, 2017b). Fiscal space would be more limited once contingent liabilities and off-budget operations are considered; this is illustrated in figure I.14 by the colour of the bars which indicate whether debt ratios would rise or fall under different scenarios. Moreover, as will be discussed in chapter II, in the light of the financing requirements for achieving sustainable development, enlarging the fiscal space should remain a priority for several countries. (For a detailed discussion on fiscal space, including alternative measures of it, see also ESCAP, 2017b).

Based on official targets and other information, fiscal deficits in the Asia-Pacific region are expected to narrow slightly in 2018, from an estimated 3 per cent of GDP in 2017. This outcome seems to reflect primarily stronger economic growth, as most countries are maintaining a proactive and expansionary fiscal stance.

Figure 1.12. Fiscal position



Source: ESCAP, based on World Bank, Fiscal Space Database, and its own calculations.

Note: Panel A: numbers in parentheses indicate the number of countries, based on which the median is presented. Panel B: if the primary balance, borrowing cost and GDP growth remain as in 2016, countries in RED will see their debt ratio increase, while for others it will fall. Under a less favourable scenario in which a 1 standard deviation shock is applied to the differential between borrowing costs and GDP growth, only the countries in GREEN would see their debt ratio decrease, while for others (RED plus ORANGE) it would increase.

China's fiscal stimulus measures in recent years, including large public infrastructure outlays and wide-ranging tax breaks, were important for boosting the country's economic growth, which in turn also supported regional trade and contributed to the region's resilience against weak external demand. Domestically, such demand support measures also helped mitigate some near-term drag on activity resulting from supply-side reforms. However, large fiscal stimulus also resulted in local government debt problems. To address this situation, the Chinese Government is taking an approach known as "opening the front door and blocking the back door". While offering no implicit guarantees on financing vehicles, local governments were allowed to issue special purpose bonds, debt which is repaid through returns on investment projects rather than fiscal revenues.

India has been on a gradual consolidation path, with the goal of lowering government debt to 60 per cent of GDP by fiscal year 2022/23. However, its deficit has overshot targets, as the recent monetary and tax reforms weighed on immediate economic activity despite the expected medium-term benefits (ESCAP, 2017b). Another reason for the wider deficit was the debt restructuring of State power distribution companies. The national budget deficit target for the 2018/19 fiscal year is 3.3 per cent of GDP, lower than the estimated 3.5 per cent deficit in 2017/18, but higher than previously set targets (India, Ministry of Finance, 2018). The latest budget contains provisions for corporate tax breaks for small and medium-sized enterprises, more spending for the rural economy and a new national health insurance scheme for the poor. The wider deficit, however, has increased sovereign yields. To raise revenues, the Government increased customs duties on mobile phones and other imported consumer items, and introduced a new long-term capital gains tax.

Indonesia has made notable progress in recent years in reallocating a larger share of the budget towards social and infrastructure programmes through tax and subsidy reforms. Improving connectivity, especially in regions outside Java and Sumatra, has been a priority. Key social programmes – including housing for the urban poor, credit for micro and small businesses, and education assistance and health care for low-income earners – will continue to feature prominently in 2018 (Negara, 2017). The Government also decided to remove the electricity subsidy gradually as part of ongoing reforms in the energy sector. Indonesia has relatively low government debt, and the fiscal deficit for 2018 is targeted at 2.19 per cent of GDP, lower than the actual 2.57 per cent in 2017. Thus, there is fiscal space. However, more progress is needed in improving administrative capacity and avoiding delays and back-loading in budget disbursement. The country's capacity to collect taxes also needs to be improved in view of persistent revenue shortfalls in recent years.

Spending better for long-term growth

Although aggregate budget deficits or public debt can serve as useful indicators of short-term macroeconomic stability, they offer little indication of the long-term effects of fiscal policy on economic growth and development (ESCAP, 2013; World Bank, 2006). For the purpose of development, what matters is where and how the deficit is being spent. Is it, for instance, being spent for enhancing human, physical or social capital that would improve productivity and hence economic growth? If that is the case, then public debt, even though it rises in the short term, would be sustainable.

Precise estimation of long-term fiscal multipliers is not straightforward, but several studies have found sizeable (indirect) positive impacts on economic growth. For instance, Li and Huang (2010) found that a 1 per cent increase in mean years of schooling can lead to an increase in GDP growth by 0.25 - 0.5 per cent, and a similar increase for health outcome as proxied by life expectancy. The importance of public investment in developing countries is also well known, as economic diversification and upgrading critically depend on having good-quality infrastructure.

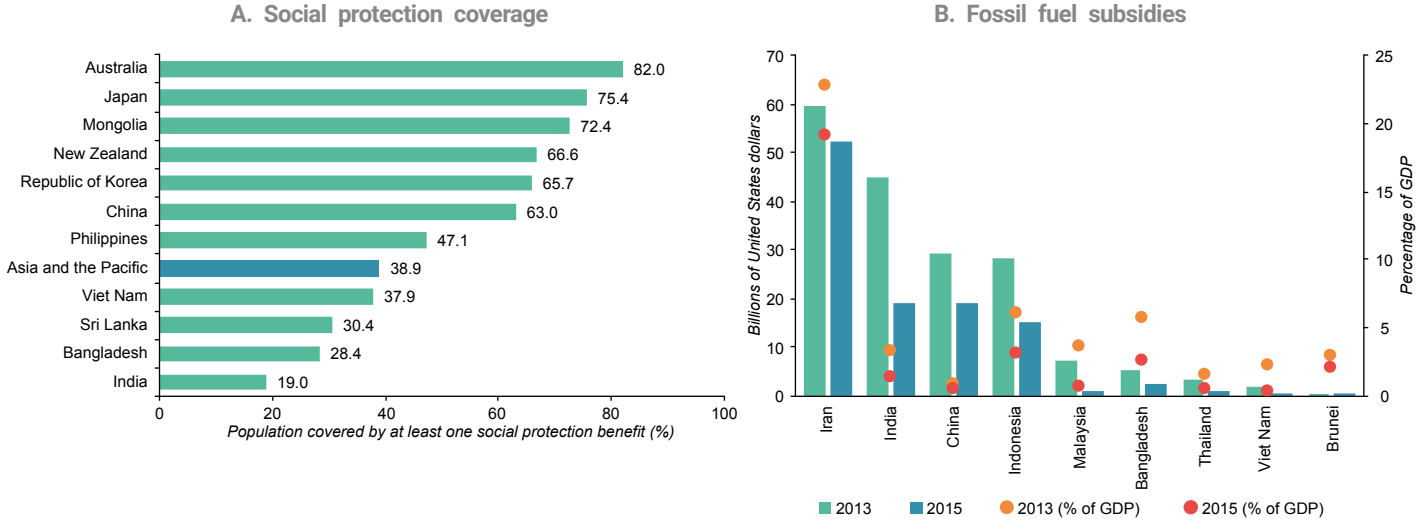
Governments of countries in the region have made efforts to enhance the composition and quality of public expenditures in support of their development priorities. For instance, many

countries have identified new sources of fiscal space to extend social protection coverage and benefits. For example, Thailand reallocated part of its military expenditures for universal health; Mongolia financed a universal child benefit from a tax on mineral exports; and Indonesia extended its social protection programme through a reform of energy subsidies (figure 1.13). Latest available data indicate that 38.9 percent of the population in the region are now covered by at least one social protection benefit. Available data for 10 countries indicate that, between 2013 and 2015, fossil fuel subsidies were reduced by as much as 89 per cent for Viet Nam and 12 per cent for oil-exporting Islamic Republic of Iran. Despite such progress, there seems to remain significant room for strengthening and reorienting the national budget towards these priority areas. For instance, combined education and health expenditures remain at below 5 per cent of GDP in such countries as Cambodia, Bangladesh and Pakistan (table 1.7).

In addition to budget reallocation, Governments could increase expenditure efficiency and ensure equal access to basic public services. Without such efforts, additional spending may not translate into better development outcomes. Estimation of public expenditure efficiency would suggest that many countries in the region have ample room to improve on this front. For instance, compared with regional peers at the frontier of expenditure efficiency, Pakistan could decrease its public expenditures by some 33 per cent in education and 17 per cent in health to produce the same level of education and health outcomes (figure 1.14; ESCAP, 2017a). Similarly, IMF (2015) found that on average about 30 per cent of the potential benefits of public investment are lost due to inefficiencies in the investment process.

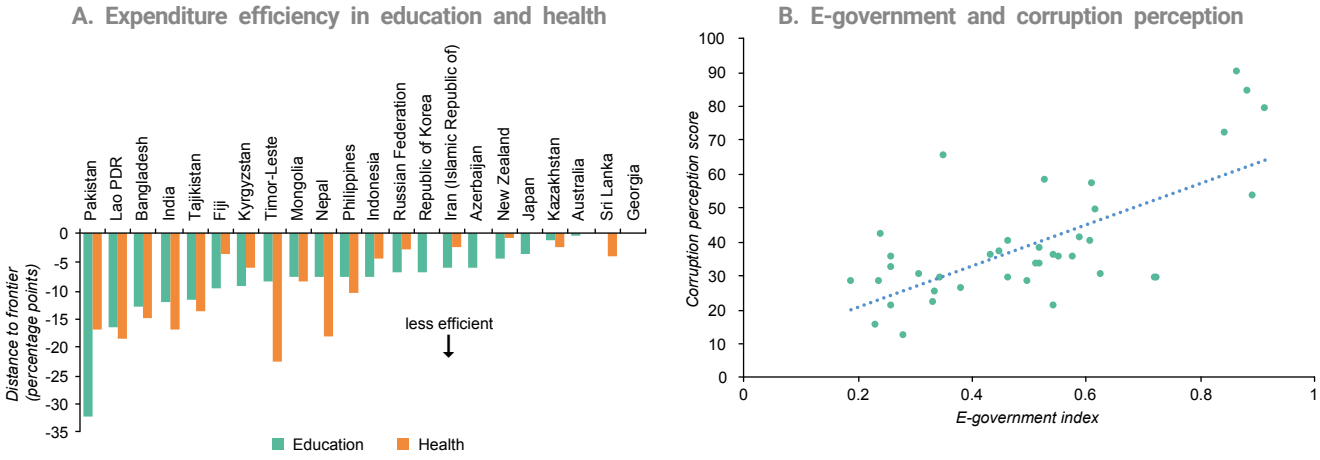
While there are sector-specific ways to improve expenditure efficiency, a cross-cutting factor is good governance. Between 2005 and 2014, the impact of better governance on public sector efficiency was as high as 57 per cent in Georgia in the health sector and as high as 32 per cent in Indonesia in the education sector (ESCAP, 2017a). Moreover, as will be discussed in chapter II, good governance could help better leverage private capital for infrastructure development. One of the ways in which Governments could improve fiscal governance is by leveraging technology (ESCAP, 2017b). Countries which proactively use e-government tools also tend to perform better in terms of corruption perception (figure 1.14).

Figure 1.13. Social protection coverage and fossil fuel subsidies – examples of budget reallocation



Source: International Labour Organization, *World Social Protection Report 2017-19: Universal Social Protection to Achieve the Sustainable Development Goals* (Geneva, 2017). Available from www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/---publ/documents/publication/wcms_604882.pdf.; and ESCAP Statistical Database.

Figure 1.14. Government expenditure efficiency



Source: ESCAP, *Economic and Social Survey of Asia and the Pacific 2017: Governance and Fiscal Management*. Sales No. E.17.II.F.8.

5.3. Structural reforms – fostering inclusive innovation

As previously discussed, technology is key to enhance productivity and thus accelerate economic growth and welfare. However, it could also bring disruptions to global and regional production patterns, countries' comparative advantage and the labour market. To harness the potential of frontier technologies and mitigate associated risks, policymakers can proactively take actions to provide an enabling environment. Many of the leading technology-savvy countries in the region have taken a "whole-of-Government approach", with an overarching governance structure for science, technology and innovation (STI) based on committed leadership that has oversight of the STI strategy. Japan, for example, set up the STI Council within the Cabinet Office to coordinate STI policies and resources. The Council is under the direct leadership of Japan's Prime Minister (ESCAP, 2016b). Strong political support for innovation can ensure access to and use of technologies.

Moreover, fundamental infrastructure for information and communications technologies (ICT) is essential to underpin innovation and technological progress. In the region, there is room for countries to improve their ICT infrastructure, such as availability, access and affordability of broadband, Wi-Fi and mobile data-intensive services. A major investment push can help countries to deploy such backbone infrastructure. With stronger ICT infrastructure, countries can not only conduct research and connect it to business sectors more quickly, but also narrow the existing digital divide and disparities through financial, transport and trade links.

Furthermore, the working population should be equipped with the correct skills. The innovative capacity of any country depends on the skills set of its population, which relies heavily on education and training systems. Not all countries in the region have sufficient talent to innovate and operate new technologies. In order to develop core skills for people to be flexible and responsive to rapid changes brought about by new technology, more students, especially female students, should be encouraged to take science, technology, engineering and mathematics (STEM)-related courses; Governments and businesses need to anticipate the skills needed and provide technical and vocational education and training (TVET) (Chang and Huynh, 2016). The availability of low-cost online courses has greatly expanded the opportunities for continuous learning (ESCAP, 2016b). Many countries in the region have launched open online courses, including China, Indonesia, Japan, Malaysia, the Republic of Korea and Thailand, and have attracted millions of users (Kubota, 2016).

In addition to creating an innovation-enabling environment, policymakers also need to ensure that the benefits of innovation-led economic growth are widely shared. From the perspective of industrial

Table 1.7. Government expenditures

	% of GDP							
	Health		Social Protection		Education		Research and development	
	2010	Latest	2010	Latest	2010	Latest	2010	Latest
East and North-East Asia							**2.46**	**2.52**
East and North-East Asia (excluding Japan)								
China	2.7	3.1	6.7	6.3	3.1	3.8	1.7	2.1
Democratic People's Republic of Korea	..	..	..	..	..	..	..	..
Hong Kong, China	..	..	2.3	2.7	3.5	3.3	0.7	0.8
Japan	7.9	8.6	22.1	23.1	3.6	3.6	3.1	3.3
Macao, China	..	..	..	..	2.6	2.0	0.1	0.1
Mongolia	2.7	2.6	15.7	14.4	4.6	..	0.2	0.2
Republic of Korea	3.9	4.0	8.3	10.1		5.1	3.5	4.2
North and Central Asia							**1.0**	**0.9**
North and Central Asia (excluding Russian Federation)								
Armenia	1.9	1.9	7.1	7.6	3.2	2.8	0.2	0.3
Azerbaijan	1.2	1.2	7.9	8.2	2.8	2.6	0.2	0.2
Georgia	2.3	1.6	9.0	10.6	..	..	0.2	0.3
Kazakhstan	2.5	2.4	7.0	5.4	..	2.8	0.2	0.2
Kyrgyzstan	3.7	3.6	8.2	9.0	5.8	5.5	0.2	0.1
Russian Federation	3.7	3.7	16.6	15.6	..	..	1.1	1.1
Tajikistan	1.6	2.0	..	..	4.0	5.2	0.1	0.1
Turkmenistan	1.2	1.3	..	..	..	3.1	..	..
Uzbekistan	2.8	3.1	11.2	11.6	..	..	0.2	0.2
Pacific								
Pacific island developing economies								
Cook Islands	..	..	..	..	..	..	..	..
Fiji	3.0	3.0	3.4	3.4		3.9	..	..
Kiribati	8.7	8.3	..	12.0	..	..	..	..
Marshall Islands	14.4	14.4	..	..	..	..	..	..
Micronesia (Federated States of)	12.6	12.4	..	..	..	12.5	..	..
Nauru	8.5	2.9	..	..	..	..	..	..
Palau	7.6	6.5	9.7	7.1	..	..	..	..
Papua New Guinea	3.2	3.5	..	3.6	..	..	..	..
Samoa	5.0	6.5	2.3	2.0	..	..	..	..
Solomon Islands	7.0	4.6	8.2	6.6	10.0	..	..	..
Tonga	3.7	4.3	..	..	..	..	..	..
Tuvalu	16.6	16.4	..	..	..	..	..	..
Vanuatu	4.2	4.5	..	..	..	5.5	..	..
Developed countries								
Australia	6.1	6.3	16.7	18.8	5.6	5.2	2.4	2.2
New Zealand	9.3	9.1	20.3	19.7	7.0	6.4	1.2	1.2
South and South-West Asia							**0.7**	**0.6**
Afghanistan	2.9	2.9	7.2	2.8	3.5	3.3	..	..
Bangladesh	1.1	0.8	..	1.7	..	2.0	..	..
Bhutan	4.5	2.6	3.0	2.7	4.0	7.4	..	..
India	1.2	1.4	..	2.7	3.4	3.8	0.8	0.6
Iran (Islamic Republic of)	2.7	2.8	12.5	..	3.9	2.9	0.3	0.3
Maldives	5.3	10.8	5.1	..	4.6	5.2	..	..
Nepal	2.9	2.3	3.1	3.0	3.6	3.7	0.3	0.3
Pakistan	1.0	0.9	0.2	0.2	2.3	2.6	0.4	0.2
Sri Lanka	1.6	2.0	3.2	6.5	1.7	2.2	0.1	0.1
Turkey	4.4	4.2	12.8	13.5	..	4.8	0.8	1.0
South-East Asia							**0.5**	**0.6**
Brunei Darussalam	2.5	2.5	..	..	2.0	3.4	0.0	0.0
Cambodia	1.4	1.3	0.6	1.2	1.5	1.9	0.1	0.1
Indonesia	1.0	1.1	0.9	1.1	2.8	3.6	0.1	0.1
Lao People's Democratic Republic	1.3	0.9	0.7	1.2	1.7	3.3	..	..
Malaysia	2.3	2.3	3.4	3.8	5.0	5.0	1.0	1.3
Myanmar	0.3	1.0	..	..	..	..	0.2	0.2
Philippines	1.6	1.6	1.6	2.2	..	..	0.1	0.1
Singapore	1.4	2.1	2.3	4.2	3.1	2.9	2.0	2.2
Thailand	2.8	3.2	2.7	3.7	3.5	4.1	0.3	0.6
Timor-Leste	0.8	1.3	3.3	3.3	10.4	7.8	..	..
Viet Nam	3.0	3.8	4.6	6.3	5.1	5.7	0.2	0.4

Source: International Labour Organization, *World Social Protection Report 2017: Universal Social Protection to Achieve the Sustainable Development Goals* (Geneva, 2017). Available from www.social-protection.org; World Bank, World Development Indicators database.

strategy, technology and innovation policies should move beyond the traditional focus on economic competitiveness. Governments should work with enterprises and support industries that have dynamic linkages to other economic sectors, enhance industry-services linkages and promote technological diffusion across a wider range of firms, including small enterprises, to stimulate broad-based productivity and employment gains.

From the perspective of public policies, Governments can consider a wide range of redistributive measures to mitigate the risks of technology-induced inequality and unemployment. Progressive income taxes and wealth-related taxes could help mitigate inequalities while creating needed revenues for better public education, training and social protection. Reducing taxes on labour generally encourages employment, reducing the need for redistribution, whereas taxing new technologies risks reducing economic growth and technology adoption, and reducing sources for redistribution. Instead, taxing rents and high profits arising from concentrated market structures may be more conducive to balance social and economic objectives (United Nations, 2017).

Other more radical proposals are available but are considered somewhat controversial. The proposal most closely associated with the impact of technology on unemployment is the notion of a universal basic income, whereby every individual would receive an unconditional cash grant (box 1.5). This proposal would serve to guarantee a minimum level of income regardless of employment status and simplify the administration of various public programmes. Other proposals, associated for example with Varoufakis (2016), attempt to directly distribute profits more equitably with a "universal basic dividend". Under this strategy, a fixed share of new equity issuance by firms is placed in a public trust, generating an income stream which is then distributed evenly among segments of society. Taxes on robotics are also under discussion but have yet to be tested; however, they are more problematic to implement.

For all countries, but in particular those with low technological capacities, regional and international cooperation are effective instruments to harness technological dividends and reduce capacity inequalities. In line with the 2030 Agenda, Governments have committed to fostering technology development, dissemination and transfer, and to the strengthening of scientific and technological capabilities of all countries. Regional and international collaboration can help countries, especially those with special needs, to gain access to much-needed investment and to facilitate cross-border technological learning through trade, FDI, mobility of human resources and access to technology and knowledge.

Various regional and international mechanisms and platforms are in place to facilitate technology development and dissemination, and to ensure that new technologies can be employed in a way that moves the world closer to sustainable development. Examples include: Asia and Pacific Centre for Transfer of Technology (APCTT); Regional Space Applications Programme for Sustainable Development (RESAP); the decision to launch a technology facilitation mechanism as called for by the Addis Ababa Action Agenda to support achievement of the Sustainable Development Goals; and the United Nations technology bank established to help least developed countries in particular to lift themselves out of poverty (ESCAP, 2016b).

5.4. Quality of growth – enhancing economic resilience

It is increasingly being recognized that persistently high levels of poverty, rising economic inequality and environmental degradation are detrimental to sustained economic growth and undermine economic resilience to shocks. Thus, tackling these broader development goals is also important for economic growth.

Despite the considerable reduction in extreme poverty that has occurred in the region – led by China – the incidence of poverty remains relatively high in several economies, especially in South and South-West Asia and in the least developed countries (figure 1.15a). In developing countries of the Asia-Pacific region, the incidence of poverty has declined from 49.5 per cent in 1990 to 10.2 per cent in 2012 based on the

Box 1.5. Universal basic income

Universal basic income (UBI) is a form of social security that offers periodic cash payments to all individuals in a country, universally and unconditionally. This is not a new idea. Many OECD countries provide non-contributory, non-means-tested benefits, although only for certain groups (mainly children or pensioners) (OECD, 2017b). No country has made UBI the central pillar of its social security system. UBI has received increasing attention recently due to concerns on rising inequality, atypical forms of education and fears of potential massive job losses due to automation.

Different from traditional programmes, UBI is universal and unconditional. Advocates believe that UBI could provide a broader and more substantial safety net for all citizens, eradicate extreme poverty quickly and effectively, improve wealth redistribution and reduce inequalities. According to IMF (2017), UBI could reduce the Gini coefficient by five points in all countries on average (before financing). Moreover, UBI does not face a potential poverty trap – benefits cannot be withdrawn if income increases; therefore, individuals would still have incentives to work. In addition, workers would have stronger bargaining power to refuse jobs with unhealthy and unsafe working conditions, as they would have a regular income to raise them out of poverty (Malul, Gal and Greenstein, 2009). Women could benefit from UBI in particular because they are more likely to be in extreme poverty.

Furthermore, UBI could offer a policy option in response to increasing digitalization and automation. Technology has changed the structure and nature of work throughout history; although its impacts are notably positive for society, technology can create challenges for certain industries and jobs categories. Lower-paid lower-skilled jobs are more susceptible to being replaced by automation, leading to mass unemployment and increasing the inequality gap between groups. Moreover, such changes in the underpinning of work will call for re-evaluation of welfare policies, which are designed in line with traditional employment contracts as well changes in labour institutions. Consequently, in a society with rising unemployment and inequality, UBI presents itself as a tool to improve the society's overall well-being; it can be argued that the benefit would function as an income replacement for those people who were replaced by technology. Last but not least, UBI does not impose social stigma on anyone.

However, UBI involves considerable fiscal costs, which depend on the level at which UBI is set. IMF (2017) estimated that, if it were set at 25 per cent of median per capita income, the fiscal cost would be about 6-7 per cent of GDP in advanced economies and 3-4 per cent in emerging markets and developing economies. Research in OECD countries would suggest that, without additional taxes, a budget-neutral UBI would be lower than the poverty line of a single individual, that is, not sufficient to eradicate poverty (OECD, 2017c). A simple back-of-the-envelope calculation would suggest that the fiscal cost of UBI (targeted at providing $1.90 per day for the working-age population) in the Asia-Pacific region could be about 14 per cent of GDP on average. In most developing economies, especially countries with special needs, the current public expenditure on social protection is not sufficient to cover such a provision of UBI (see figure below).

This leads to the issue of how to finance UBI, which is critical because the manner in which UBI is financed has a direct link with economic activities and the redistributive impacts. Stilwell (2016) argued that, if UBI comes at the expense of investment in infrastructure, housing, education or other public services, a cost-benefit analysis may not be favourable to UBI. In view of their limited fiscal resources, many countries may choose a budget-neutral method, such as allocating current spending on social protection, in order to finance UBI. In such a case, the distributive effect would depend on the coverage and progressivity of the existing transfer system. Since the existing expenditure on social protection is not financially sufficient to cover UBI, to spread the expenditure out equally may not be distributionally neutral. Lower-income households could be worse off if they receive transfers under the current system. Additionally, IMF (2017) suggested financing UBI though indirect taxes. The net distributive impact could be progressive if income inequality is high. OECD (2017b; 2017c) argued that UBI should be taxable along with other incomes. Therefore, its net value would fall for those in a higher tax bracket; it could then better target lower-income groups that

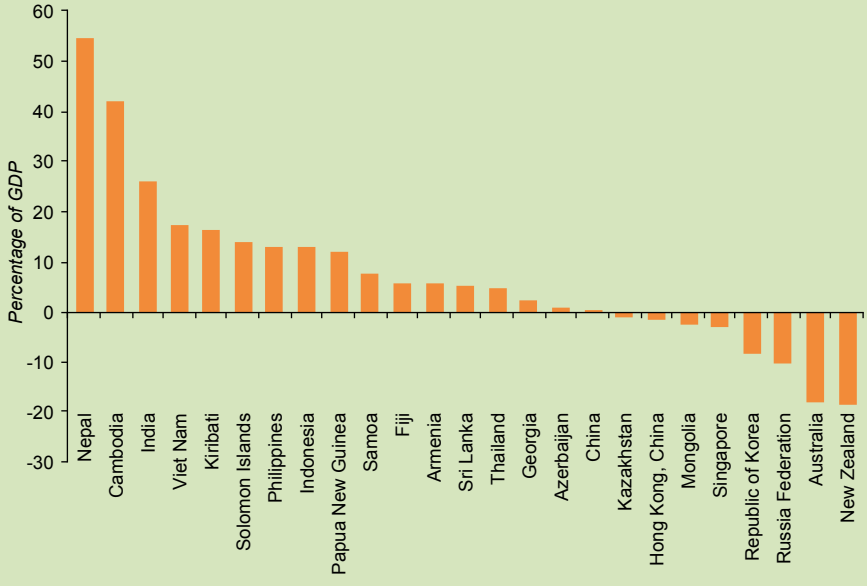
Box 1.5. *(continued)*

pay their tax at lower rates. This approach could help relieve the criticism of leakage. In any case, raising fiscal resources, including through taxes, would likely be inevitable to finance UBI. OECD (2017b) also suggested retaining some targeted cash transfer alongside UBI to support lower-income groups that lose out from UBI systems.

Many economies in the region are not ready for introducing UBI. Given the volatility of economies, an expenditure commitment, such as a regular universal income, could lead to problems with financial sustainability, especially if the country concerned suffers from cyclical budget deficits. The affordability and efficiency of UBI is also contingent upon inflation, which could reduce its potential benefits. Administrative challenges would also be considerable, given that a well-functioning taxation system would be a prerequisite to implement such a policy. Another risk comes from the possible influx of migrants. If people migrate to countries with UBI without contributing first, the sustainability of the programme could be compromised.

In the Asia-Pacific region, India has piloted some UBI projects in its rural areas. The outcome is positive for increasing economic activities and reducing inequalities. The Government of India is considering scaling up the programme to the national level. In the country's annual Economic Survey 2016-2017, a feasibility study of UBI was published. The amount proposed to be given is 7,620 rupees ($113) a year. This estimation is based on the assumption that in practice any programme cannot strive for strict universality, so a target quasi-universality rate of 75 per cent was set. This yields a figure of 4.9 per cent of GDP. Although the amount is less than the minimum monthly wage in a city, it is expected to cut absolute poverty from 22 per cent to 0.5 per cent. Such a policy would be financed by reorganizing the budget from the existing 950 welfare schemes in India, including subsides for water, food and fertilizers, which add up to roughly 5 per cent of GDP. However, since the proposed UBI project is quasi-universal, how the selection would be made, either by means-tested or a voluntary opt-out, has yet to be defined (India, Ministry of Finance, 2017).

Fiscal gap to finance universal basic income with existing expenditure on social protection, as a percentage of GDP, based on data from the latest available year



Source: ESCAP, based on data from International Labour Organization, *World Social Protection Report 2017-19*. Available from: www.social-protection.org/ (accessed 19 February 2018); United Nations, Department of Economic and Social Affairs, *World Population Prospects 2017*. Available from https://esa.un.org/unpd/wpp/ (accessed 19 February 2018); World Bank, World Development Indicators database. Available from https://data.worldbank.org/ (accessed 19 February 2018).

Note: The universal basic income (UBI) programme is aimed at providing only the working-age population with $1.90 per day. The fiscal gap reflects the difference between fiscal needs of this UBI project and the total public expenditure on social protection as a share of GDP.

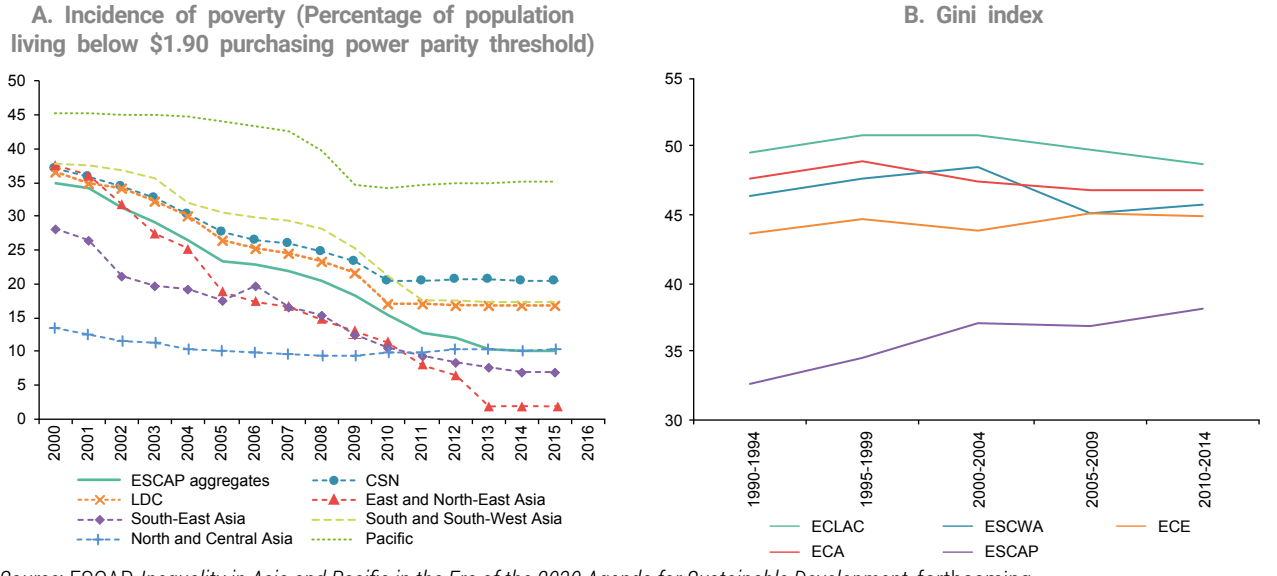
$1.90 purchasing power parity threshold, but with wide variations across countries. Moreover, such factors as technological progress, globalization and market-oriented reforms that have supported rapid economic growth are contributing to wider inequality of income and wealth, which does not bode well for inclusive development in the region. The Gini coefficient in the region increased from 32.7 for the period 1990-1994 to 38.1 for the period 2010-2014 (figure 1.15b).

The adverse implications of environmental degradation and intensive and unsustainable use of countries' natural resource wealth for economies and societies should not be underestimated. In 2015, the Asia-Pacific region accounted for more than 50 per cent of global domestic material consumption and 55 per cent of the global material footprint. Productivity losses due to excessive levels of air pollution are much higher in the region (close to 0.2 per cent of GDP) compared with the rest of the world (Lancet Commission on Pollution and Health, 2017). Climate change-induced agricultural loss is substantial; in India, it was found that such losses can reduce annual agricultural incomes by 15-18 per cent (India, Ministry of Finance, 2018). Moreover, inefficient and unplanned urban expansion has resulted in the conversion and loss of forests, wetlands and other ecosystems and has increased the already high exposure to disasters. Between 1970 and 2016, the Asia-Pacific region lost assets worth $1.3 trillion as a result of floods, storms, droughts, earthquakes and tsunamis (ESCAP, 2017e).

To enhance economic resilience, Governments could strengthen social protection. This is important keeping in view the persistent challenges of poverty and inequality, the further risks arising from demographic transitions (risk of skills shortage among youth on one hand, and risk of old-age poverty on the other) and labour market disruptions associated with reforms and technological innovations. Understandably, trade-offs are involved among the three aspects of social protection systems – universal coverage, sufficient benefit levels and financial sustainability. Countries should expand coverage earlier than later. Universal coverage may be based on low benefit levels, but it still helps empower those in financial need. Nevertheless, financial gaps are likely to remain in efforts to effectively support social protection programmes; hence the need for strengthening and expanding the fiscal space.

At the same time, a comprehensive policy response is needed to counter the prevailing environmental challenges and climate risks, and make a transition to sustainable economic growth. To this end, countries should mainstream resource efficiency targets into national plans and budgets as well as into sectoral policies, and establish

Figure 1.15. Poverty and inequality



Source: ESCAP, *Inequality in Asia and Pacific in the Era of the 2030 Agenda for Sustainable Development*, forthcoming.

Note: Gini index is shown by five year averages, using country classification of the five UN regional economic commissions. ECLAC covers Latin America and the Caribbean; ECA covers Africa. ECE covers Europe; ESCAP covers Asia and the Pacific; ESCWA covers Western Asia.

appropriate legal and regulatory measures to enforce standards and to promote awareness. Promoting an enabling financing framework, re-evaluating trade portfolios and their implications for resource efficiency, and leap-frogging to efficient technologies and improving innovation capacity could also prove to be quite helpful. In addition, countries could further prioritize life-cycle approaches and effective waste management. Carbon tax and emission trading systems could also play a critical role. Several countries have also phased out fossil fuel subsidies, including Bangladesh, India, Indonesia and Malaysia, which is a step in the right direction.

6. Concluding remarks

As discussed in the present chapter, domestic demand has been the primary driver of economic growth in recent years of weak external demand. While this resilience reflected the region's increased purchasing power, this was also a time when productivity gains and expansion of decent jobs were relatively weak, such that households and corporates came to rely increasingly on credit. Such a pattern cannot be sustained; aside from financial stability concerns, it weighs on future domestic demand. Moreover, the region's economic growth continues to come at significant environmental costs, with intensive use of natural resources and heavy pollution eventually also undermining long-term growth prospects.

Thus, while sustaining its growth momentum, the Asia-Pacific region should maintain a long view and enhance the fundamental drivers of economic growth by lifting productivity and translating it into gains in real wages and broad-based consumption such that this in turn will stimulate productive investments. In this regard, the chapter contained an examination of recent consumption patterns, investment dynamics and labour market developments to gauge the strength and quality of domestic demand.

There are important regional dimensions to sustaining the growth momentum and improving the quality of growth. Strong domestic demand could have positive spillover effects and provide new impetus to intraregional trade. Productivity and employment prospects also depend on shifts in regional production patterns. While China is rebalancing towards services, many countries, including India, are trying to expand their manufacturing base, to realize the demographic dividend and further diversify their economies. The chapter contained a preliminary assessment on such issues, with a focus on China's economic transformation and its implications for the region.

Given the low and stable rate of inflation, monetary policy is expected to maintain its accommodative stance and provide support for economic growth. However, as the impact of low policy rates has been limited by high corporate leverage and non-performing loans, broader financial sector reforms and enhanced oversight would be required. Countries should also be prepared for a tightening in global financial conditions in view of the ongoing monetary policy normalization in the United States.

On the fiscal front, most countries are expected to maintain an expansionary and countercyclical policy stance. Fiscal sustainability is not an immediate concern given the low or declining government debt-to-GDP ratios; nevertheless, fiscal space needs to be enlarged to support sustainable development, as will be argued in chapter II. Moreover, it is imperative that existing fiscal space be used effectively through enhanced composition and quality of expenditures and better governance, as emphasized in the Survey for 2017. More and better spending on education, health, social protection, research and development and infrastructure could support long-term growth and redistribution objectives.

While the Asia-Pacific region has come a long way in reducing extreme poverty to emerge as the world's economic powerhouse, the strains from rapid structural transformation – from rising inequality to environmental degradation – have become more acute and are threatening the region's economic dynamism. Addressing these challenges and implementing these policies will require better use of existing resources but also mobilization of additional resources, including through tax reforms, prudent sovereign borrowing and leveraging of private finance – the focus of chapter 2.